

**FACTORS AFFECTING AUDIT QUALITY IN LISTED MANUFACTURING
AND COMMERCIAL SERVICES COMPANIES IN KENYA**

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DECLARATION

I hereby declare that this project titled “Factors Affecting Audit Quality in listed Manufacturing and Commercial Services Companies in Kenya” submitted by me to Nairobi University in partial fulfillment of the requirement for award of an MBA degree is my original work done under the supervision of MR. JAMES NGANGA. Further, I declare this project has not been presented in any institution of higher learning for award of a degree or diploma.

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My deepest gratitude goes to my supervisor, Mr. James Nganga for his guidance through every stage of the research. Also, the indispensable pieces of advice I got from my friends and classmates were instrumental in achieving the end results.

DEDICATION

This research paper is dedicated to Denis Kimeu, my husband and best friend.

TABLE OF CONTENTS

DECLARATION.....	ii
ACKNOWLEDGEMENTS.....	iii
DEDICATION.....	iv
LIST OF TABLES	vii
ABSTRACT	viii
CHAPTER ONE: INTRODUCTION	1
1.1 Background to the Study	1
1.1.1 Factors Affecting Audit Quality	3
1.1.2 Measurement of Audit Quality	4
1.2 Statement of the Problem	5
1.3 Research Objectives	7
1.3.1 General Objective	7
1.3.2 Specific Objectives	7
1.4 Value of the study.....	7
CHAPTER TWO: LITERATURE REVIEW	9
2.1 Introduction	9
2.2 Theoretical Literature Review.....	9
2.2.1 Theory of Agency Costs by Barry Mitnick.....	9
2.2.2 Role Theory and the Concept of Audit Expectation Gap.....	10
2.3 Empirical Literature Review	12
2.3.1 Audit Firm Tenure	12
2.3.2 Audit firm size	13
2.3.3 Self Review Risk	14
2.3.4 Partner Rotation	15
2.3.5 Management’s Fraudulent Financial Reporting	16
2.3.6 Audit Fees	17

2.3.7 Political Interference.....	18
2.4 Local Research Review.....	19
2.5 Conclusion.....	21
CHAPTER THREE: RESEARCH DESIGN AND METHODOLOGY.....	23
3.0 Introduction.....	23
3.1 Research Design.....	23
3.2 Population and Sampling.....	24
3.3 Data Collection.....	24
3.4 Data Analysis.....	25
3.5 Analytical Model.....	25
3.6 Test of Significance.....	26
CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION.....	27
4.1 Introduction.....	27
4.2 Descriptive Analysis.....	27
4.3 Regression Results.....	29
4.4 Multicollinearity Test.....	32
4.5 Interpretation of Findings.....	32
CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS... 	34
5.1 Introduction.....	34
5.2 Summary.....	34
5.3 Conclusions.....	35
5.4 Recommendations for Policy.....	36
5.5 Limitations of the Study.....	36
5.6 Suggestions for Further Research.....	37
REFERENCES.....	38
APPENDIX I.....	41

LIST OF TABLES

Table 4. 1 :Descriptive Statistics (Quantitative variables)	27
Table 4. 2: Descriptive Statistics (Ordinal Variables).....	29
Table 4. 3: Regression Results	30
Table 4. 4: Variance Inflation Factors.....	32

ABSTRACT

This study sought to establish the factors affecting audit quality in listed manufacturing and commercial services companies in Kenya. A cross-sectional approach was adopted in the analysis in which a linear regression model was used to establish the impact of the independent variables namely; auditor size, financial status of the company and the logarithm of the auditor fees. The logarithm of audit fees was taken so as to make the data normal. The independent variable was leverage ratio (total debts divided by total assets of the company). This variable was used as a proxy for debt pressure by the companies. Debt pressure by the companies can be used as a proxy for the audit quality because high debts in relation to company assets can lead to bankruptcy. Ten manufacturing and commercial service companies listed at Nairobi Stock exchange were used as the sample of the study.

The results of analysis indicated that logarithm of audit the fees, financial status of the company, and auditor size were significant in influencing the leverage of the companies and thus audit quality. The size of audit firm had a positive impact on audit quality, while the companies that were struggling financially were more likely to have poor audit quality. The logarithm of audit fees was negatively related with the audit quality. The recommendations made is that there should be regulation of audit fees as well as taking action on the audit companies that does not adhere to auditing standards and the officials of companies who take part in misstating the financial statements and other financial records so as to conceal the actual financial position of the company.

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

In the recent past (2010-2015), Kenya has observed the mushrooming of audit firms to serve the rising demand for audit services. The Institute of Certified Public Accountants of Kenya (ICPAK) seems overwhelmed and unable to perform its role of supervising and regulating the audit firms to ensure that audit standards are adhered to and the partners of these audit firms who sign the audit opinion have the required expertise to review financial statements. Audit quality seems to have been compromised due to the conflict of interest that arises due to the exorbitant audit fees charged. This minimizes audit objectivity and a wrong audit report may be issued.

Audit reports can be classified as unqualified, qualified, adverse report or disclaimer of opinion report. An opinion is said to be unqualified when the auditor concludes that the financial statements give a true and fair view in accordance with the applicable financial reporting framework used to prepare and present the financial statements. A qualified opinion is similar to an unqualified opinion except for a certain exception highlighted by the auditor. This opinion is issued if the auditor experiences a limitation of scope when performing his duties or identifies a single non-compliance with the reporting standards. The financial statements are therefore not grossly misstated.

An adverse report is issued when the auditor is of the opinion that the financial statements are materially misstated and do not adhere the applicable financial reporting standards. This opinion can adversely affect the reputation of a company and can deter investors. A disclaimer of opinion report is issued when the auditor could not form an opinion or

consequently refuses to present an opinion due to significant limitation of scope or a substantial doubt about the client's going concern.

The conduct of the Big 4 audit firms namely PwC, Delloite, Ernst & Young and KPMG has also not escaped criticism. DeAngelo (1981) argued that large accounting firms were less likely to compromise their independence compared to smaller firms because they had greater reputations to protect. In Kenya, PwC was investigated in the wake of Uchumi Supermarket's near-collapse in 2006 on whether its opinion was in line with the financial reporting standards. Delloite also risked losing its operating license after failing to disclose CMC's subsidiary in South Sudan in the annual reports, understating revenue on vehicles and not reporting interest payments for cars sold on credit.

The Enron scandal revealed in October 2001 laid bare the shortcomings of audit and the reiterated the need to maintain auditor's independence. Arthur Andersen, Enron's auditors did not survive the scandal and was dissolved. Arthur Andersen was accused of setting up Enron's internal accounting procedures; the very procedures that contributed to Enron's subsequent collapse. The provision of accounting advisory services alongside audit services poses a self-review risk because at that point, criticism of the accounting system would be tantamount to an admission of incompetence. Unfortunately this has become the trend in the recent past, and consulting services are arguably more profitable than audit services which mean that audit firms would not be willing to let go unless obliged to do so by the law. Users of financial statements need to know they can rely on audited financial statements.

1.1.1 Factors Affecting Audit Quality

This study will focus on three critical risk factors that could undermine the quality of an audit. Auditing standards explicitly acknowledge the presence of audit risk arising from the inherent inability of auditors to examine all transactions and events. The three factors which we identified are audit tenure, audit fees, and audit firm size.

Auditor tenure (the length of the auditor/client relationship) potentially affects both the auditor's technical ability to identify misstatements and the auditor's objectivity in correcting or reporting those misstatements. Technical ability to identify misstatements is generally thought to be jeopardized by short audit tenures, while the auditor's objectivity is often argued to be jeopardized by longer tenures. Using bankruptcies and the type of audit opinion issued, Gieger and Raghunandan (2002) find significantly more audit reporting failures for short audit tenures than for long tenures.

The Sarbanes-Oxley Act of 2002 specifically mandates rotation of the lead audit partner of public companies, but stops short of requiring audit firm rotation. Some speculate that the mandate to rotate the lead audit partner may lead to audit firm switches at the same time, or that the next step in the regulatory process will be to require audit firm rotation but this is always the case. Certainly the length of the relationship between the auditor and the client has been indicted as a causal factor in the coverage of recent (2010-2015) corporate scandals.

Audit size is another key factor which affects audit quality by virtue of the fact that it directly affects resources available to a firm to conduct the audit. It is expected that big

audit firms higher have level of technical competence and resulting ability to detect financial statement misstatements.

Big 4 audit firms heavily invest in industry expertise and develop a reputation for industry specialization, and therefore have incentives to protect that reputation hence more likely to report misstatements. Users of audited financial statements often use size of audit firm in their assessments of audit quality and the resulting financial statement credibility (Colbert and Murray 1998).

Audit fees that lead to economic dependence are a major risk factor of audit quality. The risk on audit quality increases with the provision of non-audit services to the same client due to greater financial dependence. The non-audit fees ratio is based on the fact that auditor independence becomes impaired as auditors weigh the value of independence with the cost of losing non-audit fees from a client over an audit dispute. The total fees (the sum of audit, tax, advisory and other fees) are a measure of economic dependence, and could impact on audit quality.

1.1.2 Measurement of Audit Quality

Audit quality is complicated to define and there is no exact definition of it due to its subjectivity. The two most cited definitions of audit quality have been provided by (i) DeAngelo (1981), who defines audit quality as the joint probability that auditors both “discover a breach in the client’s accounting system, and report the breach;” and (ii) by DeFond and Zhang (2013) who believe higher audit quality is “greater assurance of high financial reporting quality.”

A direct measure of audit quality is discovery of post-audit quality deficiencies without previously modified opinions. Other indicators of audit quality are financial statement restatements, financial reporting compliance with IFRS or applicable reporting framework, and lawsuits filed against audit firms.

Our study will use post-audit quality deficiencies discoveries as a measure of audit quality since it is most suitable in the Kenyan context and will rely on publicly available information.

1.2 Statement of the Problem

The threats to auditor's independence and the loss of confidence by shareholders in the ability of a financial statements audit to ensure accountability in the management of shareholders' funds raises questions on whether audits are relevant. Many accounting firms have been accused of performing substandard audits that fail to identify the key risks faced by an organization in time for corrective action to be taken and thereby affecting an entity's going concern. These sentiments focus on the risks, challenges, uncertainties and dangers posed by fast evolving operating environment.

Keasey and Wright, (2012), in their past study on issues in corporate accountability and governance stated that unscrupulous directors were misappropriating shareholders' funds through lavish executive compensation, while focusing on short-term objectives as opposed to the long term goals. The study recommended enhancing of the perceived objectivity of the audit through rotation of auditors, directors engagement terms limited to 3 years and the setting up of remuneration committees to determine executive pay. However, the study is still limited in certain dimension, in particular, it recognizes the

limited role of audit in providing oversight but a gap still exists as it does not provide a viable alternative means of regulating companies with more active stakeholder involvement. There are still a number of issues that are surrounding audit, corporate governance and accountability, and the audit practice in Kenya is still at an immature stage and that it is highly experimental.

The Institute of Certified Public Accountants of Kenya (ICPAK), needs to diligently perform its regulatory and supervisory mandate and to carry out proper investigations when concerns are raised against accounting firms that are free from biases.

Users of financial statements need to be protected so that they do not fall victim to fraudulent financial reporting. According to Grace and Ambrose (2013), financial statements should be credible. The external users comprise of the government, investors and financial institutions. The government uses the audited financial statements to analyze whether the tax paid is accurate while financial institutions rely on audited financial statements to decide whether to provide a company with credit or not. Investors depend on the audited financial statements to assess the financial strength of a company to aid in making informed investment decisions.

It is in this context that this study attempts to look at the factors affecting audit quality in promoting accountability in the management of shareholders' funds and ways on how confidence can be restored in the audit profession. The study will investigate challenges faced by accounting firms; the restrictive laws; lack of proper expertise, competition among others. It is hoped that by insight into the risk factors, the audit practice in Kenya will become more efficient.

1.3 Research Objectives

1.3.1 General Objective

To investigate the factors affecting audit quality in listed manufacturing and commercial services companies in Kenya.

1.3.2 Specific Objectives

- i. To investigate the key risk factors affecting audit quality in Kenya.
- ii. To investigate the audit quality in listed manufacturing and commercial services companies in Kenya.
- iii. To establish the impact of the key risk factors affecting audit quality on manufacturing and commercial services companies listed in the Nairobi Stock Exchange (NSE) in Kenya.

1.4 Value of the study

The findings of this study will help in determining the factors hindering the performance of quality audits in Kenya and suggest possible solutions to the problems to regain confidence of shareholders in the ability of an audit to promote accountability in the management of their funds.

This research will be necessary to the Directors/Owners of a firm to set standards for Audit governance and monitoring to ensure value for money since audit fees have significantly increased.

The study also serves as a reference to other researchers who may wish to carry out research on the same or related topic.

The findings also serves as a guide to all prospective investors who are already in the field and those who may wish to make investments in the future so as to make informed decisions. The research also intends to be an eye opener for the policy makers, regulatory bodies and management so that they may know exactly how to ensure transparency and objectivity in the delivery of the audit function. Students interested in the audit profession will gain more insight on the financial statement audits and the significant role it plays in providing assurance to stakeholders in Kenya.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

The introductory part of the literature review opens up the study to the factors that limit external auditors' independence and therefore shed doubt on their work. Of direct interest to this paper are the effects if impaired auditors' independence and the dangers it poses in the economy. The literature review then shifts focus to assess the current level of confidence on the work of external auditors and how the impact that this has had on the users of the financial statements. Possible solutions to the independence dilemma are then assessed and remedial measures are proposed in order to restore faith in the crucial role performed by accounting or audit firms.

2.2 Theoretical Literature Review

2.2.1 Theory of Agency Costs by Barry Mitnick

The theory of agency costs is one of the theories that respond to the essential imperfections of agency relationships.

Jones (1996) explained that audit services are required as the monitoring methods due to the conflicts that may arise between managers and owners, and also for them who come from different classes of security holders. In addition, he explained that audited statements' provision is the least cost contractual response to intra-owner and owner-manager's conflict of interest, which leads to the rise of agency costs. The agency costs is different from different firms and also for over time to some clients. Besides, a heterogeneous demand required by clients for the audit services is resulted from different

agency cost for some firms such as when the levels of auditing that requested is not as usual.

Jones (1996) also argued that the audit services' quality is mentioned as the market-assessed joint probability where the auditor is able to find out a breach in the client's accounting system and report the breach. On the other side, the specified audits may enhance the financial information's credibility as the result of the independent verification of management-provided financing reports, thus may minimize the investor's information risk as proposed in the study conducted by Johnson et al. (2002).

2.2.2 Role Theory and the Concept of Audit Expectation Gap

Sikka et al [10] explains that the main reason behind the audit practice is to enable them to express an opinion whether the financial statements presented, portray a true and fair view. The objective of an audit is to ensure that the financial records on which the auditor is reporting show a true and fair view and are not misleading. The general public however seems to have a high expectation that the auditor will detect or prevent all frauds i.e. financial information users believe that auditors should assume a responsibility past examining and attesting the fairness of financial statements and shoulder a direct responsibility to protect the interest of the audit beneficiary through detecting and reporting frauds as irregularities.

Some cases of audit expectation gap are as a result of unreasonable expectations of the user groups. These possibly points out that the users need to be educated regarding what to expect of auditors. Society in general requires to be educated in order for them to form a reasonable expectation of the auditors' duties and responsibilities.

2.2.3 Contingency Theory in Auditing

In his book, “Organization Theory and Design,” Richard L. Daft writes: “Contingency means: one thing depends on other things” and “Contingency theory means: it depends.”

The contingency theory in auditing accepts that external factors impact results. According to the contingency theory, the coordination and control of organizational members is shaped by the task environment and the technical nature of the work they perform.

The contingency theory of leadership and management states that there is no standard method by which organizations can be led, controlled and managed. Organizations and their functions depend on various external and internal factors. Davoren (2015) elaborated that the functions of audits are, themselves, affected by various factors in the environment and the unique characteristics of each organization. The presence of such factors is why auditing can be managed by applying the contingency theory, with a recognition that processes and outcomes of audits are dependent on variable and contingent factors such as agreed upon auditors’ scope and responsibilities.

Audit functions are task-oriented and can be loosely structured. The functions also can vary considerably, depending on the area of a company under audit and the type of business model, so auditors must carefully manage their inspections and take variables into account to get the job done. The contingency theory also can be applied to an audit team’s structure. Typically, audit team managers receive audit projects. They then create ad hoc audit teams for the projects, selecting auditors based on expertise and experience in the subject areas, and on auditor availability, all of which add up to contingencies for any given audit project.

2.3 Empirical Literature Review

The quality of audit work performed by audit firms is influenced by various factors (internal and external) which are discussed in detail below.

2.3.1 Audit Firm Tenure

Johnson et al. (2002) explained audit firm tenure as the number of consecutive years that the audit firm has audited the client. The definition of short auditor tenure is generally explained to mean three years or less and long auditor tenure as nine years or more. Based on the previous studies conducted, imposing mandatory limits on auditor tenure is expected to improve audit quality by reducing client firms' influence over auditors as proposed by Myers, Myers and Omer (2003).

As proposed by Ball and Shivakumar (2005), the impact of the long relationship audit firm is by having excess confidence in the client besides the scholars also suggests that the above mentioned learned confidence may result in the audit firm using less strenuous and less innovative audit procedures. Hopwood, McKeown and Mutchler, (1994), in their past study on audit firm tenure further defined that different audit tenure in an experimental setting besides able to gather that experienced audit committee members perceived that auditors with 5-year tenure were more likely to detect errors than auditors in the first year of an engagement or auditors with audit tenure of 20 years.

There is no evidence that auditor tenure is negatively associated with audit quality, even though the setting may be conducive to a loss of auditor independence. Second, we find that long tenure reduces the likelihood that the auditor issues a false going concern signal. This study reviews demystifies audit and discuss the factors that influence an auditor's

independence which are audit firm tenure, audit firm size, self-review, audit or partner rotation, Management's fraudulent financial reporting and audit fees.

2.3.2 Audit firm size

In term of the audit firm size, it was revealed that smaller audit firms are more dependent on few large clients than larger audit firms, but in general the audit quality is independent of audit firm size as supported by DeAngelo (1981) in his study. Moreover, in some of the audit quality term, where it was found in the study done by previous researchers, the term of quasi-rents, it might serve as collateral against such opportunistic behavior in the subject to loss from discovery of a lower-than promised audit quality. This finding can be proven on the theory of incentives, where the less incentive the auditor has to behave opportunistically and the higher the perceived quality of the audit when the larger the auditor as measured by the number of current clients and the smaller the client as a fraction of the auditor's total quasi-rents exist.

DeAngelo (1981) also argues no single client is important to larger accounting firms as accounting firm size is a proxy for auditor quality, and besides, larger accounting firms are less likely than smaller accounting firms to compromise their independence. In fact, theory supported by the research taken by Leuz, Nanda and Wysocki (2003), who further proposed that larger accounting firms provide higher quality services because they have greater reputations to protect.

The larger audit firms (Big 4) which perceived as more capable of maintaining an adequate degree of independence than their smaller counterparts because they usually provide a range of services to a large number of clients, hence reducing their dependence

on certain clients as mentioned by McKeown, Mutchler, and Hopwood, (1991). It is suggested that Big 4 firms can provide a superior audit quality as their sheer size would definitely be able to support more complete training programs, standardized audit methodologies, and more options for appropriate second partner reviews.

In addition, Deangelo (1981) has explained that it can't be deny that larger audit firms are generally perceived as the provider of high audit quality and might enjoy a high reputation in the business environment and as such, would strive to maintain their independence to keep up their image. Larger audit firms are also perceived to be more independent than their smaller counterparts in managing management's pressure where in the event of disputes as they normally have more clients and can afford to give up some of their more difficult clients.

High dependence on a few clients, which is more prevalent in small audit firms, has been found to affect perception of independence.

2.3.3 Self Review Risk

It has been observed that currently audit firms provide more advisory services than audit services to the market and the revenues from advisory services are more lucrative than those of audit services. This poses a self-review risk if the same audit firm in addition provides audit or tax services to the same firm as the audit firm cannot be expected to objectively critic the same policies that they helped implement. This greatly impairs auditor's independence.

We can measure audit quality by examining the likelihood of an auditor issuing a going concern report. We presume that a decrease in audit quality is indicated by an increase in

the likelihood that an auditor does not issue a going concern opinion when a company subsequently goes bankrupt like in the case of Enron, or an increase in the likelihood that an auditor issues a going concern opinion to a company that survives.

Self-review risk is a major deterrence to the performance of quality work since it is equivalent to marking one's own work, hence the probability of impartiality and objectivity is extremely low.

2.3.4 Partner Rotation

Johnson et al (2002) has revealed in his study that a lot of response to one or more audit failures is observed in long relationships between key audit staff for example partners and managers and client management which result in a decline in audit quality and are not in the public's interest.

On the other side, in some country where the audit-firm rotation is not mandatory, usually in the current regulatory regime, long audit-firm tenures without a rotation of key staff are associated not with a decline in financial reporting quality. By referring to previous researches, it can be concluded that the quality of audit services is means to be the market-assessed joint probability which a given auditor will eventually discover a breach in the client's accounting system, and may report the breach which given that probability that a given auditor will discover a breach is depends on the audit procedures, auditor's technological capabilities, the extent of sampling and so on.

In fact, the same literature based on the past study has determined that the conditional probability of reporting a discovered breach is a measure of an auditor's independence from a given client. To enhance the understanding of this, the definition of auditor

independence is used in DeAngelo (1981) and Menon and Williams (1991), who has been argue on the value of an audit depends on the auditor's incentives to disclose issues found. To add some more, a statement proposed by Myers and Omer (2003), in their study explained that auditor independence and competence are critical elements affecting the credibility and reliability of an auditor's report and, therefore, financial reporting credibility.

Audit quality is compromised by too much familiarity which is linked to a reduced propensity to report malpractices by audit staff, and to overcome the situation, a possible solution is to propose mandatory key audit staff rotation which is likely to improve audit quality.

2.3.5 Management's Fraudulent Financial Reporting

Management is compelled to report ever-increasing profits so as to please shareholders, this can lead to fraudulent reporting in order to achieve targets. Whereas the work of external auditors is not to detect fraud, the auditor will be held required to exercise outmost care and diligence in his work and to design audit procedures that can detect fraud. As stated in the International Standards on Auditing, ISA 240 on "Fraud and Error" the auditor is required to assess the risk of fraud and error during the audit of financial statements.

Under the standard also, the auditor should design audit procedures to obtain reasonable assurance that misstatements arising from fraud and error that are material to the financial statements taken as a whole are detected that based on the risk assessment. It means that the responsibility has to be put on the external auditor shoulder whereby if he/she is

unable to detect material misstatements, particularly intentional misstatements, they may be exposed to litigation.

Due to the matter, Leuz, Nanda and Wysocki (2003) summarized on the fraudulent financial reporting as a critical problem for external auditors because of the damage to professional reputation that results from public, especially on client's side's dissatisfaction about undetected fraud.

2.3.6 Audit Fees

At the heart of these audit failures lies a set of business relationships that are bedeviled by perverse incentives and conflicts of interest. In theory, a company's auditors are appointed independently by its shareholders, to whom they report. In practice, they are chosen by the company's bosses, to whom they all too often become beholden. Accounting firms frequently sell consulting services to their audit clients; external auditors may be hired to senior management positions or as internal auditors; it is far too easy to play on an individual audit partner's fear of losing a lucrative audit assignment. Against such a background, it is little wonder that the quality of the audit often suffers.

The most radical change would be to take responsibility for audits away from private accounting firms, altogether and surrender it totally to the government. Perhaps such a change may yet become necessary. But it would run risks in terms of the quality of auditors; and it is not always so obvious that a government agency would manage to escape the conflicts and mistakes to which private firms have so often fallen prey.

As an intermediate step, however, a simpler suggestion is to take the job of choosing the auditors away from a company's bosses. Instead, a government agency for example the

Central bank of Kenya (CBK) for banks, Insurance Regulatory Authority (IRA) for insurance companies, Retirement Benefit Authority (RBA) for Pensions and Capital Markets Authority (CMA) for listed companies would appoint the auditors, even if on the basis of a list recommended by the company, which would continue to pay the audit fee. Companies and especially the big companies are unfortunately not spoiled for choice when it comes to shopping for an auditor since there are not too many audit firms that can handle the magnitude of audit work demanded for a big client.

2.3.7 Political Interference

Failure to succumb to the needs of politicians predisposes the audit firms to frustrations and can even have their operating license withdrawn. This is particularly so in the audit of parastatals and government ministries where audit findings and recommendations are not received too kindly since they are a direct reflection on the management of the public organization.

The audit profession is under pressure to remain relevant to the needs of investors and other users and especially for the publicly listed companies. Regulation on audit tendering, restrictions on advertising and mandatory audit rotation pose a challenge. The regulation will increase costs and potentially impact on the viability of the audit profession as well as expose the audit firms to increased litigation risk.

The government who is the regulator should ensure that auditors are protected by the law and favorable policies put in place in order to restore confidence in the work of auditors which is crucial to rebuilding trust in institutions as a whole.

2.4 Review of Local Studies

In view of the discussion on the role of auditor in Kenya as required by law and accounting international standards, Kimutai (2012) explains that an expectation gap mainly in relation to the level and nature of auditor's responsibility exists in Kenya. She found out that expectation gap was essentially on the auditor's responsibility for the preparation of the accounting records and the soundness of the internal control structure of the entity.

In her study she found out that Kenyan investors seem to associate fraud to the failure of auditor's responsibility. They therefore expect the auditors to be able to detect such frauds in the course of their audit engagement. Respondents in the research agreed that auditing can unearth fraud but to a limited extent depending on the degree of the mandate of the audit assignment, the materiality of the fraud committed, level of adequacy of the internal control system.

Kamau et al (2012) in his study found out that that materiality of audit issue, type of information available, source of information, degree of risk of misstatement and auditor skills and independence were some of the factors influencing the sample size determination for the purposes of internal audit evidence collection in public sector in Kenya. He explained that the internal audit department has a role of providing objective assurance and consulting services designed to add value and improve an organization's operations. In performing this role the internal auditors are required to provide an auditor's opinion which is supported by sufficient and reliable audit evidence. Since auditors are not in a position to examine 100% of the records and transactions, they are required to sample a few and make conclusions on the basis of the sample selected.

The seventh schedule of the Company's Act (CAP 486) laws of Kenya requires the auditor to express in their reports whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit. They should also state whether, in their opinion, proper books of account have been kept by the company, and whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns. Finally they should express their opinion whether to the best of their information and according to the explanations given them, the accounts give the information required and in the manner so required and give a true and fair view in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year and in the case of the profit and loss account, of the profit or loss for its financial year.

Kalui et al. (2014) found out through study that only two (audit tangibility and audit responsiveness) out of five dimensions (i.e., Responsiveness, Assurance, Empathy, Tangibility and Reliability) significantly affected client satisfaction. This means that value added audits tailor-made to suit the client's dynamic needs is what companies found most crucial if an audit firm is to perform quality work and stand out from the highly competitive field. Assurance, empathy and reliability did not significantly influence client satisfaction.

2.5 Conclusion

Users of financial information face very many challenges in their pursuit to obtain objective information in the market place; this discourages investment and serves a major plow to the economic growth. One major question we should pose is: what solution can be offered to solve the challenges faced by users of financial information and restore confidence in the audit practice in Kenya? The foregoing discussion no doubt paints a dismal picture of the enormous challenges that impact on the practice of audit and the detrimental implications on the economy. All stake holders and indeed the policy makers must now be concentrated on efforts to protect and support this important practice which has the significant potential of strengthening the economy by providing all the users with objective information to enable them make informed decisions.

Arruñada, (1999) explained that the strength of a company's corporate governance structures is expected to affect a client's financial reporting quality and business risks, it is expected that governance will impact auditors' risk assessments and subsequent program planning decisions. The relation between the client's business risks and the risk of material misstatement in financial reports is increasingly recognized as a critical aspect in the audit process (Shockley, 1983).

The auditor must first recognize and properly assess the strength of corporate governance and, second, appropriately weight and use this evidence to adapt the nature, extent, timing of audit procedures, and duration of time required and/or staffing requirements. If the overall strength of the corporate governance structure is perceived to be strong, auditors could assess client associated risks as lower. This, in turn, could potentially reduce the planned audit effort. Ultimately, audit plans affect the quality of audit evidence obtained

and impact on the quality of audit decisions. Auditing standards prescribe that audit efforts are to be tailored to the level of client risks.

CHAPTER THREE

RESEARCH DESIGN AND METHODOLOGY

3.0 Introduction

This chapter describes the methods and procedures used to carry out the research. It has a direct influence on the study. It includes the research design, population, the sample and the sampling design, data description of instruments, data collection procedures and data analysis.

3.1 Research Design

A research design is a plan for selecting subjects, research sites and data collection procedures to answer the research questions. It is the conceptual framework within which research is conducted and constitutes the blueprint for the collection of data and the analysis thereof of the collected data.

Descriptive research design was appropriate as it enables the researcher to generalize the findings to a large extent. The purpose of this survey is to provide an extensive and authoritative body of factual information on the factors affecting audit quality with a view to deal with the risk factors and restore confidence in the audit practice which plays a major role in the economy.

The focus of this study is to examine the factors affecting audit quality in promoting accountability in the management of shareholders' Funds in Kenya. The study utilizes quantitative approaches in the collection of data. The approach enables data to be systematically collected and analyzed in order to provide a descriptive account of the variables under study.

3.2 Population and Sampling

A population is the total collection of elements about which the researcher wishes to make some inferences. An element is the subject on which the measurement is being taken and is the unit of the study. Study population is a well-defined or specified set of people, group of things, households, firms, services, elements or events which are being investigated. The population should fit a certain specification, and the population should be homogenous.

The population consists of all listed manufacturing and commercial services companies in Kenya as at 31st December 2014, they are 20 in number. See list provided in appendix I. This population provided a significant representation of the whole country, Kenya.

From the population, a sample of 10 companies was randomly selected for the study which was used to establish the relationship between the key audit risk factors and audit quality as indicated by the post-audit quality deficiency discoveries.

A 'sample', which is a smaller quantity of units that represent the entire behavior of a larger population, does not however guarantee the researcher that the conclusions made will generalize the wholesome attribute of the entire population.

3.3 Data Collection

The main source of data for this research was from secondary sources which is quantitative in nature. The information covers a period of five years from 2010 to 2014. The data was obtained from published financial statements and industry survey reports, ICPAK reports, and market mix information.

3.4 Data Analysis

The data was analyzed by use of summary statistics, including percentages, means and standard deviation to measure interrelationships between the variables. A linear regression analysis was used to establish causal relationship between dependent and independent variables.

3.5 Analytical Model

The researcher used regression analysis to establish the factors affecting audit quality in listed manufacturing and commercial services companies in Kenya. We established whether there is a relationship between the three key independent variables of audit quality (financial status of the company, audit fees and audit firm size) and the dependent variable of audit quality which was proxied by leverage of a company. This was the case because bankruptcies which can be used as direct measure of audit quality are rare occurrences. According to Woodland and Reynolds (2003), bankruptcies can be regarded as a direct measure of the quality of audit. However the authors argue that bankruptcies are rare occurring audit quality indicators. The same case applies to Kenya. However, leverage ratio has a very close relationship with bankruptcy as most of the firms facing bankruptcy have significant amount of debts. In this respect, the leverage was used as a proxy for audit quality. Due to the fact that the firms listed at NSE are audited, a high leverage ratio can be an indicator of low audit quality as it suggests that a company has debt pressure.

The following model was adopted:

$$\text{Leverage} = \alpha + \beta_1 \text{Status} + \beta_2 \log \text{Fee} + \beta_3 \text{AuditorSize} + \varepsilon$$

Where:

$$\text{Leverage} = \frac{\text{Total Debts (Both short term and longterm)}}{\text{Total Assets of the company}}$$

α = Constant

Status = Dummy variable for Liquidity of the company (takes value “1” if the company has liquidity problems and value “0” otherwise)

Fee = Audit Fees

AuditorSize = Audit Firm Size

$\beta_1, \beta_2, \beta_3$ = Coefficients

ε = Error Term

3.6 Test of Significance

The study used F-statistic to check the model significance (slope of the entire model) for statistical reporting. The F-test was used to determine the significance of the regression while the coefficient of determination, R-squared, was used to determine how much variation in dependent variable is explained by independent variables. This was done at 95% confidence level. Correlation analysis was carried out to find the direction of the relationship between quality and the dependent variables. The significance of the correlation coefficients was also tested. The Statistical Package for Social Sciences (SPSS) was used to analyze the data.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

The model developed in chapter three has been estimated and discussed in this chapter. Descriptive analysis has been provided in section 4.2 while section 4.3 comprises estimation results for the multiple regression model developed in chapter three. The interpretation of findings has been provided in section 4.4.

4.2 Descriptive Analysis

Several descriptive statistics were calculated so as to provide the basic characteristics of the dataset. Table 4.1 below shows the descriptive statistics for the two continuous variables (logarithm of auditor remuneration and leverage ratio).

Table 4.1: Descriptive Statistics (Quantitative variables)

	LogAuditfees	Leverage
Mean	8.814804	0.4955
Median	8.761889	0.52075
Standard deviation	1.0402	0.2655792
Minimum	6.572282	0.079
Maximum	10.4018	0.8725
Skewness	-0.2748188	-0.2048407
Kurtosis	2.64587	1.686104

Where:

LogAuditfees=logarithm of audit fees

Leverage= Total company's debt divided by the total assets (proxy for debt pressures)

From Table 4.1 above, the logarithm of audit fees has a mean of 8.814804 and a median of 8.761889. The difference between the mean and the median is 0.052915. This implies that this dataset is close to normal distribution as the mean and median are almost equal. The standard deviation of this variable is 1.0402. This value implies that there has been variation in audit fees paid by the companies under review. The minimum value for the logarithm of audit fees is 6.572282 while the maximum value is 10.4018. The skewness of this dataset is -0.2748188. This implies that the dataset is slightly skewed to the left. However this value falls in the acceptable range of -2 to 2 for a normally distributed dataset. The kurtosis of this variable is 2.64587. Kurtosis measures whether the data is flat or peaked relative to normal distribution. The kurtosis value for this dataset falls in the acceptable range of -3 to 3 for a normally distributed dataset.

The variable leverage has a mean 0.4955 and a median of 0.52075. The difference between the mean and the median of this dataset is 0.02525. This implies that the dataset is close to normal distribution as the mean and the median are almost equal. The standard deviation for this variable is 0.2655792. This implies that the values in the dataset are not widely spread out from the mean. The minimum value for this dataset is 0.079 while the maximum value is 0.8725. This dataset is slightly skewed to the left as indicated by the skewness value of -0.2048407. However, this value falls in the acceptable range of -2 to 2 for a normally distributed dataset. The kurtosis value of 1.686104 for this variable implies that the dataset is relatively flat as compared to normal distribution. However, this value falls in the acceptable range of -3 to 3 for a normally distributed dataset.

Table 4.2: Descriptive Statistics (Ordinal Variables)

Variable	Frequency	Percent
Status		
0(No liquidity problems)	12	60
1(Liquidity problems)	8	40
Auditor size		
0(Non-big two)	10	50
1(Big two)	10	50

Table 4.1b above shows the distribution of the two ordinal variables (status and auditor size) in terms of frequency and percentage. From Table 4.2b above, 40 percent of the sampled companies had liquidity problems while 60 percent of the companies sampled had no liquidity problems. In addition 50 percent of the auditing during the study period was done by the big two companies and the remaining 50 percent was done by non-big two companies.

4.3 Regression Results

The model developed in chapter three was estimated using ordinary least squares method.

The model estimated below is in the following form:

$$\text{Leverage} = \alpha + \beta_1 \text{Status} + \beta_2 \log \text{Fee} + \beta_3 \text{AuditorSize} + \varepsilon$$

Where:

$$\text{Leverage} = \frac{\text{Total Debts (Both short term and longterm)}}{\text{Total Assets of the company}}$$

α = Constant

Status = Dummy variable for Liquidity of the company (takes value “1” if the company has liquidity problems and value “0” otherwise)

Fee= Audit Fees

AuditorSize= Audit Firm Size

$\beta_1, \beta_2, \beta_3$ = Coefficients

ε = Error Term

The regression results for leverage (debt pressure) on auditor size, logarithm of audit fees and the status of the company are shown in Table 4.2 below.

Table 4.3: Regression Results

Dependent Variable: Leverage

Sample: 2010-2014

Number of Observations= 20

Variable	Coefficient	Std. Error	t-statistic	Prob.
Auditorsize	-0.2541463	0.0871856	-2.92	0.010
Status	0.3835581	0.0881888	4.35	0.000
LogFees	0.1884457	0.0564209	3.34	0.002
Constant	-0.310482	0.4021847	-0.77	0.451
R-squared	0.6073		Mean(Dependent Variable)	0.4955
Adjusted R-squared	0.5336		S.D(Dependent Variable)	0.2655792
Sum of squared residuals	1.3401135		F-statistic	8.25
Prob.(F-statistic)	0.0015			

From the table above, the auditor size, status and logarithm of the auditing fees are significant in influencing the leverage. This implies that the three independent variables

are related to debt pressure that a company has. The size of the auditing firm is negatively related to leverage. The coefficient for this variable is -0.2541463. This implies that the firms that are audited by the big two auditing companies (PWC and Deloitte) have on average leverage ratios that are less by about 0.25% as compared to the firms audited by non-big two companies. The less leverage ratio implies less debt pressure. This finding corroborates the findings by Krishnan and Schauer (2000) who found a positive relationship between audit quality and audit firm size. The t-statistic for this variable is -2.92. Because the absolute value of this t-statistic is greater than 1.96 and 2.56 the coefficient of auditor size is significant at both 5% and 1% significance level.

The coefficient of status (liquidity) of the company is positively related to leverage. The coefficient value is 0.3835581 and significant at both 5% and 1% level of significance because its t-statistic is greater than 1.96 (at 5% significance level) and 2.56 (at 1% significance level). This implies that companies that are facing financial problems on average have leverage ratios that are 38% more than the companies that don't have financial problems. The high leverage for these companies implies a high level of debts as compared to assets. Due to the fact that the financial statements of these companies are regularly audited, it can be concluded that this is an indication of poor audit quality.

The coefficient of logarithm of fees is also positively related to the leverage ratio. The coefficient is significant at both 5% and 1% level of significance because its t-statistic is greater than 1.96 (at 5% significance level) and 2.56 (at 1% significance level). This implies that holding other factors constant, an increase in audit fees by 1% would lead to an increase in the leverage by approximately 0.19%. This is logical because high audit fees reduce the ability of companies to repay their debts. In addition due to economic

dependence that arises from high audit fees, there can be compromise on quality by the auditor.

4.4 Multicollinearity Test

Table 4.3 below shows the variance inflation factors for the independent variables.

Table 4.4: Variance Inflation Factors

Variable	VIF	$\frac{1}{\text{VIF}}$
AuditorSize	1.29	0.774993
Status	1.16	0.865472
LogFees	1.13	0.881138
Mean VIF	1.19	

The largest variance inflation factor in the table above is 1.29. This implies multicollinearity between the independent variables is not a problem because the largest variance inflation factor is less than 10. If independent variables are highly correlated, the standard errors of the fitted coefficients are inflated hence leading to wrong conclusion as a result of wrong hypothesis testing.

4.5 Interpretation of Findings

The results of regression analysis imply that, auditor size, status of the company (liquidity problems) and auditor fees/remuneration are important in influencing the leverage of the companies. The leverage was used as a proxy for debt pressure by the companies. The debt pressure on the other hand is a measure of bankruptcy. Bankruptcy in most cases is used as a direct measure of audit quality. Therefore, auditor size, status of the company (in

terms of finance) and auditor fees significantly impact on audit quality. The auditor size was negatively related with leverage implying that in most cases companies that have less debt pressure were audited by big two companies. This could be attributed to the need to safeguard their credibility and market share by the top two auditing firms (PWC and Deloitte).

The company financial status was positively related with leverage. This implies that this variable is positively related with high level of debts and hence bankruptcy thereby suggesting poor audit quality. The audit fee was positively related with high leverage ratio. This implies that holding other factors constant, an increase in audit fee results to an increase in the level of debts by the company. This could be attributed to the economic dependence that arises when the auditing firm receives significant amount of revenue from the client (company). In addition, an increase in the audit fees increases the costs thereby reducing the profits for the company. This leads to an increase in the level of a company's debts. In addition the high fees charged affect the independence of the audit thereby negatively affecting the quality of the audit.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter comprises summary, conclusion and recommendations for policy. Section 5.2 is the summary of the study while section 5.3 is the conclusion. Section 5.4 comprises the limitation of the study.

5.2 Summary

This study sought to establish the factors affecting audit quality in listed manufacturing and commercial services companies in Kenya. A cross-sectional approach was adopted in the analysis in which a linear regression model was used to establish the impact of the independent variables namely; auditor size, financial status of the company and the logarithm of the auditor fees. The logarithm of audit fees was taken so as to make the data normal. The independent variable was leverage ratio (total debts divided by total assets of the company). This variable was used as a proxy for debt pressure by the companies. In addition, an increase in this variable increases the chances of bankruptcy for the companies and hence it is a direct measure of the audit quality. The variable status was a dummy variable which took value of 1 if the company had financial problems in any of the period between 2010 and 2014, and zero otherwise. Also, the auditor size was a dummy variable that took the value of 1 if the auditor was a top 2 company (in terms of market share) and value of zero otherwise. Ten companies listed at Nairobi Stock Exchange were used in the study.

The results of analysis indicated that logarithm of the fees, financial status of the company, and auditor size were significant in influencing the leverage of the companies. Because the leverage of the companies is a measure of the debt pressure by the companies, the same measure was used as a proxy of audit quality. In this respect therefore, size of auditing firm is positively related with quality of audit while the companies that have financial problems are more likely to have poor audit quality as compared to companies that have no financial problems. Lastly, an increase in audit fees leads to an increase in costs for companies as well as economic dependence. An increase in costs by companies can lead to an increase in company's debts while economic dependence leads to poor audit quality.

5.3 Conclusions

From the research findings it can be concluded that audit fees, financial status of the company and audit size significantly influences the quality of audit. Companies which are struggling were found to have high level of debts as compared to their assets. This is an indication of poor audit quality as these companies have been continuously audited and the issue of high debts had not been raised as a red flag by the auditors. In addition, high audit fees/auditors remuneration is related negatively with audit quality. An increase in audit fees was found to be positively related with leverage (debts divided by total assets). This suggest that high audit fees are positively related with poor audit quality. Because companies that were audited by big two companies were found to have less leverage ratios as compared to the companies audited by other auditing firms we can conclude that audit quality is positively related to size of the auditing firms

5.4 Recommendations for Policy

From the study findings, it is evident that audit fees, size of the auditing firm and financial status of the company significantly influence audit quality. Therefore in this respect, policy recommendations should be based on the three variables. To begin with, there should be regulation of the fee that the auditors charge by the government. This is because high audit fees create economic dependence by the auditor. This significantly affects the independence of the auditors which in turn leads to poor audit quality. In this respect, maximum fee payable should be established. The setting of the fees should take into account the size of the company.

Next is that there should be high level of professionalism by the audit firms. This means that companies that are highly indebted and auditors fail to prove that they could not detect it should be fined or operating license be withdrawn so as to safeguard the shareholders of the companies. In addition the officials of the company who engage in misstatements of the financial statements should be sacked and charged in the court.

5.5 Limitations of the Study

This study was limited in a number of ways. First, there is no accurate measure of audit quality and therefore leverage (total debts divided by the total assets of the company) was used as a proxy for debt pressure by the companies. Due to the low occurrence rates of bankruptcy even among the companies that are struggling financially, debt pressure was used as a measure of financial problems. In addition due to absence of a measure of size of auditing firms, a dummy variable had to be used.

5.6 Suggestions for Further Research

This study was only focused on listed Kenyan firms. This therefore calls for a similar study but from other countries so as to establish if there are similarities in the findings.

Also, a study about factors that lead to bankruptcies could be conducted. Due to the rare occurrence rate of bankruptcies, companies from various countries that have gone bankrupt can be sampled. After establishing these factors, the report of auditors can be assessed so as to establish whether the identified factors were captured in the auditor's report.

In addition, opinion of financial experts regarding the quality of different areas of auditors report could be collected by use of questionnaires and then factor analysis carried out to establish the main issues raised by these experts.

Because bankruptcy is usually characterized by a low liquidity position, liquidity position of the company can be used as a direct measure of bankruptcy and hence a proxy for audit quality.

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APPENDIX I

LISTED MANUFACTURING COMPANIES

1. B.O.C Kenya Ltd
2. British American Tobacco Kenya Ltd
3. Carbacid Investments Ltd aaaaa
4. East African Breweries Ltd
5. Mumias Sugar Co. Ltd
6. Unga Group Ltd
7. Eveready East Africa Ltd
8. Kenya Orchards Ltd
9. A.Baumann CO Ltd
10. Flame Tree Group Holdings Ltd

LISTED COMMERCIAL SERVICE COMPANIES

1. Express Ltd
2. Kenya Airways Ltd
3. Nation Media Group
4. Standard Group Ltd
5. TPS Eastern Africa (Serena) Ltd
6. Scangroup Ltd
7. Uchumi Supermarket Ltd
8. Hutchings Biemer Ltd
9. Longhorn Kenya Ltd
10. Atlas Development and Support Services

