EFFECTS OF TURN OVER TAX ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN CENTRAL BUSINESS DISTRICT, NAIROBI COUNTY

BY

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DECLARATION

I declare to the best of my knowledge that this project has not been presented for a degree in this or any other university.

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This research project has been presented for examination with my approval as the appointed university supervisor.

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DEDICATION

This project is dedicated to my dear family for their encouragement and who’s relentless support has brought me this far. May the almighty God bless you abundantly.
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LIST OF ABBREVIATIONS

CBD : Central Business District
GDP : Gross Domestic Product
GNP : Gross National Product
KRA : Kenya Revenue Authority
MTO : Size Tax Payers
NSE : Nairobi Stock Exchange
OECD : Organization for Economic Co-Operation And Development
ROA : Return On Asset
ROE : Return On Equity
SMES : Small and Enterprises
TMP : Tax Modernization Programme
TOT : Turn Over Tax
VAT : Value Added Tax
ABSTRACT

Tax payment is a civic duty and an imposed contribution by the government to contribute to her principle source of revenue to provide public goods and services to its citizenry. It is a compulsory unrequited payment to the Government. In an effort to maximize collection of revenue, the Government introduced Turn Over Tax through the finance Act of 2007 aimed at bringing more SMEs to the tax bracket. The Purpose of the study was therefore an attempt to establish the effect of Turn Over Tax on the financial performance of Small and Medium Enterprises in Nairobi CBD. The study employed descriptive research design. A stratified sampling was used to collect primary data from a sample size of 56 SMEs in Nairobi CBD. The study applied regression and correlation statistical models to analyse the data. The results were presented in tables. The findings indicated that the model had accounted for 88.6% of the total variance in financial performance (ROA) of the SMEs. From the findings 11.4% of Nairobi CBD SMEs financial performance was accounted for by other factors (variables ) that were not tested in the study’s model. Findings also indicated that there was sufficient evidence that the model was useful in explaining the financial performance (ROA) of SMEs in Nairobi CBD; as it was significant at the 95% confidence level (p = 0.000). The study revealed that there is a significant negative relation between Turn Over Tax and financial performance. On the other hand, firms’ Size, Liquidity, Age and Growth show a significant positive relationship with financial performance. The study recommended that businesses should employ the services of tax experts to aid them in tax planning in order to reduce the net tax payment so as to increase their financial performance. Again they should increase their asset size and ensure efficient use of those assets to reflect in the turnover of the businesses. KRA should enhance capacity of SMEs by reducing tax rates and penalty rates among other incentives aimed at assisting their business to flourish and in turn, drive economic growth.
CHAPTER ONE
INTRODUCTION

1.1 Background of the study

Governments in both developed and developing countries collect taxes to fund public services, including education, healthcare, water, security, roads, and social security among others. (Marine et al, 2002), argue that, “taxation is the only known practical manner for collecting resources in order to finance public expenditure for goods and services consumed by any citizens”. As such, taxes are compulsory payments that do not necessarily bear any relationship to the benefits of government goods and services received.

However, governments get revenue from other sources besides taxation, including non-tax revenue such as user-fees and licenses charged for services rendered by ministries, departments and agencies as well as income from sale of government assets and privatization. More over, many developing countries are dependent on foreign aid as an external source of revenue (Barnett and Grown, 2004).

In Kenya, taxation is the single largest source of government budgetary resources. Between 1995 and 2004, tax revenue constituted 80.4% of total government revenue (including grants). Kenya’s dependency on foreign aid and borrowing has declined over the last five years, averaging about 11% of the total budget relative to East Africa community members states, whose budgets are financed to the tune of 30 – 40% by developing partners (Glenday, 2002).
Given it’s central role taxation has been applied to meet two objectives. First taxation is used to raise sufficient revenue to fund public spending without recourse to excessive public sector borrowing. Second, it is used to mobilize revenue in ways that are equitable and that minimize its disincentive effects on economic activities (Glenday, 2002).

According to Barnett and Grown (2004), governments need to develop tax policies and tax systems that are guided by certain tenets. Since taxation affects incomes and prices of goods and services, individuals and businesses react differently in response to changes in income and in relative prices, emanating from taxation. Therefore, analysis of the effects of tax policy is critical for government decision makers and the public to make informed policy decisions.

The tax base in Kenya, as in most sub-Saharan African countries, is extremely narrow. So far, attempts to increase tax revenue have focused on closing the ‘taxation gap’ and expanding the tax base. In this respect, tax modernization programme was introduced to address issues of inequality and to create a sustainable tax system that could generate adequate revenue to finance public expenditures. Among key projects include, Domestic Taxes Reform and Modernisation project. Which involved creating the Taxpayer office (MTO) for size taxpayers, widening the tax net by introducing turn over tax (TOT) for small taxpayers and particularly those in the informal sector (KRA, 2012).
1.1.1 Turn Over Tax And SMEs in Kenya

A study by parliamentary Budget Office (2010) shows that, the government lost ksh.63.5 billion, ksh.69.73 billion and ksh.79.273 billion in 2006, 2007 and 2008, respectively. In other words, in 2008, by bringing the SMEs fully into the tax net, the government could have increased the tax base by approximately 7.66 percentage points, translating to revenue worth ksh.79.3 billion.

If the SME economy remain untaxed, the government will continue losing billions of shillings in terms of revenue and as more people move into the informal sector to escape the burdensome taxation, it will become increasingly difficult for the government to hit its revenue targets. Given the destabilizing effects of the budget deficits and the fact that they were becoming unsustainable, the kenya government came up with measures to address this problem the most notable fiscal policy proposals adopted being the tax modernization programme (TMP) and the Budget Rationalization Programme (Moyi and Muriithi, 2003).

A proposal was debeted by the government in 2004/2005 to increase VAT threshold from ksh.3million to Khs.5million. The total number of taxpayers envisaged to have been in that bracket was approximately 66,000. Out of this number, 52,000 were falling below ksh.5 million. A new tax to introduce those who did not qualify for VAT was designed. The finance Act of 2007 named the tax as Turn Over tax (Waweru, 2007).

Most of the micro and small traders either keep incomplete business records or do not keep any records at all. Attributed to low levels of education attained by majority of
the traders. To enhance their tax compliance, there was need to isolate the SMEs from the current tax regime in accordance with international best practice (Martin, 2012). The objective of introducing TOT was geared towards bringing the informal sector into the tax net and to simplify processes for the SMEs by; simplifying tax procedures, simplifying tax computation and simplifying record keeping.

TOT is applicable to any resident person whose turnover from business exceeds Ksh.500,000 but does not exceed Ksh.5 million during any year of income. For tax purposes, TOT is a final tax charged at 3% on the gross sales with no expenditure or capital allowances and is paid on the 20th day of the month immediately following end of the quarter.

1.1.2 Financial Performance

According to Ochieng (2012) Various researchers have used different measures to capture organizational performance including net income, sales (Dollinger, 1984), Return on investments (ROI), Return on sales (ROS), and a combination of ROI and ROS (Pegels and Yang, 2000), return on assets (ROA) (Birley and Wiersema, 2000) and market to book value of the equity as well as profitability and market share/growth (Entrialgo et al. 2000).

Gill (1990) measures a firm’s financial performance by its liquidity which is the amount of cash a company can put its hands on quickly to settle its debts. Liquidity funds consist of cash, short term investment for which there is a ready market, short term fixed deposits, trade debtors and bills of exchange receivable. Everingham and Hopkinss (1984) consider operating cash flow ratio as indicators of performance.
They determine the extent to which a company has generated sufficient funds to repay loans, maintain operating capabilities, pay dividends and make new investments without using external financing. (Palepu, et al, 2000) concur that cash flow ratios can be used to answer questions on firms’ performance since debt obligations are met with cash. Such an analysis will result in adequate lines of credit, unrestricted cash availability, debt maturity schedules with respect to financing requirement and the willingness to issue common equity. It allows the analyst to examine a company’s financial health and how the company is managing it’s operating, investment and financing cash flows.

1.1.3 Relationship Between Taxation and Financial Performance

Firm level surveys as reported by the world competitiveness report 2004 – 2005. WEF (2004), indicate that Kenyan firms are highly taxed. Kenya’s tax burden index is 3.9 against a mean of 3.6 for the 104 countries reported. The highest and lowest scores were reported by Bahrain 1.5 and malawi 4.8. Kenya is ranked in position 73 out of the 104 countries.

In comparison, Uganda’s and Tanzania’s tax burden indices were both 3.5, slightly less than the mean. Mauritius had a score of 2.8 in relation to comparative countries, Kenya’s tax burden is high by international standards and is likely to impinge on the tax competitiveness of the country as a host for investors. This calls for lowering taxation rates. However, it should be observed that lowering the tax rate faces the risk of revenue loss if the lower tax rate does not improve compliance to stimulate higher profit growth (WEF, 2004).
Gordon (2010) argue that high tax rate distort the demand and supply of labour hence productivity is impaired as people will prefer longer leisure hours. Some countries tax system is structured purely towards revenue generation and that has negative effect on the economy, Loffer (2009) cautioned that “a government simply canot tax a country into prosperity”.

Ordinarily, people abhor tax payment due to its effect on their income. Owens (2006) noted that tax policy must be generally accepted by the people if it must gain compliance. It therefore means a good tax system must be in consonance with Adam (1776) cannon of taxation: equitability, neutrality, efficiency, flexibility and simplicity.

Rohaya, Nor’Azam and NurSyazwani, (2010) conducted a study on corporate income taxes and revealed an association between income tax and profitability of corporate institutions. The study related to the impact of corporate income tax liabilities on different variables of a firm as gross profit, cost of sales and expenses. A sample of 7,306 companies was taken from the hotels and restaurants sector, 6,594 in business services and 1,484 in transport manufacturing sectors, for the accounting periods 1995 to 2000. The conclusion was that corporate income tax adversely affects the profitability of corporate institutions.

Kenya’s tax structure has numerous pieces of legislations and regulations prescribing complex deductions and allowances, extensive bands and brackets are grafted in technical jargon as to confuse most small taxpayers. Entangling the complex tax laws
also overwhelms the resources of most taxpayers causing inadvertent non-compliance (Slemrod et al, 1996).

Most small taxpayers are quite frustrated with the convoluted tax code and will invariably resort to “creative’accounting to escape the tax net. Multiplicity also allows the taxpayer to “slide from one type of tax to another or slip from a higher to lower marginal tax rate solely to reduce tax liability”. The magnitude of financial, human and time resources that taxpayers have to invest to comply with the tax laws lead to low compliance level (Slemrod et al, 1996).

The cost of engaging tax experts to file returns and interpret the numerous deduction rules, offsets, exemption and allowances overwhelms the small taxpayers (Moyo and Ronge, 2006). As was noted by Slemrod et al (1996) in the study of compliance behaviour, the cost of compliance is fixed and will not significantly vary between the large and small taxpayers thus making it regressive with respect to firm size, in the sense of being larger in proportion to size for smaller taxpayers as compared to the larger ones.

**1.1.4 Overview of SMEs in Nairobi County**

In Kenya, the SME sector is quite large, estimated at 34.3% and accounting for 77% of employment statistics. Over 60% of those working in the SMEs are the youth, aged between 18 – 35 years, 50% being women (Ouma et al 2009). The first 1993 SMEs baseline survey revealed that there were approximately 910,000 SMEs employing up to 2 million people. The second SME baseline survey (1995), estimated the size of SME sector at 708,000 enterprises employing up to 1.2 million people. Compared to
the other sectors of the economy, the contribution of the SME sector to the country’s Gross Domestic Product (GDP) increased from 13.8% in 1993 to over 18% in 1999 (Sessional Paper No.2 of 2005).

Introduction of TOT is an affirmative action which was aimed at incorporating the SME sector into national taxation system. However, the performance of TOT has not been satisfactory and TOT revenue has been below average in most months since its inception. According to KRA, in total, revenue collected from the TOT system is Ksh.221 million against a target of Ksh.645 million which is far from attaining the set target of creating an additional Ksh.2,400 million per year. On TOT recruitment, the performance has on average been below 50%. In year 2008/09, the number of SMEs which were registered with TOT was 10,605 against a target of 18,347. Between July 2009 and March 2010, 2,890 SMEs had registered with the TOT against a target of 6,928. This is a problem to the government in its endeavor to ensure that there is sufficient revenue to support its operations (Kimaru and Jagongo, 2014).

Currently, the 1999 National MSE Baseline Survey reports that almost two thirds of all SMEs are located in the rural areas and only one third are found in urban areas. Of these, about 17 per cent are located in Nairobi and Mombasa. As regards the scope of the SMEs operations, it is reported that close to 70 per cent are in the trade sector. This means that a large proportion of SMEs are involved in buying and selling goods and commodities to generate income. (Central Bureau of statistics, National MSE Baseline Survey, 1999).

The estimated distribution of business establishments registered in Nairobi County reflects the concentration of commercial and service businesses in the relatively small
area of the CBD and that of manufacturing businesses in makadara division. Key issues of concern in Nairobi county in doing business include; dealing with construction permits, getting electricity, registering property and paying taxes. (Jica, 2014).

1.2 Problem Statement

Taxation has been indentified as a major threat to the growth of small and enterprises not only in developing countries like kenya but also in developed countries (Burke and Jarrat, 2004). For instance, in Kenya, TOT is a direct tax charged on gross turnover without any deductions and firms do not benefit from any tax deductions of business expenditure. This denies them the catalyst for growth and profitability. Taxation in general increases the cost of operating SMEs. To reimburse for the increased costs of operation, prices on goods are raised thus lowering the amounts of sales. The effects of reduced sales are low profits, reduced capital base and slow creation of employment resulting to slow growth. (Thuronyi, 2009).

A study by David (2013), to investigate challenges affecting collection of turnover Tax among SMEs in Nairobi County, Kenya, had the objectives, to assess to what extent taxpayers ignorance of their obligations affects collection of TOT revenues in Nairobi, to determine to what extent the mode of payment and the frequency of filling returns affects collection of TOT revenue in Nairobi, to investigate to what extent corruption and collusion between taxpayers and tax collectors affects collection of TOT revenues and to determine to what extent Government policy formulation and quality of services to taxpayers affects collection of TOT revenues in kenya.
Using Descriptive statistics on a sample size of 150 the findings indicated that, all the identified factors have a direct influence on the tax compliance among SMEs. i.e tax rates, availability of tax information, tax compliance cost and attitude of tax payers towards paying of TOT. TOT was found to be prohibitive and higher than profits. 81% of the respondents spend more than Ksh. 50,000 in a month in expenses which are directly related to tax compliance. From the foregoing it is evident that research on TOT has been done in Nairobi but it does not pay attention to financial performance determinants among SMEs. This study therefore intend to fill this methodological gap by analysing in totality effects of TOT on financial performance using accounting based performance measures. Aduda and Musyoka (2011), advocate for accounting based performance measures.

In Kenya empirical studies on the effect of TOT on the financial performance of SMEs are limited. Kinyua (2014), in a survey to evaluate the factors affecting the performance of SMEs in the Jua Kali sector in Nakuru town, found that macro economic factors (taxation and policies) significantly affect performance. The study adopted survey research design and was collected on 265 respondents. Study findings revealed that 48.1% of the respondents generally reported that to a great extent the firm was required to adhere to taxation and financial reporting, 28.6% reported to some extent while 23.3% reported not at all. Research by Mbugua, Njeru and Tirimba (2014), which sought to establish the factors affecting the performance of SMEs traders at Limuru town market in Kiambu County also found that government policy and regulations (taxation and licences) affect business performance.
The survey research targeted 965 licenced SMEs operating in Limuru market. The study established that government policy and regulations affects businesses in Limuru Town market to a great extent as evidenced by (mean = 4.16, standard deviation = 1.09). However, the respondents’ had varying opinions on the extent to which policy and regulations have on the businesses as evidenced by the significant value of more than one standard deviation.

Global research finding supports local existing literature on effect of taxation on financial performance of SMEs. Kneller, Bleaney and Gemmell (1999) focused on 22 OECD countries for the period 1970 – 1995. They used five years average of the annual data to avoid business cycle effect. They employed static panel econometric techniques to investigate the relationship between fiscal policy and growth. The study found a significant and positive relationship between non-distortionary taxation (indirect tax) and economic growth. They concluded that indirect tax is less harmful to the economy as it dosn't cut down on return on investment compared to direct tax.

While above researchers made great contributions on effect of taxation on performance of firms, contextual gap exist where none of the research has focused on the sensitivity of the effects of taxation to contextual factors that determine firm’s financial performance. There is also a significant methological gap on the measurement of effects of taxation on financial performance of firms. Therefore the proposed study will evaluate distinct components of determinants of financial perfomance of SMEs separately and make different attributions depending upon which component is being evaluated. There exists a knowledge gap relating taxation to, determinants of firms financial performance. For as long as the link is unknown to
policy makers, designing a tax structure which can enhance growth in the economy will always remain elusive.

It is therefore against this background that the researcher will examine the effect of TOT on financial position of SMEs. The study will seek to answer the following question: What is the relationship between TOT and the financial position of SMEs?

1.3 Research Objective
To establish the effect of turn over tax on financial performance of small and medium enterprises in Nairobi Central Business District.

1.4 Value of the Study
Government can be able to understand the extent to which the policies affect SMEs in terms of financial performance. The rules and regulations set by the government affect the sustainable growth in SMEs and bearing in mind that the role that SMEs play in achieving vision 2030, these factors under the governments control should be put into consideration and observed to ensure that the business environment is favourable for continuous growth.

For revenue and policy makers, the information from the TOT payers themselves will be captured by this study and this study will enable them to provide the data that can be used to tailor a solution to the challenges of TOT. Other policy makers in different countries of the world may borrow from the findings of this research when seeking solutions to a similar problem in their countries.
For the taxpayers the study will help them understand the structure of TOT and mobilize the public on its importance, making the link thus more visible rather than a hidden burden. The scholars and researchers who would like to debate or carry out more studies on TOT will find this study useful as a basis of carrying out more studies in Kenya.
CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction
This chapter discusses justification for taxation and how it affects financial performance of SMEs. It first discusses 3 theories that provide the theoretical background of this study. These theories are the ability to pay theory of taxation, the partnership theory and the Allingham and Sandmo theory. The second part discusses the determinants of financial performance of SMEs. The existing empirical evidence that have been advanced by different scholars is discussed. In conclusion summary is drawn from this review of literature.

2.2 Theoretical Review
Under this section, the researcher has analysed three major theories related to the study, namely, the ability to pay theory of taxation and the partnership theory of taxation. These two theories support the paying of TOT according to ones paying capacity to support government activities. Finally, the classical approach to tax compliance (AS Theory) that shows the effect of tax compliance cost which compels the government to the government to deters tax evasion through sanctions and audits of taxpayers.

2.2.1 The Ability to pay Theory of Taxation
This theory was advanced by Swiss philosopher Jean (1712 – 1778), the French political economist Say (1767-1832) and the English economist Mill, (1806-1873). This theory holds that the taxation should be levied according to an
individual’s income or ability to pay and is the basis of progressive tax where tax rate increases by the increase of the taxable amount (Jones et al, 2011).

This theory is indeed the most equitable tax system since people with greater income or wealth and can afford to pay more taxes should be taxed at a higher rate than people with less individual income tax and has been widely used in industrial economies.

The basic tenet of this theory is that the burden of taxation should be shared by the members of society on the principles of justice and equity and that these principles necessitate that the tax burden is apportioned according to their relative ability to pay. This theory suggest that the tax payers of TOT should pay unconditionally and according to their paying capacity (Chigbu, Eze and Ebimobowei, 2012).

2.2.2 The Partnership Theory of Taxation

This theory was advanced by Geier, (2004). The theory has visceral appeal because it appears to provide a ‘social justice’ basis for taxation. That is, the government is entitled to mandatory contributions because citizens owe their financial well-offness, to significant degree, to the government.

Partnership theory of taxation posits that government should share in the profits of economic enterprise by way of an income tax. One might call the partnership theory the economic version of the Benefit theory. The partnership theory is based on the notion that the government should share in national income (or more technically, gross national product, or GNP), because government, by supplying infrastructure in
the broad sense (physical infrastructure, national and domestic security, a capitalism-enabling legal system and regulatory structure) earns a share of the GNP.

This theory is especially appealing to some income tax advocates, because it seems to normatively prescribe an income tax in preference to a consumption tax. The government should therefore collect TOT given that it contributes to the general environment enabling business to be conducted (Dodge, 2005).

2.2.3 Classical Approach to Tax Compliance (AS Theory)

This theory was advanced by Allingham and Sandmo (1972). The AS theory holds that the government deters tax evasion through a sanction arrangement and audits. A tax payer will decide to violate the fiscal laws and evade his or her tax obligations when he or she perceives that the cost of evading tax is too low, believing he or she is unlikely to be detected or audited.

Tax payers would also evade tax when he or she perceives the cost of compliance is high. Tax systems and procedures that are involving and cumbersome tend to encourage tax evasion. Tax payers who feel that tax rate is high and punitive will evade tax. There is a negative correlation between tax evasion, the probability of detection, the degree of punishment and high transactional costs associated with tax laws (Sandmo, 1972).

Income tax evasion was pioneered by Allingham and sandmo (1972). Where a rational and a moral taxpayer maximizes expected utility, which solely depends on income. When caught, the agent must pay penalties, imposed on the amount of evaded
income. A key comparative static result is that when the tax rate goes up, competing income and substitution effects might lead to more or less tax compliance. The substitution effect encourages evasion since the marginal benefit of cheating goes up with the tax rate. On the contrary, the income effect tends to suppress evasion since a higher tax rate makes the taxpayer with decreasing absolute risk aversion feel worse-off, and thus decrease risk-taking, therefore, the net effect is ambiguous.

However, Shlomo (2002) showed that when the penalty is imposed on the amount of evaded taxes, as it is under most current tax laws, the substitution effect vanishes. At the original optimum, the penalty paid on concealed income increases proportionally with the tax rate, and hence, there is no substitution effect. The remaining income effect is responsible for inducing the taxpayer to cheat less. Therefore, the net effect is better compliance, result is perhaps the single most important finding in the early tax evasion literature, having spurred a lot of remarkable extensions. The SMEs are prone to tax evasion as they face difficulties in complying with tax laws. They are expected to comply with strict deadlines, keep proper books of accounts. This kind of environment leads to tax evasion.

2.3 Determinants of Financial Performance of SMEs

This section reviews the determinants of financial performance, those included in this study include, Size of the Company, Liquidity, Growth, Age of the firm, cost of production, Operating expenses and Profitability.
2.3.1 Size of the Company

Financial performance is positively related with size of company. Arguments were floated by Hardwick (1997) that there is a positive relationship between performance and company size due to operating cost efficiencies through increasing output and economizing on unit of cost. Large corporate size also enables investors to effectively diversify their assumed risks and respond more quickly to market conditions.

A positive relationship between firm size and profitability was found by Vijayakumar and Tamizhvela (2010). In their study, which was based on a simple semi-logarithmic specification of the model, the authors used different measures of size (sales and total assets) and profitability (profit margin and profit on total assets) while applying model on a sample of 15 companies operating in South India. Papadognas (2007) conducted analysis on a sample of 3035 Greek manufacturing firms for the period 1995 – 1999. After dividing firms into four size classes he applied regression analysis which revealed that for all size classes, firms’ profitability is positively influenced by size.

2.3.2 Liquidity

Liquidity of the firm is a key determinant of the firm’s financial performance. Liquidity risk can be measured by two main methods: liquidity gap and liquidity ratios. The liquidity gap is the difference between assets and liabilities at both present and future dates (Pelg, 2006). Liquidity ratios are various balance sheet ratios which should identify main liquidity trends. These ratios reflect the fact that a firm should be sure that appropriate, low cost funding is available in a short time. This might involve
holding a portfolio of assets that can be easily sold, cash reserves, minimum required reserves or government securities. (Santalo and Becerra, 2008).

Liquidity as studies done by Shiu (2004) proves that companies with more liquid assets are likely to perform better as they are able to realize cash at any point of time to meet its obligations and are less exposed to liquidity risks. By not having sufficient cash or liquid assets, companies may be forced to sell investment securities at a substantial loss in order to settle claims promptly. This in effect will affect their financial performance.

2.3.3 Growth

Profitability and growth are the key variables in economic analysis of a firm’s performance. Growth can occur in many different aspects of a firm’s operations such as its cashflow, net income, customer base, sales and market share (Murphy et al, 1996). To examine the growth of small and medium-sized British firms, Robson and Bennett, (2000) in their study observed a positive relationship between both profitability and sales growth.

Better growing firms increase their profitability. If there is an increase in total assets it means it has a high growth and it tends to be more profitable. We will measure growth as a percentage increase in total assets. Thus we expect positive relationship between growth rate and profitability of firm (Nousheen and Arshad, 2003).
2.3.4 Age of the Firm

Age is a key determinant of financial performance of the firm. The period of operation that a firm has been in operation highly determines the financial performance of the firm. Firms that have a vast experience in the market are able to gain economies of scale from the suppliers and other stakeholders of the firm as a result of good relationships and trust. Such a firm is more likely to perform better than a firm that is new in an environment. The firm might spend alot of money before it gets adapted to the new environment (Santalo and Becerre, 2008).

A growing asset (Size) is related to the age of the organization (Shekhar & Lekshmy, 2007). The quality of assets is a very important criterion that determines the ability of an Organization to earn consistently. It basically determines the profitability of the Organization. It also explains the suitability and growth in earnings in the future.

2.3.5 Cost of Production and Operating Expenses

Rivera and Oliva, (2003) cites that production costs are expenses, such as materials and labor that a company incurs in the course of producing the product to sell to consumers. While operating expenses refer to selling, general and administrative expenses. In general, the lower the costs, the higher the profit, or the amount left over after subtracting expenses from sales revenue. However, low production costs do not necessarily guarantee a high profit. A business may have unsustainably high fixed costs, such as rent, or may cut production costs of producing an inferior product that nobody wants.
A firm maximizes profit by operating where marginal revenue equal marginal costs. A change in fixed costs has no effect on the profit maximizing output or price. The firm merely treats short term fixed costs as sunk costs and continues to operate as before. This can be confirmed grafically. Using the diagram illustrating the total cost – total revenue perspective, the firm maximizes profit at the point where the slopes of the total cost line and total revenue line are equal. An increase in fixed cost would cause the total cost curve to shift up by the amount of the change. There would be no effect on the total revenue curve or the shape of the total cost curve. Consequently, the profit maximizing point would remain the same. This point can also be illustrated using the diagram for the marginal revenue-marginal cost perspective. A change in fixed cost would have no effect on the position or shape of these curves (Palepu et al., 2000).

2.3.6 Profitability

Profitability is the primary goal of all business ventures. Without profitability the business will not survive in the long run. Profitability results from the excess of income over expenses. A firm that is highly profitable has the ability to reward its owners with a large return on investment (Hovakimian et al., 2004).

Firms facing financial constraints are unlikely to meet their investment obligations. The firm may be paying out more than it is receiving and more likely to go bankrupt (Stewart, 2011). This implies that in the long run the chances of survival of the firm are low and this would yield a lower valuation. On the contrary firms with adequate cash flow are likely to meet their financial obligations on time and hence improved performance.
2.4 Empirical Studies

Derwent (2000) in a case study on taxation behaviour in five different countries (USA, Gambia, Nigeria, South Africa and Kenya), concluded that increased tax burden is a major threat. The results show that the increase in tax rates leads to higher production, distribution and selling costs which lead to higher prices and as a result consumers change their buying behaviour. People react to the higher prices by buying less of the product. When sales fall, some manufactures cut back on production and some workers may lose their jobs. The productive resources i.e. land, capital, labour and entrepreneurship are allocated to other industries or go unused. For instance when the government increases taxes on items such as beer and cigarettes for the purpose of realizing revenue and discouraging their consumption people tend to buy local brews. The study recommends government should provide motives for technological progress and innovation that can lower production costs and help firms surpass structural and strategic advantages more effectively.

SMEDA (2007), in survey study on basic situation of SME and their support structures in pakistan with objectives to find out basic situation of SME and their support structures, to determine short term and Long term issues. The study found out that SMEs encounter an increasing complex legal, tax and administrative environment, both in starting and developing their business. According to research, 67% of small business list tax regulations as most problematic, while 28% of SMEs felt that taxes in the country are too high. It also found that the present tax structure and administration generally distort incentives and discriminate against small firms. Smaller firms found tax related issues more restrictive than larger firms, 69% of firms, whose size was less than 1 million faced the greatest of tax related problems.
Many small firms claim it is not possible for them to maintain books as per law or hire a professional due to cost constraints. The study recommends government coordination and regular information exchange mechanism among institutions for collective SMEs development.

Rosen et al (2001) analysed the personal income tax returns of a large number of sole proprietors in Kenya before and after the tax reform act of 1986 and determined how the substantial reductions in marginal tax rates associated with that law affected the growth of their firms as measured by gross receipts. They found that individual income taxes exerted a statistically and quantitative significant influence on firm growth rates. The results showed that raising the sole proprietors’ tax price by 10%, increased receipts by about 8.4%. This findings is consistent with the view that raising income tax rates discourages growth of small businesses. The study recommended review of income taxes.

Chipeta (2002), examine the parallel economy in Malawi. The objective of his study was to first establish the size of the parallel economy in Malawi and secondly to establish the extent of tax evasion. He employed the monetary approaches of Guttman and Tanzi to come up with the size of the parallel economy from 1965 to 1990. He indentified that a higher tax rate increases taxpayers’ burden and reduces their disposable income therefore, the probability of evading tax is higher. The study concludes that reducing the compliance costs and tax rate increases the SMEs profit margin and recommends a revision of income taxes downward.
Australia Board of Taxation (2007) adopted qualitative approach in a study to find out tax compliance costs facing the small business sector. The study found that there is a consensus that tax compliance costs are amongst the highest regulatory burdens faced by small business. Compliance costs make up about 20 per cent of a business’s administration costs. Around two-thirds of the time spent on compliance activities are related to tax compliance activities. In 1997 compliance costs in Australia were estimated to be 1.36 per cent of GDP. The larger a business is, the smaller its compliance costs are as a percentage of turnover. In some cases, this extends to negative compliance costs for large businesses. This is a result of larger businesses generally having tax compliance expertise in house (reducing the need to pay for external advice), economies of scale, and larger businesses being in a better position to take advantage of cash flow benefits and tax deductibility of compliance costs. The study recommended mandatory calculation of compliance costs when government departments are costing new policy initiatives and simplifying tax administration.

Masinde (2010) in a study to find out the revenue potential of SMEs in Kenya found tax compliance is low among SMEs as a result of several factors such as poor management and internal control practices as many enterprises are merely trying to make ends meet. Another contributory factor to low compliance among SMEs is the informal approach to establishment, operation and dissolution which creates an ease of mobility, consequently making it difficult for the tax administration to keep pace with them.

Cash-based economies have also had inadequate accounting records and audit trails in practice. Tax compliance is low among SMEs also because compliance costs for the
SMEs are much higher relative to larger business operations that are competing against. In addition, small businesses have limited resources and technical capacity. Often, the priority of tax administration is to focus on large taxpayers because of the high delinquency rate and low revenue yields associated with small businesses, with very little enforcement action. The study recommends KRA should intensify taxpayer education and disseminate information on tax updates more frequently in order to improve the levels of tax knowledge for voluntary tax compliance.

Were (2011), applied correlation analysis in a study to determine the relationship between presumptive income tax system and profitability of SMEs in Uganda. He also found out that presumptive tax has not favoured the growth of SMEs in the Nakawa division of Uganda because they are encroached on expected revenue. He concluded that presumptive tax negatively affects the profitability of SMEs, recommending that businesses should keep proper books of account to ensure that correct tax assessments are made to avoid over taxation thus improving on their profits. SMEs owners should also join micro finances so that they are able to get loans with low returns for businesses expansion which will lead to increase in stock and sales thus increase profits.

A study by Ojeka (2011) on Tax policy and the Growth of SMEs. Found that small and enterprises play a very important role in development of the nigeria economy, making up about 97% of the entire economy. The research work sought to establish if any relationship exists between the growth of SMEs and the tax policy in Nigeria. It was found that most SMEs surveyed were faced with the problem of high tax rates, multiple taxation, complex tax regulations and lack of proper enlightenment or
education about tax related issues. Data was collected for 107 respondents and analysed using spearman’s Rank Correlation which measures strength of association between two variables.

Although there was a general perception that tax is an important source of fund for development of the economy and provision of social services, the study revealed a significant negative relationship between taxes and the business ability to sustain itself and to expand. A suggested solution by this study was increasing tax incentives through reducing tax rates and increasing tax authorities support services towards small and enterprises.

Mika et al (2012) In a study to explore impact of tax system on the growth of SMEs in Shinyanga, Tanzania, had the objective to determine the managers/executive officers’ perception of tax system effectiveness in promoting SMEs growth in Tanzania. The study found that, whenever prices increase due to increase in tax rates, prices of goods and services increase and there is a drop in the consumption rate and a decrease in sales volumes which leads to retarded growth of SMEs. Tax payment is among the outflows of cash from the business which reduce the purchasing power of an enterprise. This is due to the fact that a large amount of cash collected is used to pay taxes rather than to expand the business. The study showed that the purchasing power of an enterprise drops immediately an organisation pays taxes. The study is based on a survey of 120 respondents and used descriptive analysis. It recommends reforming of the tax policies in the country.
Onias et al (2014) adopted a descriptive research design to assess the effectiveness of presumptive tax collection system and its impact on the viability of SMEs in Zimbabwe. Using 67 Bindura commuter transport operators as respondents to the case study. The major objectives of the study were to establish the reason(s) why SMEs are subject to presumptive tax, whether there was any relationship between viability of SMEs and the payment of presumptive tax and the effectiveness of Zimbabwe Revenue Authority’s tax awareness campaigns. 67.5% of the respondents agreed that presumptive tax negatively affected their profits and 7.5% were not sure. Only 25% said presumptive tax did not affect their profits. This suggests an inverse link between presumptive tax and viability of SMEs. Major recommendations included intensification of presumptive tax awareness campaigns and involvement of taxpayers in setting up tax amounts. The findings were consistent with those by Were (2011).

2.5 Summary of the Literature Review

This chapter looked at the theoretical review and empirical review. In theoretical review, the researcher looked at the theories which act as the foundation of the study. The study paid emphasis on the ability to pay theory, partnership theory and Allingham and Sandmo theory. The major contributions from the theories are tax should be paid unconditionally, according to ones paying capacity to support government activities and that the government deters tax evasion through sanctions and audits of taxpayers.

The empirical reviewshow evidence of negative relationship between taxation and performance of SMEs. However contextual gap exist where none of the research has focused on the sensitivity of the effects of taxation to contextual factors that
determine firm’s financial performance. To improve on the studies, the basic models should control for the contextual effects that include; the effect of taxes on return on asset, how tax affect size of firm, the effect of taxes on age of firm, how taxes affect of the firm liquidity as well as how taxes affect firms’ growth. Among those Studies reviewed that recognize such a positive relationship between taxation and financial performance exist include, Australia Board of Taxation (2007) on a study to find out tax compliance costs facing the small business sector, Ojeka (2011) on Tax policy and the Growth of SMEs, Nigeria and Onias et al (2014), to assess the effectiveness of presumptive tax collection system and its impact on the viability of SMEs in Zimbabwe.

In summary there, are no detailed studies investigating the effect of tax on determinants of financial position to support their findings, in particular, the effect of taxes on return on asset, how tax affect size of firm, the effect of taxes on age of firm, how taxes affect of the firm liquidity as well as how taxes affect firms’ growth. This literature has ignored applicability of accounting measures in determining firms financial performance. Additional research should be carried out, therefore the proposed study will bridge this gap in empirical study. Though the study considers effects of TOT, it will be expanded to incorporate various financial performance determinants that are expected to influence firms performance.
CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction
This chapter presents the research methodology to be adopted in conducting the study in order to achieve the study’s objectives. The chapter is thus structured into research design, target population and sample, data collection and data analysis.

3.2 Research Design
Research design is a strategy for conducting the research that specifies the procedures necessary to obtain the information needed to structure and solve the research problems (Cooper and Schindler, 2003). A descriptive design was used for this study as it enables the researcher to collect a large quantity of in-depth information about the population being studied. The main benefits of this research method is being able to use various forms of data as well as incorporating human experiences. It gives researchers the ability to look at whatever they are studying in various aspects and can provide a bigger overview as opposed to other forms of research (Mugenda and Mugenda, 2003).

3.3 Target Population
The focus of the study was SMEs operating in Nairobi CBD. The population of interest for this study comprised of 560 TOT payers created from information received from the K.R.A records. Cooper and Schindler (2003), define a population element as the subject on which the measurement is being taken and is the unit of study. Nairobi CBD was of particular focus for this study due to its large
concentration of business entities and diversity which will make it easier for the researcher to get a representative sample and use less time and money.

3.4 Sampling Size and Sampling Technique

Sampling is a means of selecting a part of a group from a population to represent the characteristics of the entire group or the population of interest. The advantage of sampling is that it reduces the length of time needed to complete the study and cuts cost. In addition, collecting data from fewer cases means that one can collect more detailed information (Saunders, Lewis and Thomhill, 2000). According to Coopers and Schindler (2003), a sampling frame is a list of elements from which the sample is actually drawn and closely related to the population. By adopting this approach, the researcher ensured that the sampling frame was current, complete and relevant for the attainment of the study objectives.

The study adopted both non-probability and probability sampling techniques. Coopers and Schindler (2003) argue that stratified random sampling increases a sample’s statistical efficiency and provides adequate data for analyzing the various sub-populations. This method provides a more representative sample than strictly random sampling does. The study therefore will adopted stratified sampling, a probability sampling technique, to ensure the sample selected was representative. The study population will be stratified into three mutually exclusive subgroups. The subgroups were composed of three sectors under which majority of Turnover enterprises fall; wholesale and retail, service related activities and others.
A stratum is a subset of the population that shares at least one common characteristic. The procedure ensures homogeneity within each stratum. Within each of the three strata’s purposive sampling and non-probabilistic sampling technique was used to arrive at the desired sample. A total of fifty six (56) was selected from the target population based on the 10 – 30 % sampling rule from each stratum (Mugenda and Mugenda, 2003). This was an ideal number considering the time and resources available and also considering the large population. Using the 10% rule the following is the stratified sampling frame from the population of interest.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Population</th>
<th>Sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesale and Retail Trade</td>
<td>290</td>
<td>29</td>
</tr>
<tr>
<td>Service related activities</td>
<td>140</td>
<td>14</td>
</tr>
<tr>
<td>Hardware/motor/bike stockiest</td>
<td>57</td>
<td>6</td>
</tr>
<tr>
<td>Other type of business</td>
<td>73</td>
<td>7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>560</strong></td>
<td><strong>56</strong></td>
</tr>
</tbody>
</table>

### 3.5 Data Collection

The study used primary data collection technique in the form of self administered questionnaire. The questionnaire was divided into 2 sections. In A the respondent provided general information about the business concerning the name of the business and number of years in operation. Section B captured financial information.

The questionnaire was administered to the respondent chosen for the study by use of drop and pick later method. Kothari (2004) terms the questionnaire as the most
appropriate instrument due to its ability to collect a large amount of information in a reasonably quick span of time. According to Mugenda and Mugenda (2003), questionnaires are commonly used to obtain important information about a population under study. The questionnaire was carefully designed and tested with a few members of the population for further improvements. This was done in order to enhance its validity and accuracy of collected for the study.

3.6 Data Analysis

Completed questionnaires were edited for completeness and consistency. Data was analysed using descriptive statistics and multivariate regression analysis. This was achieved through the use of statistical packages for social sciences (SPSS) and MS Excel to generate frequency distributions and percentages to assist in answering the research questions. The analysis sort to answer research questions and explain the nature and strength of associations between the dependent and independent variables. While descriptive statistics was used to meanfully describe measurement using statistics. The output which was presented in form of tables and multivariate regression analysis resulted in a prediction equation that described the relationship between the dependent variables and independent variables.

The regression model will be as follows:

\[ Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \epsilon \]

Where;

\( Y \) = Return on total asset which will be measured as the ratio of net profit on total assets

\( X_1 \) = Turn over tax which will be measured as ratio of tax to net operating income
\[ X_2 = \text{Firm size which will be measured as natural log of total assets} \]
\[ X_3 = \text{Age of firms which will be measured by natural log of number of years in operation} \]
\[ X_4 = \text{Liquidity will be measured as ratio of current asset to current liabilities} \]
\[ X_5 = \text{Growth will be measured by natural log of firm’s total sales revenue} \]
\[ \beta_0 = \text{Constant term} \]
\[ \beta_1 \ldots \beta_5 = \text{Beta coefficients} \]
\[ \varepsilon = \text{Error term} \]

The dependent variable \(y\) is defined by the financial performance of a firm. It was measured by the ROA. The independent variables were Turnover tax \((x_1)\) this is tax expense measured as ratio of Tax to net operating income, firm size \((x_2)\) this measured the financial effectiveness of the firm. It was measured by natural log of firm’s total assets (Net sales to average total assets), age of firm \((x_3)\) which is the number of years the firm has been in operation it was measured by natural of number of years in operation, liquidity \((x_4)\) refers to the level of exposure to liquidity risk. It was measured by the ratio of current asset to current liabilities and growth \((x_5)\) this is the economic analysis of firm’s performance it was measured by natural log of firm’s total sales revenue.

**3.7 Test of Significance**

A correlation and a multiple regression analysis was carried out to test the presence of multicollinearity in the data. This helped show any serial correlations. A multiple regression analysis was carried out. ANOVA and F-test showed the fitnes of the model used in the study. The coefficients showed how each of the variables
influenced performance. The results of significance were interpreted at 5% level of significance. Both P-values and t-tests were interpreted. To test for normality skewness and Kurtosis were used. To test for Collinearity Multicollinearity Diagnostic was used.
CHAPTER FOUR
DATA ANALYSIS, RESULTS AND DISCUSSIONS

4.1 Introduction

This chapter presents and discusses analysis and findings of the study as set out in the research methodology. The objective of the study was to establish the effect of Turn Over Tax on the financial performance of small and medium enterprises in Nairobi CBD. The study targeted 58 respondents where 35 (63%) respondents filled in and returned the questionnaires making a response rate of 63%. This is considered sufficient for a study. Mugenda and Mugenda (2003) indicate that a response rate of 50%, 60% or 70% was sufficient for a study. Data gathered was analysed using statistical package for social sciences (SPSS) version 17.

4.2 Response Rate

The overall response rate was 63 percent as per the distribution shown below.

Table 4.1. Response Rate

<table>
<thead>
<tr>
<th>Target</th>
<th>Target</th>
<th>Response</th>
<th>Response rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesale and retail</td>
<td>29</td>
<td>15</td>
<td>26</td>
</tr>
<tr>
<td>Service related activities</td>
<td>14</td>
<td>7</td>
<td>13</td>
</tr>
<tr>
<td>Hardware / motor bike stockiest</td>
<td>6</td>
<td>6</td>
<td>11</td>
</tr>
<tr>
<td>Other type of business</td>
<td>7</td>
<td>7</td>
<td>13</td>
</tr>
<tr>
<td>Total</td>
<td>56</td>
<td>35</td>
<td>63</td>
</tr>
</tbody>
</table>

Source: Research Findings

4.3 Descriptive Analysis

Table 4.2 presents the descriptive statistics in terms of the number of observations, mean and standard deviation.
### Table 4.2: Summary of Descriptive Statistics

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>0.656</td>
<td>0.255</td>
<td>35</td>
</tr>
<tr>
<td>TAX</td>
<td>0.084</td>
<td>0.052</td>
<td>35</td>
</tr>
<tr>
<td>SIZE</td>
<td>14.701</td>
<td>0.645</td>
<td>35</td>
</tr>
<tr>
<td>GROWTH</td>
<td>14.334</td>
<td>0.581</td>
<td>35</td>
</tr>
<tr>
<td>LIQUIDITY</td>
<td>0.782</td>
<td>0.227</td>
<td>35</td>
</tr>
<tr>
<td>AGE</td>
<td>1.792</td>
<td>0.692</td>
<td>35</td>
</tr>
</tbody>
</table>

Source: Research Findings

The results in Table 4.2 shows that the mean performance (ROA) was 0.656 with a standard deviation of 0.255. The mean Tax was 0.084 with a standard deviation of 0.052. The mean Size was 14.701 with a standard deviation of 0.645. The mean Growth was 14.334 with a standard deviation of 0.581. The mean Liquidity was 0.782 with a standard deviation of 0.227. Finally the mean Age was 1.792 with a standard deviation of 0.692.

### 4.4 Diagnostic tests

Table 4.3a and 4.3b presents the diagnostic statistics.

### Table 4.3a : Test of Normality

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Skewness Statistic</th>
<th>Skewness Std. Error</th>
<th>Kurtosis Statistic</th>
<th>Kurtosis Std. Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>35</td>
<td>-.255</td>
<td>.398</td>
<td>-.436</td>
<td>.778</td>
</tr>
<tr>
<td>TAX</td>
<td>35</td>
<td>1.888</td>
<td>.398</td>
<td>4.149</td>
<td>.778</td>
</tr>
<tr>
<td>SIZE</td>
<td>35</td>
<td>-.700</td>
<td>.398</td>
<td>-1.071</td>
<td>.778</td>
</tr>
<tr>
<td>GROWTH</td>
<td>35</td>
<td>-.442</td>
<td>.398</td>
<td>-1.343</td>
<td>.778</td>
</tr>
<tr>
<td>LIQUIDITY</td>
<td>35</td>
<td>-.655</td>
<td>.398</td>
<td>-.716</td>
<td>.778</td>
</tr>
<tr>
<td>AGE</td>
<td>35</td>
<td>-.373</td>
<td>.398</td>
<td>-1.149</td>
<td>.778</td>
</tr>
</tbody>
</table>

Valid N (listwise) 35
Table 4.3a shows results for Skewness and Kurtosis which were done to check for normality. A 95% confidence level was used when carrying out the test. Skewness results show tax having a positive skewness statistic of 1.888 and Size, Growth, Liquidity and Age having a negative skewness statistic in the range -0.373 < s > 0.700.

Kurtosis results show tax having a positive Kurtosis statistic of 4.149 and size, growth, liquidity and age having a negative Kurtosis statistic in the range -0.716 < k > -1.343.

**Table 4.3b: Test of Collinearity**

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
<th>Collinearity Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
<td>Tolerance</td>
</tr>
<tr>
<td>(Constant)</td>
<td>4.477</td>
<td>.970</td>
<td></td>
<td>4.618</td>
<td>.000</td>
</tr>
<tr>
<td>TAX</td>
<td>-4.695</td>
<td>.363</td>
<td>-.949</td>
<td>-12.939</td>
<td>.000</td>
</tr>
<tr>
<td>SIZE</td>
<td>.300</td>
<td>.077</td>
<td>.756</td>
<td>3.865</td>
<td>.001</td>
</tr>
<tr>
<td>GROWTH</td>
<td>-.576</td>
<td>.100</td>
<td>-1.311</td>
<td>-5.788</td>
<td>.000</td>
</tr>
<tr>
<td>LIQUIDITY</td>
<td>.202</td>
<td>.072</td>
<td>.179</td>
<td>2.790</td>
<td>.009</td>
</tr>
<tr>
<td>AGE</td>
<td>.153</td>
<td>.067</td>
<td>.415</td>
<td>2.304</td>
<td>.029</td>
</tr>
</tbody>
</table>

a. Dependent Variable: ROA

Table 4.3b shows results for Multicollinearity which measures how much the independent variables are related and how this affects the stability and variance of the regression estimates. Results show strong multicollinearity in Growth having a VIF.
staticic of more than 10 and no multicollinearity in Size, Growth, Liquidity and Age having a VIF statistic which lies between 1 – 10.

4.5 Correlation Analysis

Table 4.4 below presents the correlation analysis results in a correlation matrix with all the variables in the study. The essence of the correlation analysis was to examine the inter relationships between the independent variables to check for multicollinearity.

Pearson correlation analysis was used to achieve this end at 95% confidence level. The results establishes that ROA has an inverse relationship with Turn Over Tax with a co-efficient of -0.835. This means that whenever tax burden on the business increase it reduces the level of financial performance of the business. In relation to size, growth, liquidity and age of the firm they showed a positive association with coefficients of 0.103, 0.080, 0.100 and 0.245 respectively. This implies that an increase in business Size, Growth, Liquidity and Age will result to an increase in the financial performance of SMEs.

Table 4.4: Correlation Marix

<table>
<thead>
<tr>
<th></th>
<th>ROA</th>
<th>TAX</th>
<th>SIZE</th>
<th>GROWTH</th>
<th>LIQUIDITY</th>
<th>AGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TAX</td>
<td>-0.835</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SIZE</td>
<td>0.103</td>
<td>0.205</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GROWTH</td>
<td>0.08</td>
<td>-0.312</td>
<td>0.938</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LIQUIDITY</td>
<td>0.100</td>
<td>0.134</td>
<td>0.073</td>
<td>0.006</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>AGE</td>
<td>0.245</td>
<td>-0.394</td>
<td>0.888</td>
<td>0.927</td>
<td>-0.001</td>
<td>1</td>
</tr>
</tbody>
</table>

Correlation is significant at the 0.05 level (2-tailed)
Source: Research Findings
4.6 Turnover Tax and Financial Performance

This section presents a discussion of the results of the multiple regression analysis. The study conducted a multiple regression analysis to determine the nature of the relationship between the dependent and independent variables of the study. The findings are as presented in the following tables.

Table 4.5a: Analysis of Variance

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>1.965</td>
<td>5</td>
<td>.393</td>
<td>44.981</td>
<td>.000b</td>
</tr>
<tr>
<td>Residual</td>
<td>.253</td>
<td>29</td>
<td>.009</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>2.218</td>
<td>34</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Researcher Findings

Analysis of Variance (ANOVA) consists of calculations that provide information about levels of variability within a regression model and form a basis for tests of significance. P-values less than 0.05 are generally considered statistically significant. From the ANOVA results, the probability value of 0.000 was obtained implying that the regression model was statistically significant in predicting how Age, Liquidity, Tax, Size and Growth of business affect the financial performance of SMEs in Nairobi CBD. The F critical at 5% level of significance was 2.545. Since F calculated (value = 44.981) is greater than the F critical (2.545), this shows that the overall model was significant.
Table 4.5b: Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.941a</td>
<td>.886</td>
<td>.866</td>
<td>.09347</td>
</tr>
</tbody>
</table>

- a. Predictors: (Constant), AGE, LIQUIDITY, TAX, SIZE, GROWTH
- b. Dependent Variable: ROA

R-square values present proportion of the variation in financial performance that is attributed to the changes in the explanatory variables. From the adjusted determination coefficients, generally moderately strong linear relationships were established between dependent and independent variables. Their R-squared value of 88.6% was established and this implies that 88.6% of the variation in financial performance of SMEs is attributed to the changes in the explanatory variables. While other factors not studied in this research contribute 11.4% of the SMEs financial performance.

Table 4.5c: Regression Coefficient

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
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<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1 (Constant)</td>
<td>4.477</td>
<td>.970</td>
<td>-</td>
<td>4.618</td>
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<tr>
<td>TAX</td>
<td>-4.695</td>
<td>.363</td>
<td>-.949</td>
<td>-12.939</td>
</tr>
<tr>
<td>SIZE</td>
<td>.300</td>
<td>.077</td>
<td>.756</td>
<td>3.865</td>
</tr>
<tr>
<td>GROWTH</td>
<td>.576</td>
<td>.100</td>
<td>1.311</td>
<td>5.788</td>
</tr>
<tr>
<td>LIQUIDITY</td>
<td>.202</td>
<td>.072</td>
<td>.179</td>
<td>2.790</td>
</tr>
<tr>
<td>AGE</td>
<td>.153</td>
<td>.067</td>
<td>.415</td>
<td>2.304</td>
</tr>
</tbody>
</table>

- a. Predictors: (Constant), AGE, LIQUIDITY, TAX, SIZE, GROWTH
- b. Dependent Variable: ROA
From the regression findings, the substitution of the equation

\[ Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \epsilon \]

becomes

\[ Y = 4.477 - 4.695 X_1 + 0.300 X_2 + 0.153 X_3 + 0.202 X_4 + 0.576 X_5 + \epsilon \]

Where,

Constant = 4.477, shows that if age, liquidity, tax, size and growth of the business are all rated a zero, return on asset would be 4.477.

\[ X_1 = -4.695 \] shows that one unit change in Tax expense results in 4.695 units decrease in return on asset.

\[ X_2 = \] shows that one unit change in Size results in 0.300 units increase in return on asset.

\[ X_3 = \] shows that one unit change in Age results in 0.153 units increase in return on asset.

\[ X_4 = \] shows that one unit change in Liquidity results in 0.202 units increase in return on asset.

\[ X_5 = \] shows that one unit change in Growth results in 0.576 units increase in return on asset.

### 4.7 Discussion of Research Findings

Table 4.2 shows results for descriptive statistics. The results shows that the mean performance (ROA) was 0.656 with a standard deviation of 0.255. The mean Tax was 0.084 with a standard deviation of 0.052. The mean Size was 14.701 with a standard deviation of 0.645. The mean Growth was 14.334 with a standard deviation of 0.581. The mean Liquidity was 0.782 with a standard deviation of 0.227. Finally the mean Age was 1.792 with a standard deviation of 0.692.
Table 4.3a and 4.3b shows results diagnostic statistics. Table 4.3a shows results for Skewness and Kurtosis which were done to check for normality. Skewness results show tax having a positive skewness statistic of 1.888 and Size, Growth, Liquidity and Age having a negative skewness statistic in the range $-0.373 < s > -0.700$. Kurtosis results show Tax having a positive Kurtosis statistic of 4.149 and size, growth, liquidity and age having a negative Kurtosis statistic in the range $-0.716 < k > -1.343$. A series is said to be normal if it has a skewness and kurtosis statistic of zero. Therefore from the results of both parameters, it can be concluded that the variables do not follow a normal distribution.

Table 4.3b shows results for Multicollinearity. Results show strong multicollinearity in Growth having a VIF statistic of more than 10 and no multicollinearity in size, growth, liquidity and age having a VIF statistic which lies between 1 – 10. Table 4.4 shows results for correlation analysis. Pearson correlation analysis was used to at 95% confidence level. The results establishes that ROA has an inverse relationship with Turn Over Tax with a co-efficient of -0.835. This means that whenever tax burden on the business increase it reduces the level of financial performance of the business. In relation to size, growth, liquidity and age of the firm they showed a positive association with coefficients of 0.103, 0.080, 0.100 and 0.245 respectively. This implies that an increase in business size, growth, liquidity and age will result to an increase in the financial performance of SMEs.

Tables 4.5a, 4.5b and 4.5c discusses multiple regression analysis. Table 4.5a show result of analysis of variance. From the ANOVA results, the probabilty value of 0.000 was obtained implying that the regression model was statistically significant in
predicting how Age, Liquidity, Tax, Size and Growth of business affect the financial performance of SMEs in Nairobi CBD. The F critical at 5% level of significance was 2.545. Since F calculated (value = 44.981) is greater than the F critical (2.545), this shows that the overall model was significant.

Table 4.5b shows results of model summary. R-squared value of 88.6% was established and this implies that 88.6% of the variation in financial performance of SMEs is attributed to the changes in the explanatory variables. While other factors not studied in this research contribute 11.4% of the SMEs financial performance.

Table 4.5c shows results regression coefficient. The established regression equation was \( Y = 4.477 - 4.695X_1 + 0.300X_2 + 0.153X_3 + 0.202X_4 + 0.576X_5 + \epsilon \). The equation revealed that holding Tax, Size, Age, Liquidity and Growth of the business to a constant zero, financial performance of SMEs in Nairobi CBD would stand at 4.477, a unit increase in Size, Age, Liquidity and Growth of the business would lead to units 4.477 increase in return on asset while a unit decrease in tax would lead to units 4.477 decrease in return on asset.
CHAPTER FIVE
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction
This chapter presents the summary of the results of the study and the main conclusions drawn from analysis of the data in Chapter Four. It entails summary of the findings, conclusions made, policy recommendations, limitations of the study and suggestions for further research as per the findings. Which was to study the effect of Turn Over Tax on the financial performance of Small and Medium Enterprises in Nairobi CBD.

5.2 Summary of the Findings
The objective of the study was to establish the effect of turn over tax on financial performance of small and medium enterprises in Nairobi county. The population of this study was TOT payers operating in Nairobi CBD. A descriptive research design was adopted for the study. A sample size of 56 SMEs were selected using stratified sampling method.

The response rate was 63%, which comprised of 35 SMEs out of the 56 sampled. Primary data was collected using a questionnaire and was analysed using SPSS version 17. Collinearity analysis, correlation analysis and multiple regression analysis were performed on the data gathered. The variables used in the regression model were; financial performance of SMEs measured by return on asset (dependent variable) and Tax, Size, Age, Liquidity and growth of the businesses as the independent variables.
The findings indicated that the model had accounted for 88.6% of the total variance in financial performance (ROA) of the SMEs. From the findings 11.4% of Nairobi CBD SMEs financial performance was accounted for by other factors (variables) that were not tested in the study’s model. Findings also indicated that there was sufficient evidence that the model was useful in explaining the financial performance (ROA) of SMEs in Nairobi CBD; as it was significant at the 95% confidence level (p = 0.000).

According to the findings, Tax had a negative significant relationship with return on asset pearson correlation value of (r = -0.835, p< 0.05). This agrees to findings by Were (2011) in a study to determine the relationship between presumptive income tax system and profitability of SMEs in Uganda. He concluded that presumptive tax negatively affects the profitability of SMEs.

The study found firm size has a positive significant relationship with return on asset pearson correlation value of (r = 0.103, p< 0.05). This concur with Vijayakumar and Tamizhselva (2010) who in their study, based on a simple semi-logarithmic specification model, found a positive relationship between firm size and profitability. The authors used different measures of size (sales and total assets) and profitability (profit margin and profit on total assets) while applying the model on a sample of 15 companies operating in South India.

The study found Age of the firm has a positive significant relationship with return on asset pearson correlation value of (r = 0.245, p< 0.05). Kuntluru, Muppani and Khan (2008) in a study on financial performance of foreign and domestic owned companies
in India also argue that there is a statistically significant positive relationship between age and return on asset.

The study found Liquidity of the firm has a positive significant relationship with return on asset Pearson correlation value of \( r = 0.100, p < 0.05 \). This findings are similar to studies done by Shiu (2004) in a study to examine determinants of financial performance of general insurance companies in United Kingdom. The results of their study proved that companies with more liquid assets are likely to perform better as they are able to realize cash at any point of time to meet its obligations and are less exposed to liquidity risks. By not having sufficient cash or liquid assets, companies may be forced to sell investment securities at a substantial loss in order to settle claims promptly. This in effect will affect their financial performance.

The study found Growth of the firm has a positive significant relationship with return on asset Pearson correlation value of \( r = 0.0.080, p < 0.05 \). Findings by Nousheen and Arshad (2003) support this results. In their study they argue that better growing firms increase their profitability. If there is an increase in total assets it means it has a high growth and it tends to be more profitable. Thus we expect positive relationship between growth rate and profitability of firm.

5.3 Conclusions

The study concludes there is a significant negative relationship between Turn Over Tax and financial performance of SMEs in Nairobi CBD. These findings are in support of previous studies by Rohaya, Nor’Azam and NurSyazwani (2010) who revealed an association between income tax and profitability of corporate institutions.
The study related the impact of corporate income tax liabilities on different variables of a firm as gross profit, cost of sales and expenses. The conclusion was there is a negative association between corporate income tax and financial performance of firms. As businesses pay more tax their earning level decreases. This means that whenever tax burden on a firm increases it reduces the level of financial performance of the business. From this backdrop it is recommended that businesses should employ the services of tax experts to aid them in tax planning in order to reduce the net tax payment so as to increase their financial performance. Again they should increase their asset size and ensure efficient use of those assets to reflect in the turnover of the businesses.

On the other hand from the findings, the study concludes there is a significant positive relationship between Size, Age, Liquidity and Growth of the business with financial performance. The findings are also consistent with the study by Kadapakkam (1998) on the extent to which liquidity and firm size influence firm performance. The study findings showed that firm size and liquidity have positive effects and highly sensitive relation to financial performance. Increase in asset size leads to an increment in profit simply because an addition of an efficient asset has the possible effect of increasing the volume of sales hence increases the turnover of the business which will finally reflect in the earnings after Turn Over Tax. As the business grow they turn to implement strategies which lead to an increment in the market share meaning they sell to a wider spectrum. If this is the case then their financial performance would have to increase in the same proportion as thier size.
For the Age of the firm as the business ages, the rule of the thumb is that it becomes more acquainted to the regulations of the industry as well as the competition therefore develops strategic plans to halt the negative effect of those factors hence the results reflects positively in their financial performance. Therefore it is expected that, the age of businesses could have a positive impact on their financial performance. The findings are consistent with prior research by John, samuel and Holy (2013), which showed that Age and Growth of the firm show a significant positive relationship with financial performance.

5.4 Limitations of the study

The study was able to identify four limitations as below:

The researcher faced high level of resistance from the businesses targeted for provision of data. The business owners were reluctant to give the data thinking it was meant for other purposes other than academic purposes. The researcher moved to assure them that the data sought would only be used for academic purposes. The researcher overcame this limitation by presenting to the target respondents a data collection form from the University of Nairobi.

The study also faced a time challenge; particularly where the respondent delayed in filling the questionnaire and the time spent travelling to collect the filled questionnaire given that the sampling units were scattered and the distance between them was quite far. The researcher overcame this challenge by requesting the respondents to email back the filled questionnaire.
Some of the SMEs had poor records for financial statements where some of the data was not readily available and could only be estimated by the financial managers this created a room for the manipulation of data under analysis. The researcher overcame this by going through books of original entry.

Some of the organizations had not used recent accounting standards in presenting their data where by they had not classified their financial details into the required financial standards for instance it was challenging to ascertain the current assets due to some firms lacking cash flow statements. The researcher overcame this by personally going through documentations provided.

5.5 Policy Recommendations

KRA should Champion its literacy campaigns to improve tax payers’ ability to understand tax laws since existing literature demonstrate that mere provision of tax incentives is not sufficient.

The study recommends that to have a fully functioning TOT system among SMEs, they should be educated on record keeping standards to comply with general bookkeeping standards. To encourage this incentives such as application of lower TOT rate for SMEs meeting certain record keeping standard can be offered. Computation of taxes should also be made simple and comprehensible to all small scale businessmen.
Tax refund and Tax holidays where necessary should be encouraged for the benefit of those who comply voluntarily. There is need for management and organizational approach that emphasises services, support and information for the honest tax payers. Tax exemptions and allowance should be considered in TOT system this will help reduce the tax burden on taxpayers. Currently TOT is charged on gross sales with no expenditure or capital allowances.

KRA should encourage transition from the TOT regime to the standard regime such as by offering the possibility to claim and carry forward losses which benefit SMEs during loss-making periods. This will help the SMEs expand their operations and grow. KRA should enhance capacity of SMEs by reducing tax rates and penalty rates among other incentives aimed at assisting their business to flourish and in turn, drive economic growth.

5.6 Suggestions for Further Research

The study focused on SMEs in Nairobi County, but a significant proportion of the sample was from Nairobi CBD. This therefore limits the applicability of the findings to other SMEs in other parts of the country. The study suggests that this study be scaled up to include more SMEs in Kenya and not just within Nairobi CBD. Such a study would help improve the reliability of the findings as well as applicability to other SMEs. Tax evasion is one of the major problems facing Kenya Revenue Authority. In many cases government has lost a lot of revenue through this evil. Therefore further research on tax evasion and TOT would be necessary.
Further studies need to be done on this subject by replicating the study and using secondary data in order to enhance the quality of data collected and enable the results to be more in-depth. Companies listed at the NSE financial statements are readily available at the NSE secretariat and various companies websites as opposed to non-listed companies.

Tax policy is very important for economic growth and development of a country. Kenyas economic growth is said to be growing steadily in the recent years. Does tax policy have any implication to it? That is what should be determined.
REFERENCES


The case of kenya, Duke Center For International Development, Duke University, USA.


APPENDICES

Appendix 1: Questionnaire

This questionnaire is designed to collect information on the effect of turnover tax on financial performance of SMEs in Nairobi Central Business District.

The information obtained will only be used for academic purposes and shall be treated in utmost confidence. You are requested to complete this questionnaire as honestly and objectively as possible.

SECTION A: GENERAL INFORMATION

1. Name of business ...............................................................
2. Number of years in operation .............................................

SECTION B: FINANCIAL INFORMATION

<table>
<thead>
<tr>
<th>FINANCIAL YEAR</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
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<td>Net profit</td>
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<td></td>
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<tr>
<td>Current assets</td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Current Liabilities</td>
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<td></td>
<td></td>
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<td></td>
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<tr>
<td>Total assets</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Tax paid</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Gross profit</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Sales</td>
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<td></td>
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</tr>
</tbody>
</table>
Appendix 2: Letter of Authorization

DATE: 29/09/15

TO WHOM IT MAY CONCERN

The bearer of this letter, [Name], is a bona fide continuing student in the Master of Business Administration (MBA) degree program in this University. He/she is required to submit as part of his/her coursework assessment a research project report on a management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would, therefore, appreciate your assistance to enable him/her collect data in your organization.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you.

PATRICK NYABUTO
MBA ADMINISTRATOR
SCHOOL OF BUSINESS

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
MBA PROGRAMME

Telephone: 020-2229182
Telegraph: "Varity", Nairobi
Telex: 22095 Varsity

P.O. Box 3957
Nairobi, Kenya

UNIVERSITY OF NAIROBI
REPUBLIC OF KENYA
### Appendix 3: Research Data

<table>
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<th>SMEs</th>
<th>ROA</th>
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<th>liquidity</th>
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