

**THE INFLUENCE OF ACCOUNTING RECORDS ON THE FINANCIAL  
PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN CENTRAL  
BUSINESS DISTRICT IN NAIROBI COUNTY**

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## DECLARATION

This research is my original work and has not been presented for any academic award in any other university

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## **DEDICATION**

This project is dedicated to my family members for their financial and moral support throughout my time in school and during my study of this research project.

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## **ACRONYMS AND ABBREVIATIONS**

<b>CBD</b>	Central Business District
<b>GAAP</b>	General Accepted Accounting Principles
<b>GDP</b>	Gross Domestic product
<b>KACE</b>	Kenya Agricultural Commodity Exchange
<b>PAT</b>	Positive Accounting Theory
<b>RBV</b>	Resource Based View
<b>SASRA</b>	Sacco Societies Regulatory Authority
<b>SMEs</b>	Small and Medium Enterprises
<b>U.S.A</b>	United States of America

## **ABSTRACT**

Small and medium scale enterprises are gaining wide spread acceptance as viable drivers of economic growth. A sound accounting and internal control system in any business irrespective of its scale is crucial. Audits of small scale enterprises have proven to be worrisome for professional accountants because of the inadequacy of the internal controls. The study sought to establish whether a relationship exists between accounting systems, the manner in which accounting records were maintained by SMEs and their financial performance. The study adopted a descriptive research design on SMEs in Nairobi Central Business District. The study sampled 391 SMEs in Nairobi Central Business District. Systematic sampling technique was used to sample SMEs. Descriptive statistics and regression analysis was used to analyse the findings. The study found that revenue and expenditure accounts play a major role in ledger accounts. For ledger accounts to be effective, revenue and expenditure accounts must be well prepared to limit chances of negative financial performance of SMEs in Nairobi County. It found that an improvement in keeping and preparing purchases and sales ledgers can result in improved financial performance. It also found that all the SMEs in Nairobi CBD keep purchases and sales ledger, cash book, revenue and expenditure accounts, statement of income and balance sheet. It found that most SMEs neutrally agree that purchases ledger shows all purchases returns of the business, sales ledger shows all returns to the business and sales ledger shows all the receivables of the business. Finally, the study found that a large number of SMEs prepare balance sheets as they convey substantial information about the financial strength and current performance of an enterprise.

## CHAPTER ONE: INTRODUCTION

### 1.1 Background of the Study

Small and medium scale enterprises are gaining wide spread acceptance as viable drivers of economic growth. They have tremendous impact on employment generation. However, several of these enterprises demise without fulfilling expectations due to poor management arising from weak accounting structure (Olatunji, 2013).

A sound accounting and internal control system in any business irrespective of its scale is crucial. Audits of small scale enterprises have proven to be worrisome for professional accountants because of the inadequacy of the internal controls. Except for statutory demands, small and medium enterprises hardly give serious thoughts to the process of sound accounting yet the adequacy and ineffectiveness of accounting processes have been responsible for the ultimate collapse of a host of them (Mukaila and Adeyami, 2011).

The uniqueness of small and medium enterprises calls for a careful consideration in the design of an accounting system (Olatunji, 2013). Peacock (2000) argues that, failure by Small and Medium Enterprises (SMEs) to manage cash flows results in illiquidity and finally the demise of SMEs. He advocated for the engagement of a qualified accountant who can be instrumental in advising on strategic response to turbulent and competitive business environment. There is need to support these small enterprises so that they can grow to maturity and meet their intended purposes.

Accounting systems processes data and transactions to provide users with information they need to plan, control and operate their business. In this definition, accounting information systems are considered as tools that help management in planning and controlling processes by providing the relevant and reliable information for decision making (Romney & Steinbart, 2000). Accounting system functions are not solely for purpose of producing financial reports rather the role goes beyond this traditional view and can also be used as a controlling mechanism such as budgeting. Full adoption of the system will essentially require attainment of all the benefits of the system. Evidence from a number of studies reveals that SMEs financial accounting has remained the principle

source of information for their managers. The problem of poor adoption of accounting systems can be attributed to the initial objective of adoption of information technology (IT) that was essentially to replace manual accounting process that has now hindered further usage and exploration on the system benefits (Mauldin & Ruchala, 1999). Marriot and Marriot (2000) argue that financial awareness amongst SMEs varies considerably and the use of computers for the preparation of management information is not fully utilized to its potential.

### **1.1.1 Accounting Records**

Romney (2003) defined record keeping systems as set of components that collects, records, classifies, analyses, and processes and summarizes business transactions in the books of accounts. A system should be simple to use, easy to understand, reliable, accurate consistent and designed to provide information on a timely basis.

According to Parker (2002) record keeping involves identification, classification, storage and protection, receipt and transmission, retention and disposal of records for preparation of financial statements. He also adds that record keeping also includes policies, systems, procedures, operations and personnel required to administer records. Mc Lean (1999) points out that good record management helps in controlling the creation and growth of records to reduce operating costs, assimilation of new records management technologies and in ensuring regulatory compliance. Poor record keeping, inefficient use of accounting information to support financial decision- making and low quality and reliability of financial data are part of the main problems in financial management concerns of SMEs (Karunananda and Jayamaha ,2011).

Accounting records are the products of an accounting system. Accounting system is an orderly, efficient, scheme for providing accurate financial information and controls. Accounting systems show the books, records, vouchers, files and related supporting data resulting from application of accounting process that has observed regulatory requirements and internal administration policies (Olatunji, 2013). Accounting system must comply with the Generally Accepted Accounting Principles (GAAP). According to GAAP, any event that has a determinable monetary impact on the organization must be

recognized as an accounting transaction. A vast majority of small scale businesses cannot afford the complexity of a detailed accounting system, hence the existence of single entries in their books and in some cases incomplete records (Wood, 1979).

Success of a business enterprise is the establishment and application of controls by the owners or management in addition to the systematic record keeping of business transactions, which at the end of the period keeps the owner well informed about the performance of the business (Mbroh and Attom, 2013). A good accounting system is not judged by how well records are kept but by how well it's able to meet the information needs of both internal and external decision makers (Hussein, 1983).

According to Caruthers and Espeland (1991) accounts constitute part of the conceptual toolkit that people in business use in reflecting results or effects of their past decisions in considering present alternatives by providing technical information on the outcomes of previous business actions. They further state that accounting dates back to 2300 BC in Egypt and 1000BC in pre-Mesopotamia. Over time, accounting has become increasingly important and has become a primary source of information for businesses. New accounting standards are gradually developed to cope with the new developments in accounting and financial management in the world as a result of changing business environments.

### **1.1.2 Financial Performance**

Performance refers to an ongoing process that involves managing the criteria for which an institution, agency or project can be held accountable (Duranti and Thibodeau, 2001). These criteria are represented as components parts of an internal system and cover the institutions ability to; control financial expenses, satisfy staff, deliver timely interventions and respond to target group reactions to interventions.

Performance of a business refers to the ability of business to meet the required standards, increase market share, improve facilities, ensuring returns on profitability and total cost reduction and once this is achieved, a business is believed to be performing effectively (Fitzgerald, 2006).The need for an effective accounting system in promoting good performance in small and medium enterprises cannot be overlooked. SMEs may not be

able to adopt elaborate systems but should be encouraged to use customized adaptive systems for a profound impact on their corporate performance (Olatunji2013). Indeed Lybaert (1998) asserts that the quality of accounting information utilized within the SMEs sector has a positive relationship with an entity's financial performance. The financial crisis Advisory Group ([www:ifrs.org/news.press](http://www.ifrs.org/news.press)) identifies "Effective Financial Reporting" as one of the key principles that "plays an integral role in the financial systems by striving to provide unbiased transparent and relevant information about economic performance and condition of business".

Performance measures are quantitative and qualitative ways that characterize and define performance. They provide a tool for organization to manage progress towards achieving pre-determined goals, defining key indicators of organizational performance and customer satisfaction. Guest, Michie and Conway (2003) defined performance as outcomes, end results and achievements (negatives and positives) arising out of organizational activities. They argued that it is essential to measure strategic practices in terms of outcomes. Those outcomes vary along a continuum of categories such as: financial measures (ROA, ROE, turnover, PBT); measures of output of goods and services such as number of units produced, number of clients attended to, number of errors in the process, customer satisfaction indexes or measure of employee satisfaction (Locke & Latham, 1990, Guest , 2003).

According to Kaplan and Norton (1992) consideration to traditional financial measure alone is inadequate; attention should be given to people, processes and customers. This is important because performance indicators (KPI) vary across firms.

Evaluation of performance is a complex process that involves assessing interaction between environment, internal operations and external activities. Internal performance involves analyzing accounting data. Generally financial ratios are used to evaluate a firm's performance. The four basic categories of ratios include: liquidity ratios, debt ratios, activity ratios and profitability & investment ratios. Pandey (2009) notes that financial statements are important tools for diagnosis of a company's performance. Operating performance of a firm shapes its financial situation. Financial ratios are based on financial statements.



### **1.1.3 Small and Medium Enterprises (SMEs)**

What constitutes “small” in terms of government support and tax policy varies by country and by industry. Karlibbala (1994) and Ngobo (1995) state that in Kenya businesses with 10 or fewer workers are called micro-enterprises. Those with 11-50 people are small enterprises and 51-100 are medium. However, the number of people may not be a good indicator especially if the industry is labor intensive. This is true for countries like India where there is labor intensive approach to industrialization policy. In some cases it is possible for a trading organization to transact huge sums of business worth transactions and yet employ few people.

Millichamp (1984) observed that in most small and medium scale enterprises accounting and financial management are carried out by just one person, making segregation of duties impracticable and irrelevant. Controls have to depend on owners in management and it is fair to expect that small and medium enterprises incur costs to justified limits since accounting is not an end in itself. This calls for adoption of accounting systems to the needs of those businesses (Abeygunasekera and Fonseka, 2013).

In many developing countries, the role of these industries is crucial as they provide employment to a large number of people (Gamage, 2001). In countries like India and China, a large number of goods such as clothes, toys, furniture, edible oil and leather goods are produced by small scale traders. The SMEs sector in Kenya contributes an estimated 18% of Gross Domestic product (GDP) thereby contributing to economic growth. SMEs in Kenya employ up to 80% of Kenya’s workforce. Considering such significant contribution towards employment creation and growth of country’s economy, one of the goals outlined in Kenya’s vision 2030 is how this sector can attain its potential of contributing up to 40% or more to the country’s economic growth [www.africog.org](http://www.africog.org). National bodies have been formed to provide assistance to players in the private and public sectors. One such body is the Kenya Agricultural Commodity Exchange (KACE) that links small scale farmers with the markets, enhances their capabilities, provide business training and technical assistance. KACE reaches one million farmers a day and allows an estimated 250,000 small scale traders in agricultural commodities to access their services on daily basis (Karugu, 2010).

In Kenya, Nairobi County has the largest number of registered SMES in the country spanning across various sectors of the economy. The county offers a wide range of licenses for businesses depending on the floor space per square foot and the number of employees. There were recent attempts by the government of Kenya to spur growth through creation of employment for the youth which constitutes about 65% of the population. This has been done through creation of the Youth, Uwezo and the Women Funds as well as allocation of 30% of government tenders to the youth. This has seen the number of registered SMES in various sectors increase tremendously in the county as the youth increasingly set up enterprises to take advantage of these opportunities (Karugu, 2010).

Increase in accounting systems and accounting records lead to a considerable benefit that will accrue to an entity as a whole in the long run as it will lead to increased processing power, timely generation of reports and general reduction of associated operating costs. The need to reduce direct human interface in record management as well as reporting enhances credibility of reports generated to aid decision making and hence reliability by the end users due to minimization of biases. According to Damanpour and Gopalakvishnan (2001), companies achieve a high performance when they can afford the implementation of certain technological developments however there are other firms that have shown that performance drops immediately after the implementation by taking several years to realize the full benefits of IT adoption. Wah (2000) also indicates that many firms have invested in accounting systems and accounting records but do not succeed in attaining the established performance goals. Most research works have been concentrated on large firms however, the analysis on the impact on the smaller firms would be particularly important because it creates a competitive hedge for the firm and even enhances market positioning in achieving better results.

#### **1.1.4 Accounting Records, Accounting Systems and Financial Performance**

Accounting systems provide a source of information to owners and managers of SMEs operating in any industry for use in the measurement of financial performance. Reported profits reflect changes in wealth of owners and this explains why major economic

decisions in business are centered on financial performance as measured by profitability (Maseko and Manyani, 2011).

Record keeping plays a key role in management of knowledge necessary for good business performance. Modern organizations are concerned with the capture, use and storage of knowledge. Record keeping provides evidence of how the transaction was handled and substantiates the steps that were taken in order to comply with business standards. Record keeping is the foundation on which compliance program should be built upon. Measures should be put in place to capture the documentation and events that takes place throughout transaction commencing from delivery and payment (Reed, 2010).

Record keeping conveys substantial information about the financial strength and current performance of an enterprise. Managers find organizational statements useful in making decisions. As managers develop operating plans, they think how those plans will affect the performance of the organization (Onaolapo, 2014).

According to Ikechukwu (1993) keeping records is crucial for the successful performance of a business. Records helps entrepreneur to develop accurate and timely financial reports that show the progress and current condition of the business. Accurate record of the business financial performance is a vehicle to monitor performance in specific areas.

Regarding accounting control procedures for small and medium enterprises Sathyamoorthi (2001) observed that it is important to have systems of control over all business activities that are well implemented to help ensure: protection of resources against waste and fraud, accuracy and reliability in accounting data and success in the evaluation of the performance of the business. Relying on professional accountant, small firms can get the competencies that they need (Curley, 2005).

In the context of SMEs, accounting information is important as it helps firms manage their short term problems in critical areas like costing, expenditure and cash flow by providing information to support monitoring and control (Mitchell, 2000). Thus financial reporting systems are necessary to ensure that SMEs economic resources are used effectively and efficiently in pursuit of its goals. It also follows that there is a particular need in growing SMEs for the skills of financial analysis which will allow financial

statements to be read and understood, whether they contain historical or forecast information (Mcmahon, 1995).

## **1.2 Research Problem**

A lot of emphases have been made on the protection of informal and small business sector in creating employment and generating income for majority of Kenyan people. Questions on SME's management of finances and book keeping practices continue to be asked. Earlier studies on SMEs reveal their predicaments and suggest solutions to the problems they face. Businei (2012) studied the factors influencing the use of accounting services by small and medium enterprises in Kenya. He found low levels of compliance with accounting legislation and low growth of SMEs.

Osongo (2010) investigated the use of accounting services by SMEs in Kisii. The results showed that bookkeeping practice in this region as not adequate and seriously affected financial performance.

Back (1978, 1981 & 1985) investigated the role of a practicing accountant in Queensland as an advisor of small firms. He concluded that small firms that seek the services of a qualified accountant have significantly less incidences of illiquidity, failure, business stagnation and lack of credit compared to those that don't.

Katwei (2009) conducted a study on the constraints faced by small scale enterprises in accessing formal financing and concluded that poor record keeping was a significant contributor of the challenges of SME financial access. Information available on comprehensiveness of financial practices adapted by SMEs is limited. The government has adopted strategies and made policy changes in an effort to streamline and promote small scale traders. The traders on the other hand, need to keep their records of accounts straight in order to determine their trend in performance with regard to industry, time, level of investment and applied strategies in business operations. Consequently the study sought to answer the question as to whether there is a relationship between the keeping of accounting records by small scale and medium size enterprises and their financial performance.

### **1.3 Objectives of the Study**

To establish whether a relationship exists between accounting records maintained by SMEs and their financial performance.

### **1.4 Value of the Study**

The finding of this research can assist in identifying the grey areas if any in the way SMEs keep their business records in order to offer relevant advice. It also can create an opportunity for SMEs to appreciate the role played by accountants in a business entity. The tax authority through this study can determine the extent of reliance of financial statements prepared from SMEs available records. Lenders can gain a general overview of the reliability of information made available from SMEs financial records. Finally this research established if SMEs financial performance is in any way linked to record keeping.

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

This chapter presents literature on relevant theories of accounting and performance as well as their application to SMEs. It discusses performance determinants and also presents empirical reviews related to area under study.

### **2.2 Theoretical Framework**

The basic motive behind any investment is to earn profit. It is among the goals of any enterprise to maximize shareholders wealth by employing relevant resources appropriately as shall be explained by theory of resources based view. Effectiveness of company managers and resources efficiency directly affects the development of the state in which a business operates. Positive financial performance results from decisions made in the course of business as articulated by decision usefulness theory (Decision Usefulness Approach 2009). According to accounting theory transactions data requires precise measurement and consistency in classification. Accounting systems are also needed to ensure that all transactions of an entity are entered (Schrader, 1962).

Watts and Zimmerman (1978) helped generate positive accounting literature which offers an explanation of accounting practice. The extent to which accounting choice affects the contracting parties' wealth depends on the relative magnitudes of the contracting costs. Positive Accounting Theory (PAT) has been referred an as important aspect in accounting practice.

#### **2.2.1 Decision Usefulness Theory**

Decision usefulness is an approach to the preparation of financial accounting information that emphasizes on theory of investor decision making in order to infer the nature and types of information that investors need (Decision Usefulness Approach 2009). It is an approach usually adopted to satisfy the information needs of primary users of the financial reports. Decision usefulness accounting theory emphasizes the recording of business transaction for the purpose of effective decision making in business. Decision

usefulness recognizes that usefulness is defined contingent upon the user. The nature of information and designated relevance is the primary standard to be used in selecting among accounting alternatives because it reduces “uncertainty about the actual state of affairs of concern to the user”. Revenue authorities’ in-charge of tax collection in a country and financiers of SMEs demand to inspect the records of accounts and financial statements in order to make informed decision. Accounting professionals retain the responsibility of determining which information provides the most utility to accounting users because users often are not competent to determine what information is most useful to them or at least not articulate in stating their needs.

According to Wild (2008) accounting is viewed as the measurement activity that provides financial reports in support of decision makers and their business decisions. Financial reporting is the communication of financial information useful for making investment, credit and other business decisions (Chiappetta, Show and Wild, 2009). Williams (2009) states that accounting research for the past four decades has focused heavily on the concept of decision usefulness which has become the agreed guide for judging the effectiveness of accounting and financial reporting.

### **2.2.2 Positive Accounting Theory (PAT)**

PAT is an expression of neoclassical economic theory. Fundamental to it is a belief in rational choice theory. In PAT, self-interest is the reason for the choice of accounting methods and techniques and policy decisions. In PAT the firm (organization, company, etc) is described in terms of collection of contracts – a nexus of contracts between managers, suppliers of capital and employees who must cooperate to maximize the wealth of the business owner. Wall and Zimmerman (1978) claimed that PAT sought to “explain the world in which we live”. As such it attempts to provide answers as to why certain accounting methods are chosen over others and why regulation of accounting was left in the hands of accounting professionals rather than direct government involvement. Watts (1995) claimed that PAT research was designed to explain (provide reasons for why accounting takes the form it does) and predict (how accounting changes across time and place). SMEs can therefore be able to keep books of accounts in a manner that is justified and based on the nature of their business.

### **2.2.3 Resource Based View**

Pearce and Robinson (2011) defined the Resource Based View (RBV) as a method of analyzing and identifying a firm's strategic advantage based on examining its distinct combination of assets, skills, capacities, and intangibles as an organization. This theory is concerned with internal firm specific factors and their effect on performance. It views the firm as a bundle of resources which are combined to create organizational capabilities which it can use to earn above average profitability (Grant 1991). Each firm develops competencies from these resources and when they are well developed, these become the source of the firm's competitive advantage. SMEs accounting systems, staffs' degree of qualification and organization of physical resources may have a bearing on their performance. Penrose (1959) explains the importance of unique bundles of resources that are controlled by a firm and crucial for its performance. Such resources include all tangible and intangible assets, capabilities, organizational processes, firm's attributes, information and knowledge controlled by a firm in order to improve efficiency and effectiveness that will lead to higher financial performance (Daft 1985). This theory helps in explaining performance variations.

### **2.3 Determinants of Financial Performance**

Performance can be defined as an approach determining the extent to which set objectives of an organization are achieved in a particular period of time. The objectives or goals can be in financial or non-financial terms. Performance may be determined by macro and micro-factors. According to Oliver (2000) macro-economic factors are those pertinent to a broad economy at the regional or national level and affect a large population rather than a few select individuals. Macro factors include GDP growth, inflation, unemployment, interest rates, exchange rate and level of competition. Micro factors include individual risk exposure, operating strategies and degree of management strategies.

According to Cooper (1992) factors which influence business performance are experience, education, occupation of parents, gender, race, age and entrepreneurial goals. Lerner and Hisrich (1997) conducted a study on Israel women entrepreneurs and found



that their performance was influenced by factors that he grouped in 5 perspectives: motivation and goals, social learning theory (entrepreneurial socialization), network affiliation (contacts and membership in organization); human capital (level of education and skills) and environmental influences (location, sector participation and social political variables).

Thibault, Wicock and Kanetkar (2002) attributes business performance to demographic variables and business factors such as amounts of financing, use of technology, age of business operating location, business structure and number of full time employees as important factors in examining performance of a small scale business.

A company financial performance is directly influenced by its market position. Profitability can be split into its main components; net turnover and net profit margin. Ross, Westerfield and Jatte (1996) argue that both components influence profitability. High turnover means better use of assets owned by the company and therefore better efficiency while a higher profit margin means that the entity has a substantial market power.

Risk and growth influences a firm's financial performance. Since market value is conditioned by company's results, the level of risk exposure can cause changes in its market value. High risk business should have high returns. Economic growth helps a firm to achieve a better position on the financial markets, because market value also takes into consideration expected future profits.

According to reputation perspective, an organizations communication with external parties about its levels of corporate social responsibility may help build a positive image with customers, investors, bankers and suppliers for better business performance (Fombrun and Shanley, 1990).

Technical and strategic human resource management is an important determinant of a firm's performance. It involves designing and implementing a set of internally consistent policies and practices that ensures a firm's human capital (employees' collective knowledge, skills and abilities) contributes to its business objectives (Mark and Susan, 1997).

According to Costea (2011) another factor that influences financial performance is the size of the firm. Large firms have easier access to resources but SMEs have to struggle to win the trust of financial institutions.

## **2.4 Empirical Review**

### **2.4.1 International Studies**

Karunananda and Jayamaha (2011) researched on the financial practices among small & medium enterprises (SMEs) in Sri – Lanka and their impact upon business performance. A total of 100 firms were used to determine the extent of their compliance to five identified reporting practice. Data was collected through structured questionnaires. In their research an attempt was made to ascertain the comprehensiveness of financial practices of SMEs. In their review they considered the SMEs financial systems, financial audits, historical and future oriented financial reporting practices and analysis of historical financial statements .Through using correlation coefficients, they were able to establish that there exists a significant connection between the comprehensiveness of financial practices adopted by SMEs and their performance. SMEs with appropriate financial systems were found to be performing better than those with inferior systems. Their findings revealed poor record keeping by SMEs, inefficient use of accounting information to support their financial decisions, low quality and unreliable financial data. They recommended that SMEs should engage proper financial practices for better performance. Sri Lanka recognizes the need to accelerate the growth of SMEs for sustainable development.

Amoako (2013) investigated the record keeping strategies utilized by SMES in Kumasi (Ghana). Data was based on responses to a structured questionnaire from 210 SMES in Kumasi that were conveniently selected. This was done on wide range of retail businesses including pharmaceuticals, hard wares, hotels, general merchants, printing and stationary enterprises, workshops (motor and furniture) amongst others. The questionnaire had three parts that covered business demographic profile, categorization of business that keep and those that do not keep proper records and finally categorization of responses based on reasons why a business maintains or do not maintain accounting records. Data was

analyzed through descriptive statistics. This study revealed that SMEs in Ghana do not keep proper records due to lack of necessary accounting knowledge and high cost of hiring accounting professionals. Application of financial information to support assessment of financial performance by SMEs in Ghana was found to be inefficient. He recommended accounting training programmes for SMEs in order to formalize their operations and to tell the state of affairs of their business. He also recommended that authorities design specific guidelines for SMEs accounting and provision of templates for accounting practices by SMEs. This should be done in effort to simplify technicalities involved in maintaining accounting records.

Kurniawati (2013) carried a study on the impact of accounting information for business decision making and performance assessment of SMEs in Indonesia. A sample of seventy five SMEs was conveniently selected from Central Java, Indonesia. Data was gathered through interviews and questionnaires then analyzed through quantitative technique .The results showed that SMEs only kept records of cash inflows and outflows. However scanty records were kept to assist in decision making .She recommended that SMEs be motivated to keep accounting records.

Onaolapo (2014) investigated the effect of keeping accounting records on the performance of small scale enterprises in Oyo state in Nigeria. A combination of descriptive and cross sectional research design was used. He used a stratified method of sampling and had 113 respondents in his sample who were then grouped on the basis of type of their business. Data was collected through personal interview and questionnaires and then analyzed through descriptive statistics. The independent variables incorporated in his model showed that 86% of an enterprise's performance depended on accounting records. His findings revealed that majority of respondents did not keep comprehensive accounting records. However these enterprises measured their profitability vaguely but lacked budgets and failed to prepare annual financial statements. He recommended that owners and managers of small scale enterprises should embrace proper accounting practices in record keeping for effective financial performance.

### **2.4.2 Local Studies**

Okwena (2011) assessed the effects of proper book keeping practices on financial performance of SMEs in Kisii Municipality. His study employed a cross-sectional survey research design. The target population consisted of 3528 owners/managers of SMEs. Stratified and simple random sampling techniques were used in the study to select a sample of 97 SMEs. Structured questionnaire were used to collect quantitative data from the primary sources. Descriptive statistics such as frequency distribution and percentages were used to facilitate the change of raw data into a form that is easy to understand and interpret. Pearson correlation coefficient and simple linear regression model were used to analyze quantitative data.

He found that about 63.9% of SMEs in Kisii practice single entry book keeping. Pearson correlation analysis showed that financial performance has a very strong positive relationship to effective book keeping at a coefficient of 0.944. He however found little knowledge of book keeping among SMEs and this highly contributed to SMEs failure. He recommended for sensitization programmes to equip SMEs owners with book keeping knowledge

Muchira (2012) investigated the relationship between record keeping and growth of micro and small enterprises in Thika Municipality. The study used an exploratory approach and the target population included owners and managers of micro and small enterprises in Thika Municipality. The sample was purposively selected and data was collected through questionnaires. Quantitative and qualitative techniques were used to obtain required data from a sample of eighty four selected micro and small enterprises. This study revealed that most micro and small enterprises do not keep complete accounting records and as a result, there is insufficient accounting information to support firms' performance. She recommended training programs for entrepreneurs and suggested that record keeping be made mandatory to improve the survival chances of micro and small enterprises.

Waweru (2012) investigated the challenges of financial management that affect performance of SMEs. A descriptive research design on a target population of six

hundred SMEs in Nairobi Central Business District was used. A sample was selected by simple random method from a stratified population. Questionnaires were used to collect required data. Data was then analyzed using descriptive statistics to establish the correlation between the variables. According to this study, SMEs in Nairobi Central Business District keep accounting records and prepare simple financial statements. She however recommended training for SMEs and integration of information technology in keeping of accounting records.

Muiru (2013), researched on the influence of innovativeness on the growth of SMEs in Kenya. He adopted descriptive survey in his research. The study targeted 4560 SMEs in Nairobi County who were registered by the ministry by the year 2013. A sample of 456 respondents was randomly selected. Data was collected from the primary source by questionnaire and by interview. Analyses were done with the help of SSPS software program. A regression model was also developed and the results indicated that innovativeness influence the growth of SMEs in Kenya. The tendency by owner/manager to engage in and support new ideas, novelty, experimentation and creative processes results in new products, services or technological processes which has a great influence on the performance of SMEs. He recommended that managers should be time efficient and should use appropriate systems of control in management and provide a working schedule, set competitive prices and meet clients' costs.

Lesirma (2014) investigated the relationship between accounting functions and financial performance of SACCOs in Nairobi County. Nairobi County has twenty six deposit taking SACCOs out of the total ninety six that are registered with Sacco Societies Regulatory Authority (SASRA) in the country. The target population was the twenty six deposit taking SACCOs in Nairobi. The study was based on both primary and secondary data. Questionnaires were used as data collection instrument and analyses were done using both qualitative and quantitative techniques. A regression model was used to establish the relationship between accounting functions and performance .The study found a positive relationship between return on assets and budgeting, balance sheet review, working capital management and credit management functions of accounting. The study however found that a negative relationship exists between return on assets and

all the accounting functions under study. He recommended that managers of deposit taking SACCOs in Nairobi need to review their emphasis on expenditures in strengthening accounting functions since they do not influence financial performance of SACCO's significantly.

## **2.5 Summary of Literature Review**

Financial statements are most meaningful if they reflect the true position of a business. These statements are a reference to the owners of the business and other third parties provided they are not manipulated towards impressing a targeted person or group. Above reviews indicates that most SMEs keep records of accounts but incomprehensively. The question that lingers is how reliable are such statements to users who may base their decisions on them. Adopting an appropriate accounting system and in-depth scrutiny by users of financial statements may compel SMEs owners to be more thorough in keeping of accounting records. This study shall look into accounting systems adopted by SMEs in recording keeping and their influence on performance.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

This chapter outlines the research methodology that was used to carry out the study. It includes the research design, study population targeted, sampling technique used, data collection procedures, analyses and presentation methods.

### **3.2 Research Design**

Research design is a conceptual framework within which research is conducted. A descriptive research design was used in this study. The object of descriptive research was to portray an accurate profile of persons, events or situations' (Sauders, Lewis and Thornhill, 2007). Descriptive research design gave a description of phenomenon's characteristics and association of variables, in this case, the relationship between accounting systems, record keeping and financial performance. Descriptive research was appropriate since it enabled high level of analysis such as correlation and regression analysis between the variables and reduces data to a manageable form. Accounting records kept were the independent variables and were measured by presence and use of cashbooks, purchases and sales ledgers, revenue and expenditure accounts and statements of income within the SMEs. The dependent variable was financial performance and was represented by Return on Equity (ROE).

### **3.3 Population**

According to Sekaran and Boungie (2010), population refers to the entire group of people, events or things of interest on which the researcher wishes to investigate. The population can have the observable characteristics from which the researcher intends to draw generalizations. There were an estimated 50,000 registered SMEs in Nairobi County of which an estimated 19,000 were in the Central Business District (Nairobi City Council, 2014). This made a target population of 19,000 SMEs in Nairobi Central Business District.

### 3.4 Sample Design

A research sample is a group of cases, participants, events, or records consisting of a portion of the target population, carefully selected to represent the population, while sampling is the process of selecting individuals for a study (Cooper and schindler, 2003).

According to Israel (1992), a sample size can be determined by a scientific formula when the population is large or more than 10000. The sample size is then determined scientifically by the formula:

$$n=N/(1+Ne^2)$$

Where

n= desired sample size for the study area

N= total no. of house-holds in the study area

e= desired margin error

Source: (Israel, 1992)

A margin error of 0.05 is selected since it is logistically difficult to deal with a larger sample size (Mugenda et al., 2003)

$$\text{Thus } n=19,000 / (1+19,000*0.05^2)$$

$$n=391$$

A sample of 391 SMEs was drawn from the population of the study.

The study used major streets in Nairobi Central Business District (CBD) to group the town into blocks for the purposes of the study. The study therefore sampled 10 blocks in Nairobi Central Business District (CBD) namely Kimathi street, Moi avenue, Biashara street, Konange street, Kenyatta avenue, Harambee avenue, Mama Ngina street, Haile Selassie avenue, Muindi Mbingu street and Tom Mboya street.



Systematic sampling technique was used to sample SMEs from each block. Systematic sampling is a method of polling that separates the population into groups with commonalities and then polls members of each group. As a result of separating the groups it is then possible to obtain a more accurate poll and to identify specific target groups (Babbie, 2001). The researcher sampled every Tenth SME that was found in each block until the sample size of 39 SMEs was reached in each block. The researcher used the same sampling techniques in the 10 blocks which made a total sample size of 391 SMEs in Nairobi Central Business District (CBD).

### **3.5 Data Collection**

Primary data was collected from owners/ managers of the SMEs. Data required was quantitative and qualitative in nature. A structured questionnaire was used for data collection and a short interview in order to get direct and true picture of the SMEs selected and to help overcome any bias.

### **3.6 Validity and Reliability**

The accuracy of data largely depends on the data collection instruments (Mugenda and Mugenda 2003). Validity is the degree to which results obtained from analysis of data actually represents the phenomenon under study (Robinson, 2002). Reliability is the measure of the degree to which research instruments yields consistent results after every repeated trial. Validity and reliability were ensured by pre-testing the sample to establish the reliability of coefficients. The information from sample selected was tested for accuracy and comparisons were made to conventional record keeping.

### **3.7 Data Analysis**

Simple descriptive statistics was used in the analysis of data. According to Borg (1996), the commonly used methods in reporting descriptive surveys include frequency distributions, calculating the percentages and tabulating them appropriately.

The data collected was coded, classified and systematically analysed. Descriptive statistics such as mean, mode, standard deviation and frequency distribution were used to

analyze the data. Data was coded and entered into the Statistical Package for Social Sciences (SPSS) for analysis. Mugenda et al (2003) asserts that it is advisable to use computer for any kind of data analysis in order to save time and increase the accuracy of the results. Data presentation was done by the use of pie charts, bar graphs, percentages and frequency tables.

Regression analysis was also used to determine the relationship between variables (the dependent and independent variables). The dependent variable were maintenance and preparation of purchases and sales ledgers, cashbook, revenue and expenditure accounts and statements of income within SMEs while the dependent variable was financial performance measured by return on equity. Likert scale questions were computed to determine means for all the variables and then regression analysis was done. The algebraic expression of the regression model which consists of the constant term coefficient and error term took the format below;

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + e$$

Where

Y= Financial performance measured by Return on Equity

$\alpha$  = Constant term

$\beta_{1-5}$  = Beta coefficients

$X_1$  = Purchases and sales ledgers

$X_2$  = Cashbook

$X_3$  = Revenue and expenditure accounts

$X_4$  = Statements of income

$X_5$  = Balance sheet

e= Error term

## CHAPTER FOUR: DATA ANALYSIS, FINDINGS AND DISCUSSION

### 4.1 Introduction

This chapter is organized as follows: the first section provides a detailed analysis of the influence of accounting records on the financial performance of SMEs in Nairobi County. Further, the relationship between the various variables and financial performance of SMEs are discussed. Descriptive and inferential statistics have been used to discuss the findings of the study.

### 4.2 Response Rate

The study sought to gather information from individuals working on selected SMEs in Nairobi Central Business District (CBD). A total of 391 questionnaires were distributed to selected SMEs and 313 were collected having been filled completely. This made a response rate of 80% which was sufficient for data analysis. According to Mugenda and Mugenda (1999) this response rate was excellent since a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent.

**Table 4.1: Response Rate**

	<b>Frequency</b>	<b>Percentage</b>
Responded	313	80%
Not Responded	78	20%
<b>Total</b>	<b>391</b>	<b>100%</b>

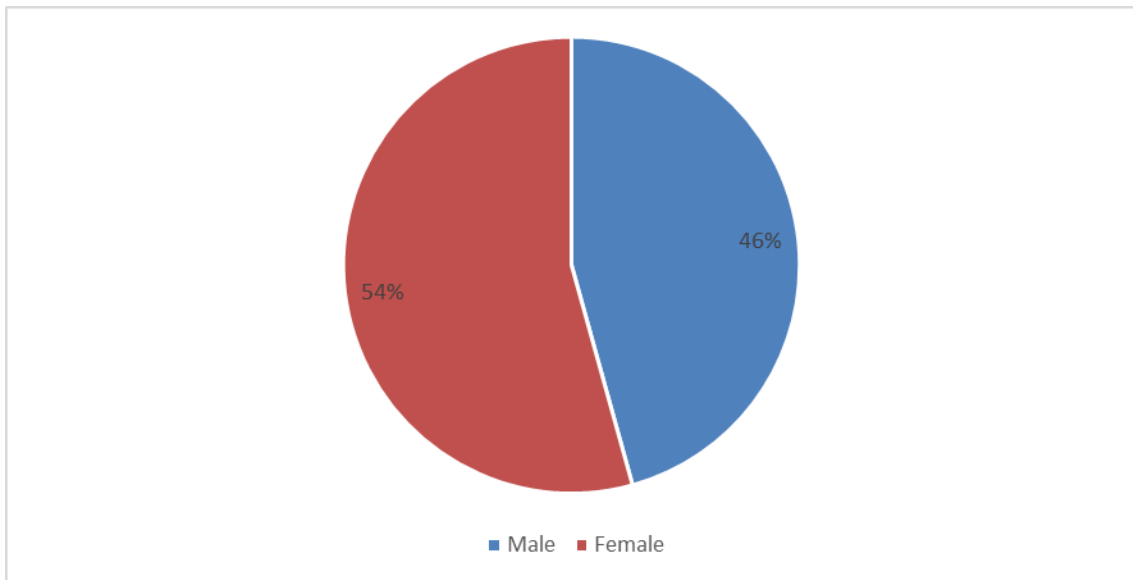
### 4.3 General Information

The study sought to find out the general characteristics of the respondents that included their gender, level of education and age bracket.

#### 4.3.1 Gender of the Respondents

The study sought to find out the gender of the respondents. The findings are shown in Figure 4.1.

**Figure 4.1: Gender of the Respondents**

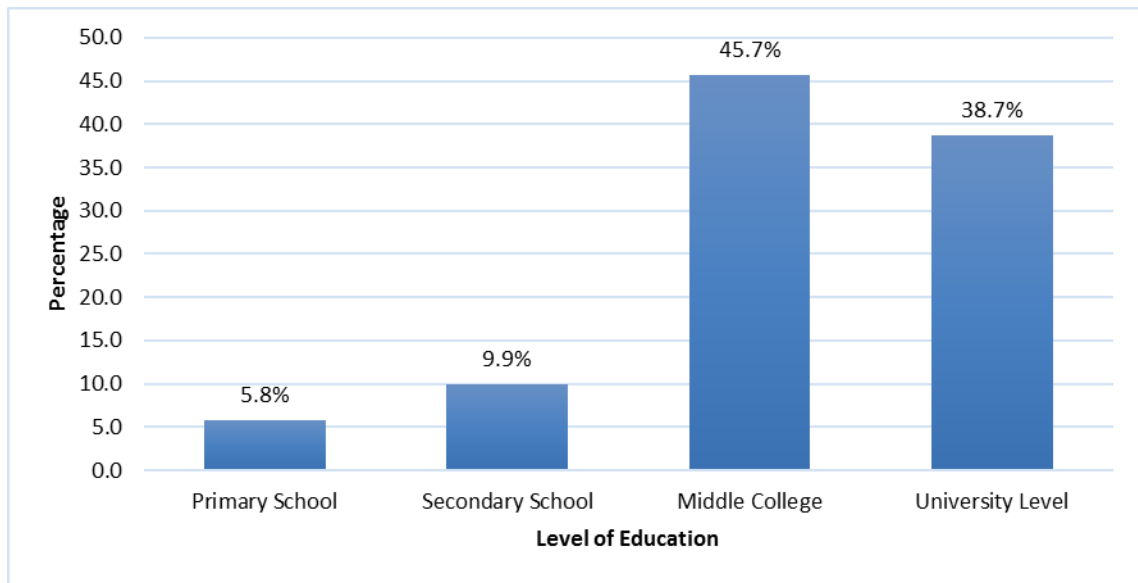


The findings indicate that 54% of the respondents were male while 46% of the respondents were female. This indicates the number of males involved in filling the questionnaires for the study was higher than that of females.

### 4.3.2 Level of Education

The study sought to find out the level of education of the respondents. The findings are shown in Figure 4.2.

**Figure 4.2: Level of Education**

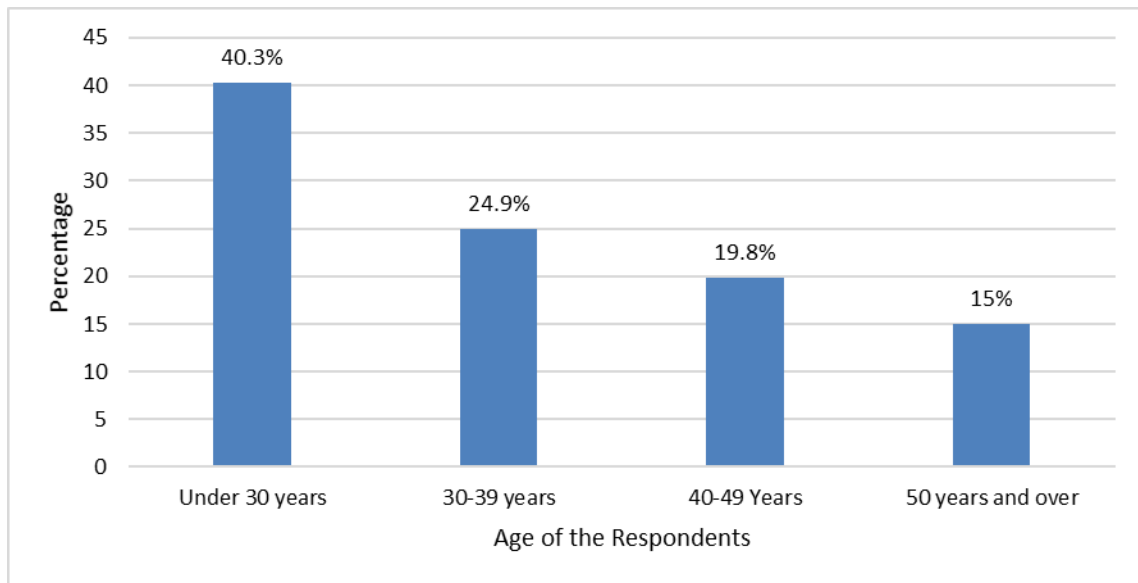


From the findings, majority of the respondents (45.7%) had middle college education, 38.7% had university level education, and 9.9% had secondary education while 5.8% had primary education. In view of the above, the study concludes that most of the SMEs were in a position to make informed choices in regard to the questions posed in the questionnaire.

### 4.3.3 Age of the Respondents

The study sought to find out the age of the respondents. The findings are shown in figure 4.3.

**Figure 4.3: Age of the Respondents**



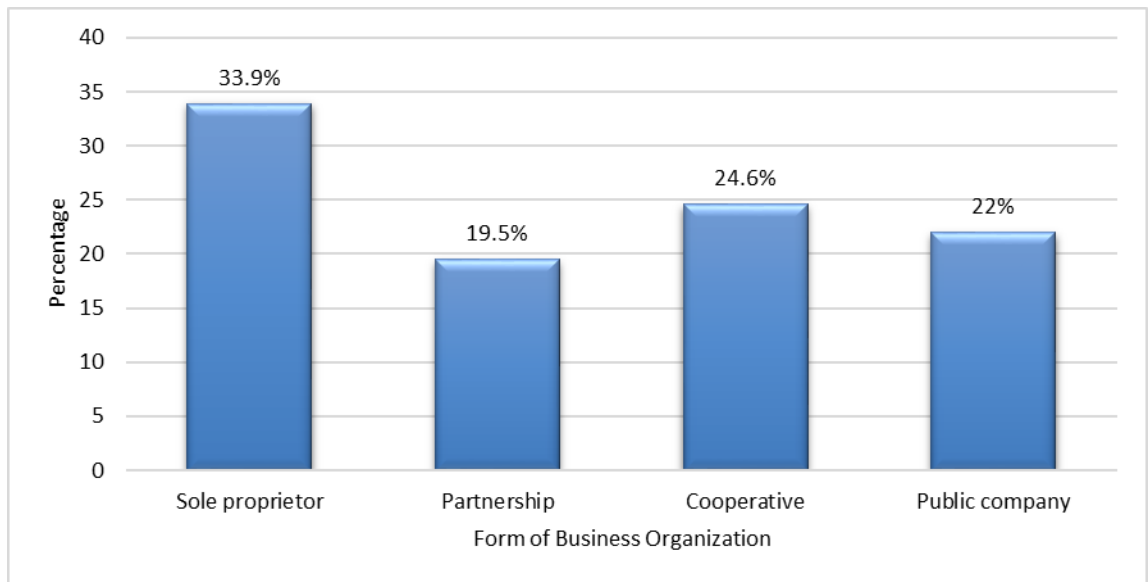
The findings indicate that 40.3% of the respondents were aged under 30 years, 24.9% were aged 30-39 years, 19.8% were aged 40-49 years, while 15% were aged 50 years and above. These results therefore show that a large number of individuals under the age of 30 years managed most SMEs in Nairobi County.

## 4.4 Information about the Enterprise

### 4.4.1 Form of Business Organization

The respondents were requested to provide information about the form of their business organization. The results are shown in figure 4.4.

**Figure 4.4: Form of Business Organization**

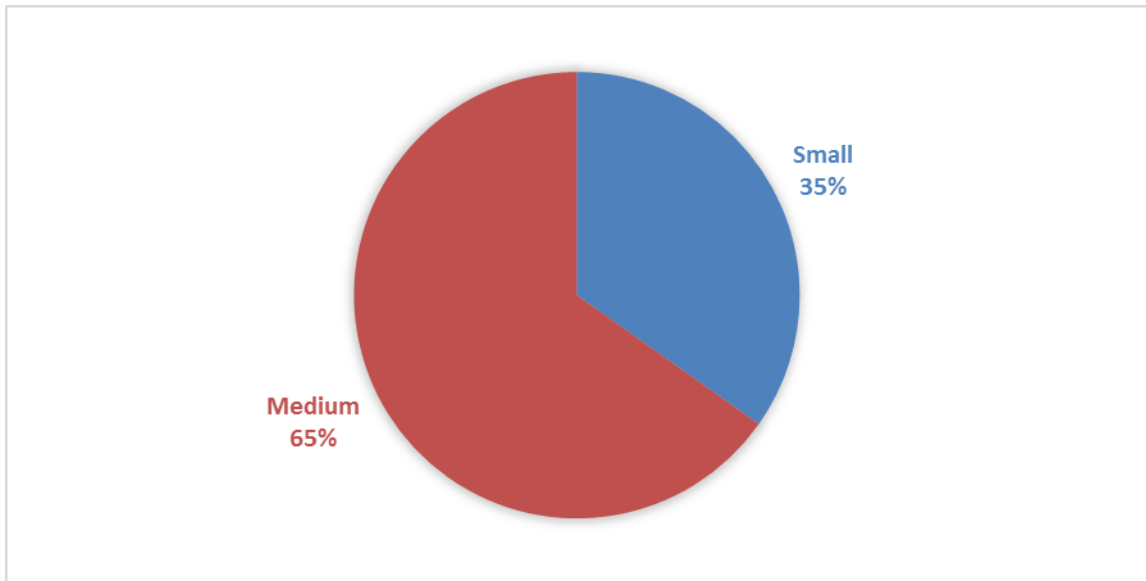


As shown in figure 4.4, majority of the respondents (33.9%) indicated sole proprietor as their form of business organization, 24.6% of the respondents indicated cooperative as their form of business organization and 22% of the respondents indicated public company as their form of business organization while 19.5% of the respondents indicated partnership as their form of business organization. From the study data most of the respondents in the selected SMEs in Nairobi County were operating as sole proprietors.

#### 4.4.2 Classification of the Business

The questionnaire asked the respondents to indicate classification of their business. The responses are illustrated in figure 4.5.

**Figure 4.5: Classification of the Business**



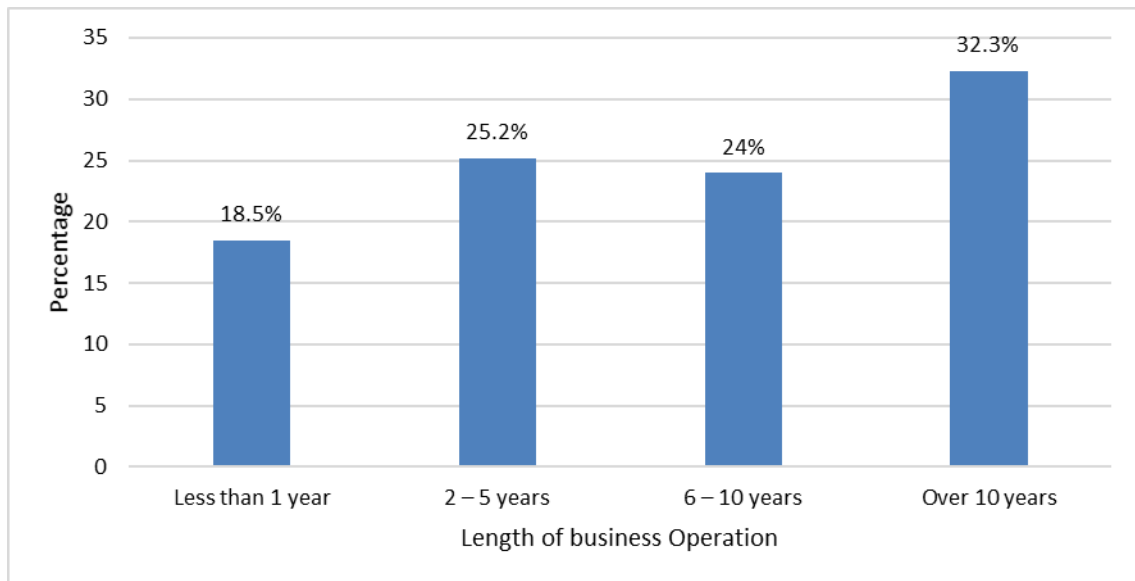
From the findings, most of the respondents (65%) were medium sized enterprises while 35% of the respondents were small enterprises. The findings therefore show that medium scale enterprises have a large percentage in Nairobi County.



### 4.4.3 Length of Business Operation

The study sought to find out how long the business had operated. The results are presented in figure 4.6 below.

**Figure 4.6: Length of Business Operation**

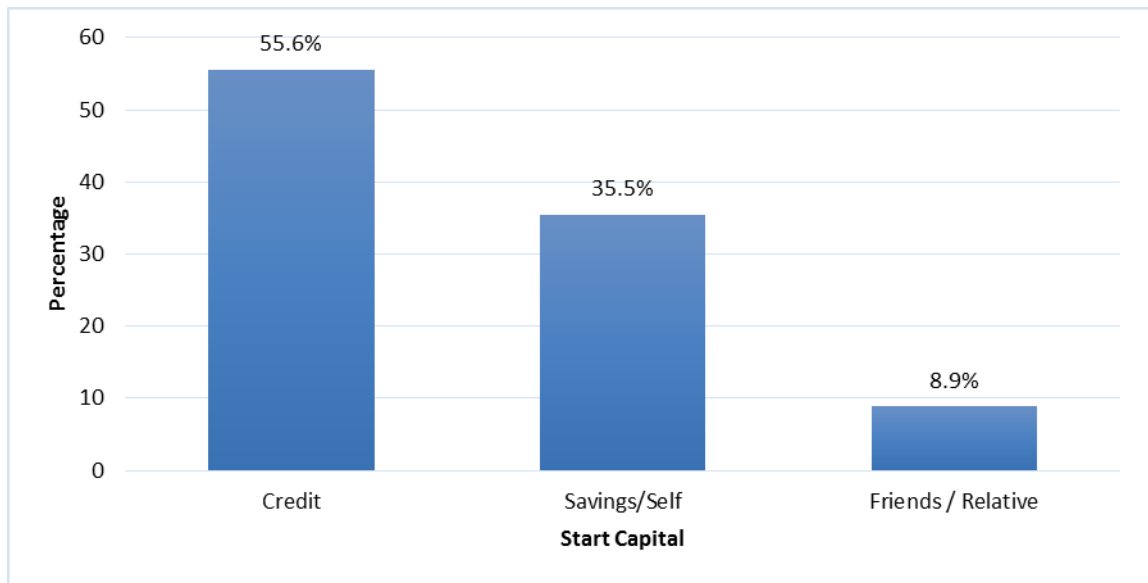


From the findings, majority of the businesses (32.3%) had been in business for over 10 years, 25.2% had been in business for between 2 to 5 years, 24% had been in business for 6-10 years while 18.5% had been in business for less than 1 year. Based on the study results, the SMEs had the desired experience to furnish the study with information on the accounting records maintained by SMEs and their financial performance.

#### 4.4.4 Start Capital

The study further asked the respondents to indicate how they funded their initial capital to start business. Figure 4.7 indicates the responses.

**Figure 4.7: Start Capital**



From the findings, most respondents (55.6%) and (35.5%) identified credit and savings/self as the source of starting capital respectively. A small percentage of the respondents (8.9%) identified friends/relative as the source of starting capital for their business. The findings therefore show that SMEs in Nairobi County started their business with credit as their source of starting capital.

#### 4.4.5 Record Keeping

The study asked the respondents to state if they kept records of their business transactions. From the findings, all the respondents (100%) indicated that they keep records of their business transactions. This finding shows that most SMEs in Nairobi County keep the records of their businesses.

A vast majority of small scale businesses cannot afford the complexity of a detailed accounting system, hence the existence of single entries in their books and in some cases

incomplete records (Wood, 1979). Most SMEs prefer record books which are simple to use, easy to understand, reliable, accurate consistent and designed to provide information on a timely basis.

#### **4.5 Information on Purchases and Sales Ledgers**

##### **4.5.1 Purchases and Sales Control Ledger**

The study asked the respondents to indicate if they keep purchases and sales control ledger. All the respondents (100%) indicated that they keep purchases and sales control ledger. The findings show that all small enterprises in Nairobi County keep purchases and sales control records due to their effectiveness in SMEs' management of short term problems in critical areas like costing, expenditure and cash flow by providing information to support monitoring and control.

##### **4.5.2 Statements on Purchases and Sales Control Ledger**

The study asked the respondents to state the extent to which they agree with the following statements relating to purchases and sales control ledgers. The responses were rated on a five point Likert scale where: 5= strongly agree; 4= Agree; 3= neutral 2= Disagree 1= strongly disagree. The mean and standard deviations were bred from SPSS and are indicated in the table below.

**Table 4.2: Statements on Purchases and Sales Control Ledger**

<b>Statements on Purchases and Sales Control Ledger</b>	<b>Mean</b>	<b>Std. Deviation</b>
Purchases ledger shows all the liabilities of the business	2.92	0.751
Purchases ledger shows all purchases returns of the business	3.65	0.776
Sales ledger shows all the receivables of the business	3.52	0.881
Sales ledger shows all returns to the business	3.60	0.939

The findings in Table 4.2 show that majority of the respondents neutrally agreed with the statements that purchases ledger shows all purchases returns of the business, sales ledger shows all returns to the business and sales ledger shows all the receivables of the business with mean scores of 3.62, 3.60 and 3.52 respectively. However, some of the respondents disagreed with the statement that purchases ledger shows all the liabilities of the business with a mean score of 2.92. The findings therefore insinuate that most SMEs neutrally agree that purchases ledger shows all purchases returns of the business, sales ledger shows all returns to the business and sales ledger shows all the receivables of the business.

#### **4.6 Information on Cashbook**

##### **4.6.1 Cash Book Ownership**

The respondents were requested to indicate whether they had cash books. From the findings, all the respondents (100%) indicated that they have cash books. The findings therefore indicate that all SMEs have cash books that can help in providing evidence of how the transaction is handled thus substantiating financial performance.

##### **4.6.2 Statements on Cash Book**

The study also asked the respondents to state their level of agreement with the following statements about cash book in the business. The responses were rated on a five point Likert scale where: 5= strongly agree; 4= Agree; 3= neutral 2= Disagree 1= strongly disagree. The mean and standard deviations were bred from SPSS and are indicated in the table below.

**Table 4.3: Statements on Cash Book**

<b>Statements on Cash Book</b>	<b>Mea n</b>	<b>Std. Deviation</b>
Only valid cash payments are made	3.84	0.832
All cash payments that occurred are recorded	2.91	0.965
Cash payments are correctly recorded in the ledger	3.54	0.816
Cash payments posted to correct payable accounts and to the general ledger	4.27	0.445
Cash payments are recorded in the correct accounting period	4.08	0.864
Cash payments are charged to the correct accounts	3.56	1.300

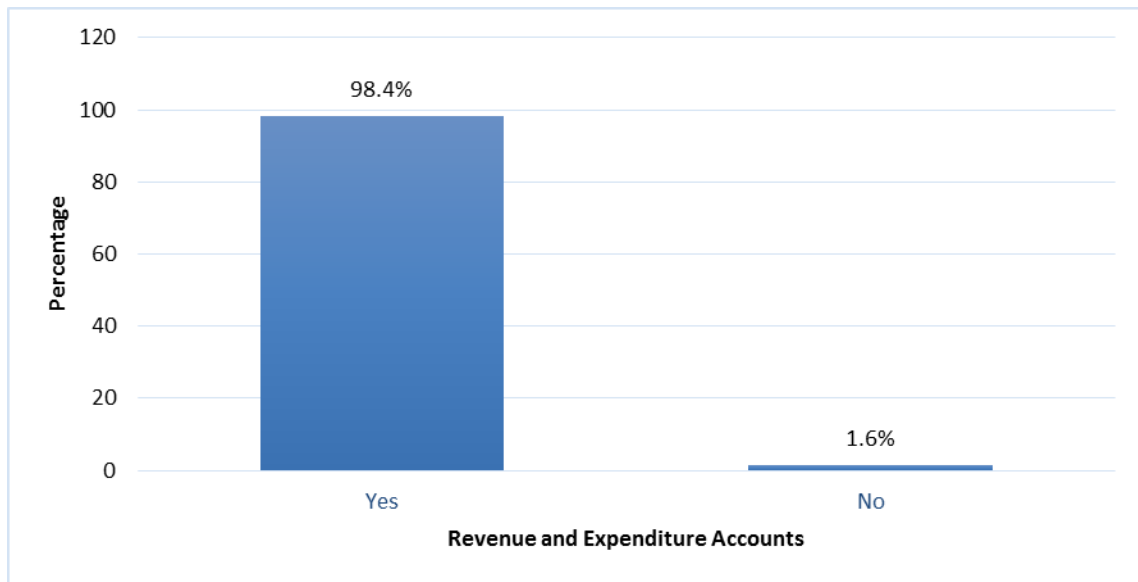
From the findings, majority of the respondents were in agreement with the statements that cash payments posted to correct payable accounts and to the general ledger and cash payments are recorded in the correct accounting period with mean scores of 4.27 and 4.08 respectively. Some respondents neutrally agreed with the statements that only valid cash payments are made, cash payments are charged to the correct accounts and cash payments are correctly recorded in the ledger with mean scores of 3.84, 3.56 and 3.54 respectively. However, some of the respondents disagreed with the statement that all cash payments that occurred are recorded with a mean score of 2.91. The findings shows that cash payments posted to correct payable accounts and to the general ledger and cash payments are recorded in the correct accounting period.

## 4.7 Information on Revenue and Expenditure Accounts

### 4.7.1 Revenue and Expenditure Accounts

The study requested the respondents to indicate whether they keep revenue and expenditure accounts. The findings are indicated in figure 4.8.

**Figure 4.8: Revenue and Expenditure Accounts**



From the findings, a large percentage of the respondents (98.4%) indicated that they keep revenue and expenditure accounts while 1.6% of the respondents indicated that they do not keep revenue and expenditure accounts. From these findings, it is clear that most SMEs keep revenues and expenditure accounts.

#### 4.7.2 Statements on Business Revenue and Expenditure Accounts

Furthermore, the study requested the respondents to state their level of agreement with the following statements about their business revenue and expenditure accounts. The responses were rated on a five point Likert scale where: 5= strongly agree; 4= Agree; 3= neutral 2= Disagree 1= strongly disagree. The mean and standard deviations were bred from SPSS and are indicated in the table 4.4.

**Table 4.4: Business Revenue and Expenditure Accounts**

<b>Business Revenue and Expenditure Accounts</b>	<b>Mean</b>	<b>Std. Deviation</b>
All revenues are recorded in this account	3.06	1.305
All expenditures are recorded in this accounts	3.19	1.030

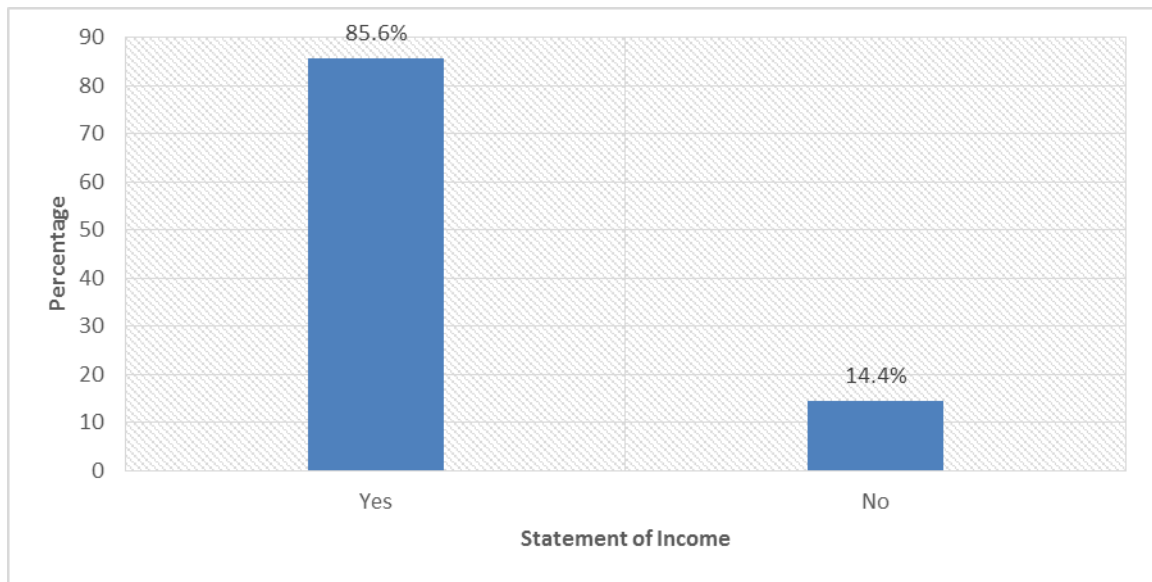
From the findings, most of the respondents neutrally agreed that all expenditures and all revenues are recorded in this account with mean scores of 3.19 and 3.06. From these findings, most SMEs neutrally agreed that all expenditures and all revenues are recorded in this account.

## 4.8 Information on Statement of Income

### 4.8.1 Statement of Income Preparation

The study sought to find out whether the respondents prepare statement of income. The findings are shown in figure 4.9.

**Figure 4.9: Preparation of Statement of Income**



From the findings, majority of the respondents (85.6%) indicated that they prepare statement of income while 14.4% of the respondents stated that they do not prepare statement of income. The findings illustrate that most SMEs prepare their statement of income.



#### 4.8.2 Agreement on Statement of income

Furthermore, the study requested the respondents to state their level of agreement with the following statements about their statement of income. The responses were rated on a five point Likert scale where: 5= strongly agree; 4= Agree; 3= neutral 2= Disagree 1= strongly disagree. The mean and standard deviations are indicated in the table 4.5.

**Table 4.5: Agreement on Statement of income**

<b>Statement of income</b>	<b>Mean</b>	<b>Std. Deviation</b>
Statement of income is prepared regularly	3.04	1.188
All revenues are presented in the statement of income	3.05	0.920
All expenditures are presented in the statement of income	4.11	0.975
Earnings per share is complete and presented on the statement of income	3.03	0.681
Profit margin is regularly computed.	2.32	0.556

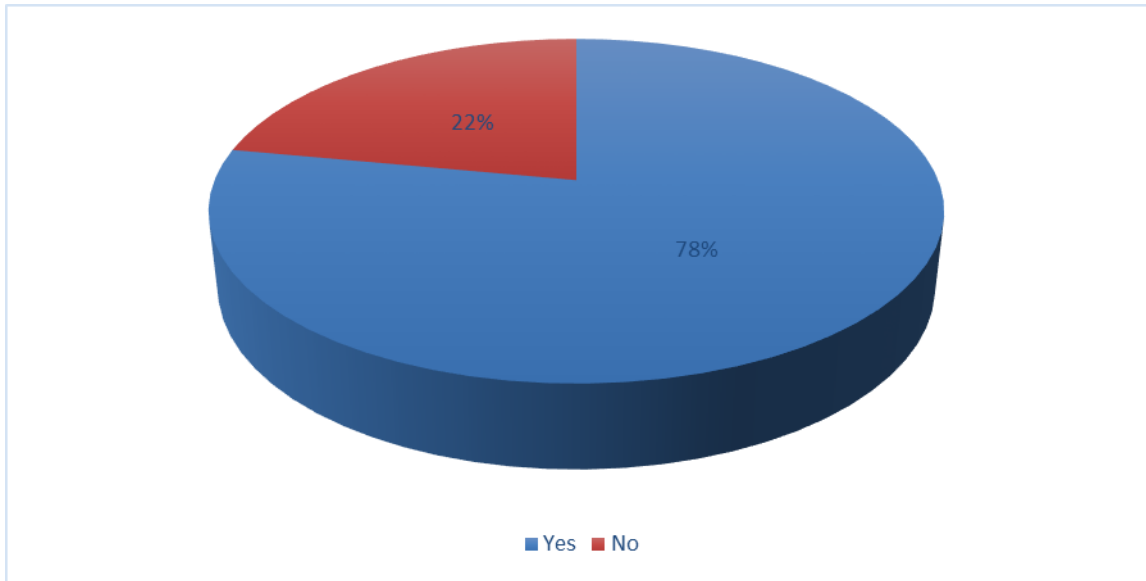
From the findings, majority of the respondents were in agreement with the statement that all expenditures are presented in the statement of income with a mean of 4.11. Some respondents were neutral with the statements that all revenues are presented in the statement of income, statement of income is prepared regularly and earnings per share is calculated and presented on the statement of income with mean scores of 3.05, 3.04 and 3.03 respectively. However, some respondents disagreed with the statement that profit margin is regularly computed with a mean score of 2.32. The findings therefore suggest that majority of SMEs in Nairobi County were in agreement with the statement that all expenditures are presented in the statement of income.

## 4.9 Information on Balance Sheet

### 4.9.1 Balance Sheet Preparation

The study requested the respondents to indicate whether they prepare balance sheets. The findings are indicated in figure 4.10.

**Figure 4.10: Preparation of Balance Sheet**



From the findings, majority of the respondents (78%) stated that they prepare balance sheets while 22% of the respondents indicated that they do not prepare balance sheets. The findings therefore show that a large number of SMEs prepare balance sheets.

#### 4.9.2 Statements about the Balance Sheet

The study requested the respondents to state their level of agreement with the following statements about the balance Sheet. The responses were rated on a five point Likert scale where: 5= strongly agree; 4= Agree; 3= neutral 2= Disagree 1= strongly disagree. The mean and standard deviations were bred from SPSS and are indicated in the table 4.6.

**Table 4.6: Statements about the Balance Sheet**

<b>Balance Sheet</b>	<b>Mean</b>	<b>Std. Deviation</b>
All fixed assets are presented at net in the balance	3.55	1.109
All current assets are presented in the balance sheet	3.16	0.771
All short term liabilities are captured in the balance sheet	3.22	0.785
All long term liabilities are computed and presented in the balance sheet	2.53	1.041

From the findings, most of the respondents neutrally agreed with the statements that all fixed assets are presented at net in the balance sheet, all short term liabilities and all current assets are presented in the balance sheet with mean scores of 3.55, 3.22 and 3.16 respectively. Some respondents disagreed with the statement that all long term liabilities are computed and presented in the balance sheet with a mean score of 2.53. From the above findings, most SMEs in Nairobi County neutrally agreed that all fixed assets are presented at net in the balance sheet, all short term liabilities are captured in the balance sheet and all current assets are presented in the balance sheet.

## 4.10 Inferential Statistics

### 4.10.1 Correlation Analysis

Pearson correlation coefficient was used to examine correlation between purchases and sales ledgers, cashbook, revenue and expenditure accounts, statements of income and balance sheet and their effect on the financial performance measured by return on equity in Nairobi County. The analysis is shown in the table below.

**Table 4.7: Correlation Analysis**

	Purchases And Sales Ledgers	Cashbook	Revenue And Expenditure Accounts	Statements Of Income	Balance Sheet
<b>Purchases and sales ledgers</b>	1				
<b>Cashbook</b>	0.311	1			
<b>Revenue and expenditure accounts</b>	0.341	0.100	1		
<b>Statements of income</b>	0.24	0.305	0.105	1	
<b>Balance Sheet</b>	.044	.201	.104	.301	1

According to findings in table 4.7, there was a strong positive relationship between revenue and expenditure accounts and purchases and sales ledgers having a correlation coefficient of 0.341. This implies that revenue and expenditure accounts play a major role in purchases and ledger accounts in that for purchases and ledger accounts to be effective,

revenue and expenditure accounts must be well prepared to limit chances of negative financial performance of SMEs in Nairobi county.

The results revealed that cashbook is strongly related to purchases and sales ledgers with a correlation coefficient of 0.311. This implies that effective preparation of cashbooks influences purchases and sales ledgers keeping.

Furthermore, there was a positive relationship between statements of income and cashbooks with a correlation coefficient of 0.305. This result indicates that better preparation and keeping of statements of income lead to better preparation of cashbooks since in the context of SMEs, statements of income is important in solving problems in critical areas like cashbooks, expenditure and cash flow by providing information to support monitoring and control.

The results further indicated that there was a positive relationship between statement of income and balance sheet with a correlation coefficient of 0.301. These results suggested that better preparation of income statement result to effective preparation of balance sheets

#### **4.10.2 Regression Analysis**

Regression model was used during the study to test the magnitude to which purchases and sales ledgers, cashbook, revenue and expenditure accounts, statements of income and balance sheet influence financial performance of SMEs in Nairobi County, Kenya. The table below presents the results of the regression models.

**Table 4.8: Regression Model Summary**

<b>Model</b>	<b>R</b>	<b>R Square</b>	<b>Adjusted R Square</b>	<b>Std. Error of the Estimate</b>
1	0.777(a)	0.604	0.369	5.234

a Predictors: (Constant), Financial performance measured by Return on Equity

The results from the table above designated that a combination of purchases and sales ledgers, cashbook, revenue and expenditure accounts, statements of income and balance sheet had 60.4% (R square= 0.604) predictive likelihood of financial performance measured by return on equity.  $R^2=60.4\%$  means that the predicator variable explains 60.4% of the variation in financial performance measured by return on equity which was attributed to purchases and sales ledgers, cashbook, revenue and expenditure accounts, statements of income and balance sheet. From the findings, 39.6% of the variance is unexplained.

**Table 4.9: Analysis of Variance (ANOVA)**

<b>Model</b>		<b>Sum of Squares</b>	<b>df</b>	<b>Mean Square</b>	<b>F</b>	<b>Sig.</b>
1	Regression	9.887	50	2.187	3.174	.000b
	Residual	80.987	263	1.114		
	Total	90.874	313			

a) Dependent Variable: Financial performance measured by Return on Equity

b) Predictors: (Constant) Purchases and Sales Ledgers, Cashbook, Revenue ar Expenditure Accounts, Statements of Income and Balance Sheet.

The P value in the study is less than 5% level of significance as indicated by sign < 000. Therefore, the study model accounts significantly more variance in financial performance measured by return on equity than would be expected by chance. The study has established variables of purchases and sales ledgers, cashbook, revenue and expenditure accounts, statements of income and balance sheet as factors that influence financial performance in Nairobi County. Significance of the study means that the regression model was also significant and therefore fit for the study.

The coefficients of the regression model are illustrated in the table below.

**Table 4.10: Regression Model Coefficients**

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.287	.014		0.187	.000 <sup>a</sup>
	X <sub>1</sub>	.214	.211	.255	1.117	0.002
	X <sub>2</sub>	.367	.413	.188	1.987	0.004
	X <sub>3</sub>	.345	.222	.077	1.134	0.001
	X <sub>4</sub>	.266	.002	.232	1.647	0.000
	X <sub>5</sub>	.311				

a Dependent Variable: Financial performance measured by return on equity

The regression equation is:

$$Y=0.287+0.214X_1+0.367X_2+ 0.345X_3+ 0.266X_4+ 0.311X_5$$

The equation above inferred that financial performance was highly influenced by better preparation and keeping of purchases and sales ledgers, cashbook, revenue and expenditure accounts, statements of income and balance sheet. Given all the predictor variables constant at zero (0), financial performance will be 0.287.

The regression coefficient for purchases and sales ledgers is 0.214. This means that the relationship between purchases and sales ledgers and financial performance is positive.

This implies that an improvement in keeping and preparation of purchases and sales ledgers can result to an improved financial performance and vice versa.

The regression coefficient for cash book is 0.367. This means that the relationship between cash book and financial performance is positive. This denotes that reliable and well equipped cash books influences financial performance and vice versa.

The regression coefficient for revenue and expenditure accounts is 0.345. This means that the relationship between revenue and expenditure accounts and financial performance is positive. This indicates that effective revenue and expenditure accounts in regard to easy of use result to an increase in financial performance of SMEs and vice versa.

The regression coefficient for statements of income is 0.266. This means that the relationship between statements of income and financial performance is positive. This infers that well-arranged statements of income are likely to significantly alter performance of SMEs, leading to an increase financial performance.

Finally, the regression coefficient for balance sheet is 0.311. This means that the relationship between balance sheet and financial performance is positive. This indicates that balance sheet positively influences financial performance.

#### **4.11 Discussion of Findings**

The study found that keeping of purchases and sales ledgers is strongly related to financial performance. It found that an improvement in keeping and preparing of purchases and sales ledgers can result to better financial performance. This coincides with Mukherji (2002) who argues that purchases and sales ledgers lead to changes in business environment that lead to an increasing number of information to be processed, generated and delivered. Thus, the critical part is the quality of information produced by the business itself which will be used in making business decisions. Purchases and sales ledgers provide a source of information to owners and managers of SMEs operating in any industry for use in the measurement of financial performance. For businesses with a sizeable number of transactions, it is impossible to scan the primary books or journal every time to know the exact position of any account. It is, therefore, very important to



maintain a ledger. In any sense, profit can analogously be viewed as the life-blood of a business and hence the accounting bases, concepts and principles adopted ought to capture and report all the relevant accounting information to ensure reliability in its measurement (Mukherji, 2002).

The study also found that cash book is strongly related to financial performance. It found that reliable and well equipped cash books influences financial performance. According to Sathyamoorthi (2001), it is extremely important to have the cash book to indicate what is happening in business as it helps in taking appropriate and timely action. Bookkeeping helps in maintaining and providing the latest financial position of the business and, therefore, assumes great significance. It is advisable to maintain books of accounts for the following reasons as well provide up-to-date information about the business.

The study also found that revenue and expenditure accounts and financial performance is strongly related. It found that revenue and expenditure accounts that were easy to use results to an increase in financial performance of SMEs. Regarding accounting control procedures for small and medium enterprises, Curley (2005) agrees with this statement by indicating that it is important to have systems of control over all business activities that are well implemented to help ensure: protection of resources against waste and fraud, accuracy and reliability in accounting data and success in the evaluation of the performance of the business. Relying on professional accountant, small firms can get the competencies that they need (Curley, 2005).

Furthermore, the study found that statements of income and financial performance are positively related. It found that well prepared statements of income are likely to significantly alter performance of SMEs, leading to an increase in financial performance. Statements of income is important as it helps firms manage their short term problems in critical areas like costing, expenditure and cash flow by providing information to support monitoring and control (Mitchell, 2000). Thus statements of income are necessary to ensure that SMEs economic resources are used effectively and efficiently in pursuit of its goals. It also follows that there is a particular need in growing SMEs for the skills of financial analysis which will allow financial statements to be read and understood, whether they contain historical or forecast information (McMahon, 1995).

## **CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS**

### **5.1 Introduction**

This chapter presents a summary of the study findings, conclusions and recommendations.

### **5.2 Summary of Findings**

The study found that most of the respondents in the selected SMEs in Nairobi County were operating as sole proprietors. It found that medium scale enterprises had a large percentage in Nairobi County. It also found that the SMEs had the desired experience to furnish the study with information on accounting systems, the manner in which accounting records are maintained by SMEs and their financial performance. Most SMEs in Nairobi County started their business with credit as their source of starting capital. It further found that most SMEs in Nairobi County keep records of their businesses as it is the gateway to better financial performance.

It found that most SMEs in Nairobi County keep purchases and sales control records due to their effectiveness in SMEs' management of short term problems in critical areas like costing, expenditure and cash flow by providing information to support monitoring and control. It also found that most SMEs neutrally agree that purchases ledger shows all purchases returns of the business, sales ledger shows all returns to the business and sales ledger shows all the receivables of the business.

In regard to cash book, the study found that most SMEs have cash books that can help in providing evidence of how the transaction is handled thus substantiating financial performance. It found that that cash payments posted to correct payable accounts and to the general ledger and cash payments are recorded in the correct accounting period.

The study further found that most SMEs keep their revenues and expenditure accounts as they help in improved financial performance. Most SMEs neutrally agreed that all

expenditures are recorded in this accounts and all revenues are recorded in this account thus leading to improved financial performance.

The study found that most SMEs prepare their statement of income as it helps with crucial information for the successful performance of a business. Majority of SMEs in Nairobi County were in agreement with the statement that all expenditures are presented in the statement of income.

Finally, the study found that a large number of SMEs prepare balance sheets as they convey substantial information about the financial strength and current performance of an enterprise. Most SMEs in Nairobi County neutrally agreed that all fixed assets are presented at net in the balance, all short term liabilities are captured in the balance sheet and all current assets are presented in the balance sheet.

### **5.3 Conclusions**

The study concluded that most of the respondents in the selected SMEs in Nairobi County were operating as sole proprietors. Medium scale enterprises had a large percentage in Nairobi County. It also concluded that the SMEs had the desired experience to furnish the study with information on accounting systems, the manner in which accounting records are maintained by SMEs and their financial performance. Most SMEs in Nairobi County started their business with credit as their source of starting capital. It further concluded that most SMEs in Nairobi County keep the records of their businesses as it is the gateway to better financial performance. Record keeping plays a key role in management of knowledge necessary for good business performance. Record keeping also provides evidence of how the transaction was handled and substantiates the steps that were taken in order to comply with business standards.

The study concluded that SMEs in Nairobi County keep purchases and sales control records. A large number of SMEs neutrally agree that purchases ledger shows all purchases returns of the business, sales ledger shows all returns to the business and sales ledger shows all the receivables of the business.

The study further revealed that most SMEs have cash books that can help in providing evidence of how the transaction is handled thus substantiating financial performance. It determined that that cash payments posted to correct payable accounts and to the general ledger and cash payments are recorded in the correct accounting period.

Furthermore, it concluded that most SMEs keep their revenues and expenditure accounts as they help in improved financial performance. Most SMEs neutrally agreed that all expenditures are recorded in this accounts and all revenues are recorded in this account thus leading to improved financial performance.

The study revealed that most SMEs prepare their statement of income. Majority of SMEs in Nairobi County were in agreement with the statement that all expenditures are presented in the statement of income.

The study concluded that a large number of SMEs prepare balance sheets. Most SMEs in Nairobi County neutrally agreed that all fixed assets are presented at net in the balance, all short term liabilities are captured in the balance sheet and all current assets are presented in the balance sheet.

#### **5.4 Recommendations**

Based on the study's findings, the following recommendations were made on the influence accounting records on the financial performance of SMEs in Nairobi County.

The study recommended creation of reforms that can promote effective performance of SMEs. Managers should work together with professionals like Institute of Certified Public Accountants of Kenya among others in encouraging good accounting practices.

#### **5.6 Suggestions for further Research**

The study recommended further research in the following areas:

1. Since this study covered the influence of accounting records on the financial performance of SMEs, further studies are recommended on other factors influencing financial performance among SMEs.

2. The study focused on SMEs only whereas financial performance is essential for all business. Arising thereof, the study recommends further studies on financial performance by large enterprises in Kenya

### **5.7 Limitations of the Study**

Nairobi County is an expansive county and populous hence coverage of the all the constituencies in the county is difficult. In addition the empirical documented data on small enterprises is still scanty especially on accounting records and financial performance of small and medium enterprises since only a few studies have been carried out in the area.

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## APPENDICES

### APPENDIX I: QUESTIONNAIRE

#### SECTION ONE: GENERAL INFORMATION OF THE RESPONDENT

1. What is your Gender  
Male           [ ]  
Female         [ ]
2. What is your level of education?  
Primary School   [ ]  
Secondary School [ ]  
Middle College   [ ]  
University Level [ ]
3. In what category is your age?  
Under 30 years   [ ]  
30-39 years       [ ]  
40-49 Years      [ ]  
50 years and over [ ]

#### SECTION TWO: INFORMATION ABOUT THE ENTERPRISE

4. What form of organization is your business?  
Sole proprietor   [ ]  
Partnership       [ ]  
Cooperative       [ ]  
Public company    [ ]  
Other (specify) \_\_\_\_\_
5. What is the classification of the business?  
Small [ ]   Medium    [ ]
6. How long has the business operated?  
Less than 1 year   [ ]  
2 – 5 years         [ ]  
6 – 10 years        [ ]  
Over 10 years       [ ]

7. How did you fund your initial capital to start this business?

Credit [ ]

Savings/Self [ ]

Friends / Relative [ ]

Others (Specify) \_\_\_\_\_

8. Do you keep records of your business transactions?

Yes [ ] No [ ]

Why?

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9. What type of books do you keep in your business?

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**SECTION THREE: PURCHASES AND SALES LEDGERS**

10. Do you keep purchases and sales control ledger?

Yes [ ] No [ ]

11. Do you agree about the following statements relating to your purchases and sales control ledgers?

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
Purchases ledger shows all the liabilities of the business					
Purchases ledger shows all purchases returns of the business					
Sales ledger shows all the receivables of the business.					
Sales ledger shows all returns to the business					

#### SECTION FOUR: CASHBOOK

12. Do you have a cash book?

Yes  No

13. To what extent do you agree with the following statements about your cash book in the business?

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
Only valid cash payments are made					
All cash payments that occurred are recorded					
Cash payments are correctly recorded in the ledger					
Cash payments posted to correct payable accounts and to the general ledger					
Cash payments are recorded in the correct accounting period					
Cash payments are charged to the correct accounts					

#### SECTION FIVE: REVENUE AND EXPENDITURE ACCOUNTS

14. Do you keep revenue and expenditure accounts in your business?

Yes  No

15. To what extent do you agree with the following statements about your business revenue and expenditure accounts? Rate using the scale provided in the table.

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
All revenues are recorded in this account					
All expenditures are recorded in this accounts					

**SECTION SIX: STATEMENTS OF INCOME**

16. Do you prepare a statement of income?

Yes  No

17. To what extent do you agree with the following statements about your statement of income? Rate using the scale provided in the table.

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
Statement of income is prepared regularly					
All revenues are presented in the statement of income					
All expenditures are presented in the statement of income					
Earnings per share is complete and presented on the statement of income					
Profit margin is regularly computed.					



**SECTION SEVEN: BALANCE SHEET**

18. Do you prepare a balance sheet?

Yes [ ] No [ ]

19. To what extent do you agree with the following statements about your Balance Sheet? Rate using the scale provided in the table.

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
All fixed assets are presented at net in the balance.					
All current assets are presented in the balance sheet					
All short term liabilities are captured in the balance sheet					
All long term liabilities are computed and presented in the balance sheet					

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