The effects of outsourcing book keeping services on the quality of financial reports among small and micro enterprises in Nairobi County, Kenya

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ABSTRACT

The study aimed to establish the effect of outsourcing bookkeeping services on the financial reporting quality of SMEs in Nairobi County, Kenya. The Transaction Cost Economics (TCE) Theory, Resource-Based View (RBV) theory and the principal-agent theory guided this research. A correlational research design was used in this study, whereby the target population (358 firms) consisted of SMEs from Nairobi County. Structurally designed questionnaires were employed and filled out by SME managers. Using descriptive and multiple regression analysis in SPSS 24, an inferential conclusion was drawn on the correlation between outsourcing bookkeeping services and financial report quality. Validity was achieved, and the questionnaire was improved following the pilot study with support from the SME managers, while reliability was established by adopting Cronbach's alpha coefficients above 0.70. Measures were taken to observe ethical considerations by seeking prior consent from all respondents involved and keeping their responses anonymous. The study found a strong and positive correlation between outsourcing bookkeeping services and the quality of financial reporting of SMEs in Nairobi County (β = 0.668; $p < 0.05$). This study sought to exemplify how outsourcing bookkeeping services could be advantageous to SMEs by enhancing their financial position and operation. These findings fill a gap in the literature and are useful to SME managers, policymakers, and other stakeholders on sound financial and reporting practices. The study concluded that outsourcing bookkeeping services enhances the accuracy, timeliness, and compliance of financial reporting among SMEs. It is therefore recommended that SMEs adopt outsourcing as a strategic tool for improving the quality of their financial reports and for ensuring better financial decision-making and accountability.

Keywords: Outsourcing, Book-keeping Services, Reporting Quality, Small and Micro Enterprises

I. INTRODUCTION

Technology innovation has significantly impacted the current global business environments and forced organizations to come up with novel strategies in the delivery of services to their clients (Ezeagba, 2017). An important part of these strategies is establishing the credibility of financial reporting to stakeholders who bring valued resources like capital and labor into business operations (Zotorvie, 2017). Small and microenterprises (SMEs) have a significant contribution towards economic development, and yet they struggle to develop quality financial reports for their businesses because of certain constraints that do not allow them to hire professional accountants (Mikko & Juntunen, 2018). Emerging trends suggest that outsourcing of bookkeeping services could be a viable way for SMEs to increase the quality of financial reporting, although it presents theoretical threats such as lack of control and confidentiality (Kenton, 2022).

The market for outsourcing of finance and accounting services is rapidly growing and is expected to gain momentum (Jalil & Hwang, 2019). The dynamic and competitive business environment in Africa has escalated the risks encountered in striving for sustainable competitive advantage since SMEs are always limited in their access to resources (Adjabeng & Osei, 2022). This makes it easy for the SMEs to tap into specialized expertise to get optimized results on organizational goals, cost reduction, fraud prevention, and professionalism, as noted by Zotorvie (2017). Existing literature indicates that the use of outsourcing enhances operational efficiency and performance of the SMEs (Nakku et al., 2020; Maiyo, 2019).

SMEs in Nairobi County struggle to present high-quality financial reports mainly because they lack adequate finances and qualified personnel. This situation leads to ineffective management of resources, wrong decisions, and lowers the competitive capability of the business. Outsourcing of bookkeeping services is an advancement, but confidentiality, loss of control, and exposure of information are inevitable (Kenton, 2022). Existing reviews of various studies show investigations that either point to positive effects of outsourcing on financial reporting quality or suggest no significant effect (Nguyen & To, 2018). Taking into account the importance of quality financial reporting in organizations' performance and the increased attention to qualitative aspects of financial reporting, and, finally, considering the economic importance of SMEs in Kenya, including Nairobi County, it is important to empirically investigate the effect of outsourcing bookkeeping services on quality of financial reports among SMEs. Therefore, knowledge about these indicators is crucial to explaining SMEs' strategic choices related to outsourcing and improving their financial management procedures.

The primary study objective is to determine the effects of outsourcing bookkeeping services on the financial reporting quality of SMEs in Nairobi County, Kenya. This research seeks to establish the extent to which the decision to outsource bookkeeping impacts the credibility, reliability, and adherence of key business reports prepared by SMEs. The study targets registered SMEs in Nairobi County, Kenya. Through exploring this relation, the study aims to contribute to the literature by helping SMEs to improve the quality of their financial reporting, increase efficiency of their decision-making, and bolster their market position.

1.1 Statement of the Problem

Many SMEs struggle with the preparation of quality financial reports due to limitations in financial resources, lack of technical expertise, and internal capacity to maintain comprehensive financial records. As a result, bookkeeping, the foundation of financial reporting, becomes inconsistent, delayed or inaccurate. Outsourcing has emerged as a potential solution, allowing SMEs to access skilled professionals without the cost burden of full-time staff. Empirical evidence in the Kenyan context remains limited, especially on how outsourced bookkeeping influences financial reporting quality. This study seeks to fill the gap by assessing whether outsourcing bookkeeping services improves financial report quality among SMEs in Nairobi County.

1.2 Research Hypothesis

The following hypothesis is formulated:

Ho_1: Outsourcing bookkeeping services has no effect on financial reporting quality among SMEs in Nairobi County, Kenya.

II. LITERATURE REVIEW

2.1 Theoretical Review

Several theories account for the connection between outsourcing of bookkeeping services and the quality of financial reporting among SMEs. Of these theories, the Transaction Cost Economics (TCE) Theory developed by Williamson emerges as the first one. TCE predicts that businesses structure their activities to reduce costs related to transactions, including search and information costs, negotiation and choice costs, and finally monitoring as well as controlling costs (Williamson, 1981). SMEs may be induced to outsource bookkeeping activities in situations where the internal cost of performing these activities exceeds the cost of outsourcing. In particular, outsourcing can cut the transaction costs due to the use of outside knowledge and volume advantages (Everaert et al., 2010). However, it may also bring negative factors, like some of the suppliers may exhibit adverse intentions, and the firm may not be able to control its financial data (Williamson, 1981). Therefore, SMEs need to consider the possible costsavings in relation to risks that might be encountered while outsourcing.

Another relevant theory is the Resource-Based View (RBV), which states that a firm's superior performance arises from valuable, rare, inimitable, and non-substitutable resources and capabilities (Barney, 1991). RBV postulates that firm resources should be used principally where they have the highest level of competence and other tasks be outsourced. In SMEs, bookkeeping is surprisingly seen as an external activity since it is not among their main business functions. Outsourcing bookkeeping services can provide access to skills and equipment beyond those available internally, thus enabling SMEs to deploy resources onto more compelling strategic activities, increase efficiency, and possibly gain improved value of financial reports (Prahalad & Hamel, 1990). However, firms should make sure that outsourcing does not harm their strategic assets or creates reliance on third-party suppliers.

The principal-agent theory also gives an understanding of outsourcing choices. This theory looks at the dilemma of principals (owners) and agents (service providers), problems of the information gap, and self-serving behavior (Jensen & Meckling, 1976). Firms outsourcing activities to other firms face agents that have different goals and sets of information. Engaging bookkeeping services involves agency costs of moral hazard and adverse selection costs whereby the outsourcing firm is not sure of how the service provider will perform the assigned tasks (Eisenhardt, 1989). To manage these risks, it is imperative that SMEs implement sound contracts, controls, and incentives that address the broad supply chain issue of commonality of interest for providing high-quality financial reports.

2.1.1 Financial Reporting Quality

Financial reporting quality is essential for SMEs because the information produced determines stakeholders' decisions in investment, lending, and managerial control. Financial reports of good standard are accurate, reliable, relevant, comparable, and understandable (International Accounting Standards Board [IASB], 2020). To the credit of SMEs, high financial reporting quality is essential in the realization of credit, investors, and legal demands. Contracting out bookkeeping services affects the quality of financial reporting in that it gives professionals' input, standard compliance where obligatory, and noble accounting systems (Lee et al., 2017). However, issues (data security, loss of control, and reliance on external providers) may reduce the quality of reporting if not well managed.

2.1.2 Book-keeping Services

Accounting services, such as bookkeeping services, are essential to any SMEs. Bookkeeping entails the process of recording, analyzing, and summarizing account transactions as a basis for preparing balance sheets, income statements, and cash flow statements (Faitusa, 2019). It is a crucial process that assists in keeping the company financially healthy and legitimate while also helping in decision-making and compliance with the legal requirements. To the SMEs, bookkeeping practices can be resource-intensive since the exercises would require a lot of financial and human capital (Mikko & Juntunen, 2020). SMEs can obtain specialized skills and reduce costs by outsourcing their bookkeeping services, which may hence increase the quality of financial reporting.

2.2 Empirical Review

Existing literature has looked into the effects that outsourcing of bookkeeping services has on the quality of financial reports of the SMEs. For instance, Kamita and Oluoch (2018), in their study done in Nairobi County, Kenya, found that outsourcing the bookkeeping services enhanced the quality of the financial reports. Outsourcing had a positive effect on accuracy, reliability, and compliance with accounting standards. In a similar manner, Mwangi (2019) pointed out that outsourcing enhances financial reporting quality through professional services and sound financial accounting systems.

Nonetheless, several issues affecting outsourcing have been documented. To analyze the risks of outsourcing bookkeeping services among SMEs in Kenya, Cahyaningtyas and Ningtyas (2020) outlined limitations and highlighted weaknesses such as reduced control over the financial processes, security of information, and reliance on the third party. To curtail those risks, Cahyaningtyas and Ningtyas (2020) encouraged SMEs to put in place effective monitoring mechanisms and appropriate contractual measures.

SMEs are essential in Kenya's economy because they offer employment, lead to innovations, and contribute to the GDP, according to Agburu et al. (2017). However, SMEs are known to have constraints including access to finance, management skills, and compliance with regulatory factors (Nzioki, 2017). The quality of financial reporting is sometimes deliberately reduced because of limited funds and incompetency. SMEs in Kenya also experience poor record-keeping based on the fact that qualified accountants are expensive to employ, most SMEs are financially constrained, and most owners lack knowledge on bookkeeping, which causes them to produce misleading accounts (Abuga & Atandi, 2020). Also, most SMEs are in the informal sector, whereby they perform their accounting informally, ignoring formal financial reporting (Kenya National Bureau of Statistics, 2017). The need to improve the quality of financial reporting is an area where outsourcing of bookkeeping services offers an opportunity for SMEs to address these challenges.

III. METHODOLOGY

3.1 Research Design

Using a correlational research design, this research aimed at establishing an association between outsourcing of bookkeeping services and the nature of financial reporting quality among SMEs in Nairobi County, Kenya. The correlational design was appropriate because it enabled determination of the extent of relationship between the independent variable (outsourcing of bookkeeping services) and the dependent variable (financial reporting quality).

3.2 Population and Sampling Techniques, and Data Collection Instruments

The target participants included 3,330 managers across SME working in different sub-counties of Nairobi County, according to the MSME Authority, Kenya (Micro and Small Enterprise Authority, 2020). They included Westlands, Dagoretti North and South, Langata, Kibra, Roysambu, Kasarani, Ruaraka, Embakasi regions, Makadara, Kamukunji, Starehe, and Mathare. Managers were selected for the study because of their understanding of their firm's financial strategies and outsourcing arrangements. In order to calculate the appropriate sample size, Taro Yamane's formula was used to arrive at a sample size of 358 SMEs. The study used a purposive sampling method, thereby engaging proportionate stratified random sampling to avoid the sample bias and increase the probability results of making generalizations.

Data was gathered from structured questionnaires completed by the managers of the sampled SMEs between January and March 2024. As for the instrument, the questionnaires were divided into demographic information and questionnaire items about outsourcing the bookkeeping services and financial reporting quality. The drop-and-pick-later method was used to ensure that respondents had enough time to fill out the questionnaires to their preference. Participants' identity was ensured by not using their names or any other identifiers throughout the study, while their anonymity and the confidentiality of their responses were guaranteed through an introductory letter and a research permit notifying them about the study and informing them that their participation was voluntary. The introductory letter is an official approval from Masinde Muliro University of Science and Technology, while the research permit is from the National Commission for Science, Technology, and Innovation (NACOSTI).

Before undertaking the main study, a pilot study was carried out in 36 SMEs in Nakuru County; this was 10% of the total sample size. Nakuru County was selected because of its closeness and business atmosphere to that of Nairobi. The pilot study was conducted with the purpose of analyzing the reliability and validity of the research instruments. Opinions that were gathered from the pilot study were employed in the improvement of the questions in the questionnaire. The internal consistency of the variables was tested using Cronbach alpha, with values above 0.70 considered adequate.

3.3 Validity and Reliability and Statistical Treatment of Data

Data acquired from the pilot study were analyzed to assess the reliability and validity of the research instruments used. Simple and construct content validity was ensured through assessing each item of the questionnaires with a check on the study's variables for clarity and relevance. Discourses with managers of SMEs also showed that all the questions in the given questionnaire were relevant. Internal consistency as a type of reliability was determined using Cronbach's alpha coefficient.

The independent variable, outsourcing of bookkeeping services, was defined based on the level and intensity of outsourcing among SMEs. These were questions on how often outsourcing was done, why outsourcing was done, what kind of bookkeeping services were outsourced, and the impression of benefits and challenges that were prominent. The respondents provided their responses by using a Likert scale of 1 (SD) through 5 (SA). The independent variable Hong Kong GAAP was meanwhile assessed, referring to financial reporting quality attributes including accuracy, reliability, timeliness, compliance with accounting standards, and decision usefulness. Significant questionnaire items were capturing these dimensions by presenting aspects such as accuracy of financial reports, compliance with IFRS, and usefulness of the financial reports in decision-making to the respondents. The items attributed to each dimension were also scored on a five-point Likert scale.

Data analysis incorporated descriptive and inferential statistics through the use of Statistical Package for the Social Sciences (SPSS) version 24. Statistical analysis factors that were taken into consideration include the appropriateness of statistical measures and the generalizability of results. Measurement without reduction included frequencies and percentages as well as means and standard deviations. Descriptive statistics as well as the correlation and regression tests were used to analyze the impact of outsourcing bookkeeping services and financial reporting quality.

3.4 Ethical Considerations

Ethical issues were strongly considered during the entire research process. In particular, respondents were assured that their participation was voluntary and that they could choose to exit at any time without any consequence. To ensure confidentiality, participants were not required to provide any personal details, and the collected data was analyzed in summary form to avoid identification of individuals and organizations involved. The researcher got all the permission to conduct the study from the relevant authorities, such as a letter of introduction from the Masinde Muliro University of Science and Technology and a research permit from the National Commission for Science, Technology, and Innovation (NACOSTI). All procedures were carried out in conformity with the ethical practices under research on human subjects.

IV. FINDINGS & DISCUSSIONS

4.1 Response Rate

Of the 358 questionnaires that were administered as illustrated in Table 1, 296 were duly completed and returned, giving a response rate of 83.1% in Nairobi County. This response rate is regarded as effective, as noted by Mugenda and Mugenda (2003), who opined that a response rate of 70% and above is ample for analysis and reporting in research. The high response rate augments the validity of the study results and may be an indicator of the level of participation among the participants.

Table I
Response Rate

Response rate	Sample size	Percentage (%)
Returned questionnaires	296	83.1
Un returned questionnaires	62	16.9
Total	**358**	**100**

4.1.1 Reliability and Validity of Research Instruments

As shown in Table 2, outsourcing bookkeeping services was 0.710 and financial reporting quality was 0.714, whereby both exceeded the accepted limit of 0.70 alpha by the Cronbach test (Mugenda & Mugenda, 2003). These results provide an assurance by establishing the validity and reliability of the research instruments used in the study.

Table 2
Summary of Cronbach alpha Reliability Coefficients for Study Variables

Variable	Number of items	Cronbach alpha
Outsourcing of book keeping services	5	.710
Financial reporting quality	5	.714

4.1.2 Demographic Characteristics of Respondents

The demographic information as highlighted in Table III collected is composed of gender, education level, and number of years of service in SMEs. These respondents were comprised of 71.3% male and 28.7% female, implying that while there may be a general perception that men are the primary bearers of managerial positions in SMEs in Nairobi County, women are equally empowered to make decisions that affect financial reporting processes in the firms. An education level was distributed such that 52.7% of the respondents had a bachelor degree, 30.1% had a master degree, and 17.2% had a diploma. These results show that the respondents had good educational standards and hence would be in a position to give credible information on issues relating to financial reporting practices. In regards to experience, an overwhelming majority, 72.3%, had worked within their SMEs for 6 to 10 years, 14.4% for 1 to 5 years, and the remaining 13.3% for more than 10 years. Obtaining responses only from experienced individuals increased the reliability of the data collected because respondents are familiar with their firm's practices of financial reporting and outsourcing.

Table 3
Demographic Data

		Frequency	Valid %
Gender	Male	211	71.3
	Female	75	28.7
	Total	**296**	**100.0**
Level of Education	Diploma	51	17.2
	Degree	156	52.7
	Masters	89	30.1
	Total	**296**	**100.0**
Experience of Experience of	1-5 years	43	14.4
	6-10 years	214	72.3
	Above 10 years	39	13.3
	Total	**296**	**100.0**

4.1.3 Descriptive Statistics on Outsourcing Bookkeeping Services

Table 4 presents descriptive statistics that describe respondents' perceptions of the impact of outsourcing bookkeeping services on financial reporting quality. The responses were obtained using a Likert scale with an interval value ranging from 1 (strongly disagree) to 5 (strongly agree). In general, most of them reported that their firms pay very little attention to bookkeeping personnel entailment in their organizations, with a mean score of 4.20 and a standard deviation of 0.81, although the respondents strongly agreed (50.7%) and agreed (30.7%) with the statement that their organizations have very few employees who are employed by bookkeeping work. The first of such implication is the outsourcing of all bookkeeping procedures to other personnel or firms from other organizations. Also, 38.4% strongly agreed and 49% agreed that outsourcing bookkeeping services is in line with their company strategic plan (mean = 4.10, SD = 0.86), clearly pointing out that outsourcing is a deliberate strategy among the SMEs.

Upon asking the respondents if their firms used outsourced firms in the preparation of bookkeeping records, they expressed a significant degree of reliance on outsourced firms in respect of this function: strongly agree=29%, agree=31% (mean=3.72, SD=1.07). In terms of increasing professionalism in bookkeeping, 40.4% strongly agreed and 22.2% agreed (mean = 3.55, SD = 1.17) that outsourcing results in better bookkeeping professionalism. Also, 43.1% strongly agreed, and 6.9% of them agreed that as a result of outsourcing services, there is a decrease in clerical errors in reports (mean = 3.90, SD = 0.88), which may support the improvement of the quality of financial reports.

Table 4

Descriptive Statistics; Outsourcing Book Keeping Services

Statement	5	4	3	2	1	Mean	Std. Dev
The firm have very few employees for book keeping works	50.7% (150)	30.7% (91)	10.6% (31)	4.7% (13)	3.3% (11)	4.2	0.81
Book keeping services outsourcing is anchored in the company's corporate strategy	38.4% (114)	49% (145)	6.3% (19)	2.1% (6)	4.2% (12)	4.1	0.86
My firm relies on the outsourced firm to prepare book keeping records	29% (86)	31% (92)	20.1% (59)	12.2% (36)	7.8% (23)	3.72	1.07
Professionalism in book keeping has improved due to outsourcing of book keeping services	40.4% (120)	22.2% (66)	26.7% (79)	2.1% (6)	8.6% (25)	3.55	1.17
Clerical errors in reports have reduced due to outsourcing services	43.1% (128)	6.9% (20)	20.9% (62)	7% (21)	22.1% (65)	3.9	0.88

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4.2.1 Regression Analysis

In order to examine the link between outsourcing of bookkeeping services and financial reporting quality as proposed in the hypothesis, the study employed simple linear regression analysis, whose outcome is outlined in Table 5. Specifically, the analysis showed that the unstandardized coefficient B for the bookkeeping services was equal to 0.668, which means that the intensification of outsourcing the bookkeeping services by one unit also intensifies the level of financial reporting quality by 0.668 units. The analysis of the coefficients of determinant showed that the standardized coefficient (Beta) was 0.661, which pointed to the fact that a positive relationship between the two variables was strong. The t-value was 2.074, compared to which its p-value was 0.017, which is less than 0.05, sufficient to reject the null hypothesis. This suggests that outsourcing of bookkeeping services has a significant relationship with financial reporting quality.

Table 5

Outsourcing of Book Keeping Services and Financial Reporting Quality Simple Regression Results

Variable	Unstandardized Coefficient (B)	Standardized Coefficient (Beta)	t-value	p-value	95% CI (lower and upper bounds)
Bookkeeping Services	0.668	0.661	2.074	0.017	

4.2.2 Hypothesis Testing

The null hypothesis (H_0) was formulated that outsourcing bookkeeping services has no impact on the quality of financial reporting among SMEs in Nairobi County. From the above regression results, the p-value is 0.017, which is less than 0.05; therefore, the null hypothesis is rejected. As a result, outsourcing of bookkeeping services has a positive impact on the quality of the financial reports of SMEs in Nairobi County.

4.3 Discussion

The findings of this study indicate that increased outsourcing of bookkeeping services results in better quality financial reports of SMEs in Nairobi County. This means that SMEs get a differential competence and professionalism that is offered by the external service providers, thus ensuring accurate, reliable, and compliant financial reports. This is in conformity with the Resource-Based View Theory, which holds the view that firms are in a position to develop competitive advantages if they are capable of using external resources to accomplish non-strategic tasks. From the details elicited from the respondents, the study established that while excluding the clerical mistakes, the elevated level of professionalism that accompany outsourcing reveals that outsourcing provides the SMEs with an opportunity to tap on specialized expertise and efficient technologies that they usually would not be in a position to access. This is also in line with the views of Mikko and Juntunen (2018), who posit that external accounting services firms increase compliance and financial performance.

In addition, the findings are in agreement with Kamita and Oluoch (2018), who observed that outsourcing accounting services improve the quality of financial reporting among the Kenyan SMEs. Their study, with the study area being Nairobi County only, established that outsourcing improves account accuracy, reliability, and comparability with accounting standards, like the current study findings. The foregoing findings on the impact of outsourcing on financial reporting quality also align with the study conducted by Kaawaase et al. (2021) while analyzing the relationship between internal audit quality and financial reporting quality in Ugandan financial institutions. As with their main emphasis on internal audit, the correlation that it holds pertains to the fact that professional financial services enhance report quality.

V. CONCLUSION & RECOMMENDATIONS

5.1 Conclusion

The study reveals that outsourcing bookkeeping services enhances the financial reporting quality for SMEs in Nairobi County, Kenya. The findings show that outsourcing bookkeeping to SMEs increases professionalism, reduces mistakes, and increases the efficiency of transaction processing. This positive relationship confirms outsourcing as a strategic decision that makes financial reporting more accurate and reliable. Consequently, this leaves SMEs in a position where they cannot afford to ignore the pros of outsourcing bookkeeping services aimed at improving their financial reporting process. Although the study poses evidence of the positive connection between outsourcing bookkeeping services and financial reporting quality, it does not contrast outsourcing with in-house practices. This limits comprehension of the differential merits and demerits of each method of management. Moreover, the study does not consider other variables such as size of the outsourcing firm, kind of industry, organizational culture, and the regulatory standards of financial reports that may mediate the outsourcing and quality of financial reports. Subsequent studies should take these factors into consideration to fill this gap in the understanding of accounting service outsourcing for SMEs.

5.2 Recommendations

The study has significant managerial and policy implications. To the managers of SMEs, outsourcing bookkeeping services can be a powerful strategic instrument to improve the quality of financial reports and, therefore, the decision-making that results in better organizational performance. Further policies should be made or established on the strategic outlook of accounting service outsourcing to conform to international standards. This may also be useful in increasing disclosure and assurance of financial statements for the growth of SMEs and their stakeholders. Also, for researchers and academicians, the study offers insight into the trends in the service outsourcing industry and the effects on the quality of financial reports amongst SMEs.

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