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Determinants of Financial Audit in Small and Medium Enterprises In Kenya A Survey Of Audit Firms In Mombasa

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Abstract: *The purpose of this study is to find out the determinants of financial audit in small and Medium Enterprises. Specific objectives of the study are; to examine whether internal control system affects audit performance in SMEs; to determine the effects of audit evidence on audit performance in SMEs; to determine whether compliance with accounting standards affects audit performance in SMEs. There are four audit theories according to [1]. They include: Policeman's theory, lending credibility theory, theory of inspired confidence and agency theory. The problem with the Kenyan SME setting is that SMEs in Kenya rarely use the services of a qualified accountant. This is demonstrated by the [2] who argued that their results showed that book keeping practice of the SMEs in Kisii Municipality is not adequate and this may negatively affect the financial performance. [3]Also found that small business failure inevitably showed poor or careless financial management.In this research, the researcher collected primary data through questionnaires and secondary data was collected from internal records. The Researcher used descriptive design in collecting the data from respondents. The target population was from Auditing Firms in Mombasa, while the study population will concentrate on Accounting and Auditing Staffs in their Audit Firms. The total population of the study was sixty five (65). From the target population of 65, a sample size of fifty six (56) respondents was undertaken. The researcher used simple stratified sampling procedure based on employees of Audit firms, whom were classified in Accounting and Auditing department. Presentation of quantitative data will be performed using Statistical Package for Social Science (SPSS Version 17) and the information generated will be presented in form of Tables, Pie-charts and Bar graphs only where it provides successful interpretation of the findings. Descriptive data will be provided in form of explanatory notes. The research study established that internal control systems, audit evidence and compliance with accounting standards. There is need to evaluate company's internal control systems as factor determining financial audit in SMEs; to implement best practices to help companies to manage their books of accounts; develop accounting policy focusing on the achievement of the minimum risk of users of information to enhance credibility.*

Keywords: *Accounting Estimate,Audit,Audit Evidence, Audit Materiality and SMES*

I. Introduction

1.1 Background to the Study

The principle purpose of independent auditing is to form an opinion on the accuracy, reliability and fairness of representations in the financial statements of enterprises and to make this available to external users. [4] report the next definition of auditing: "Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent, independent person."

Small business (i.e. not more than 10 shareholders) purchases auditing services mostly because they would like to acquire credit from banks. It has been established that bankers seek audited financial statements in their lending decisions [5], [6]

An external auditor is an audit professional who performs an audit in accordance with specific laws or rules on the financial statements of a company, government entity and other legal entities or organization and who is independent of the entity being audited. (Institute of internal auditors) The concept of SMEs varies from one country to another depending on the indicators used, [7].The first criteria, based on the number of employees, defines SMEs as those enterprises below a certain number of workers (i.e. can range from less than 10 to less than 50 employees).The second criterion defines the SMEs as the degree of legal formality, and has been used to distinguish between the formal and informal sectors. Here, Micro, small and medium enterprises (MSMEs) are considered as enterprises which are not registered and do not comply with the legal obligations concerning safety, taxes and labour laws. The third criterion defines SMEs as based on the limited amounts of capital and skills per worker.[8] categorize the micro, small and medium enterprises as follows: a micro enterprise as one with 1-5 workers, a very small enterprise with 6-9 workers and a small enterprise as one with less than 30 workers, and medium enterprise having as many as 250 workers.

Even though the definition varies from one country to another (depending on the economic structure), the regulatory and institutional framework for the Kenya's SMEs has been based on the number of employees and the company's annual turnover. For instance, the micro enterprises have been defined as those employing less than 10 workers with annual turnover of less than Kshs 500,000 and capital formation of less than Kshs5 million for services, or less than Kshs 10 million for enterprises doing manufacturing. Small enterprises are defined as those that employ between 10 and 50 workers with annual turnovers between Kshs 500,000 and Kshs 5 million and capital formation between Kshs 5 million and Kshs20 million for services or between Kshs 5 million and Kshs 50 million for enterprises doing manufacturing.

The contribution of SMEs is more than double that of the large manufacturing sector, which stands at 7% of the GDP [9]. Overall, SMEs create 75% of all new jobs. Estimates based on the 1999 baseline survey show that, in the year 2002, the SME sector employed about 5086400 people, up from 4624400 in 2001. This was an increase of 462000 persons and consisted of 74.2% of total national employment [10].

EU members have had individual definitions of what constitutes an SMEs for example, the traditional definition in Germany had a limit of two hundred and fifty five employees, while for example in Belgium it could have been one hundred employees. In July 2011, the European commission said that it would open a consultation on the definition of SMEs in 2011. In Europe, currently there are three broad parameters which define SMEs are companies up to 10 employees; small companies employ up to fifty workers, whilst medium sized contain up to two fifty employees. [11] Furthermore, SMEs are defined as firms with either a turnover of ten to fifty (10-50) million or a balance sheet ten to forty three (10-43) million.

Mostly SMEs encounter limited financial as well as non-financial resources. They depend upon the creditors like banks and other financial institutions, or private equity. In this regard, banks have become one of the major sources for SMEs fulfilling their financial requirements. However, banks are less likely to provide loans without any reasonable assurance of creditability of the firms. Banks generally rely on the financial information of the firms. They do prefer credible audited financial statements by independent auditors as a matter of assurance. In other words, most banks view auditing as a guarantee for the quality of information disclosed in companies as well as a foundation for their credit rating process. Banks believe that the credit rating would be unsure without audit obligation.[12]SMEs are unable to carry out the accounting functions internally because of inadequate knowledge and unqualified employees. For example, SMEs lack the necessary skills and resources to perform accounting functions in-house; access to the expertise and specialized knowledge of a professional accountant was evidently the most important reason to outsource [13]. Indeed, majority of SME owner/managers have no professional, management and other formal qualifications [14]. One possible way for a smaller firm to acquire competencies is to engage professional accountant [15]. Therefore, by relying on professional accountant, smaller firms can get the competence that they need [16].

The Companies Act, CAP 486 requires all limited liability companies to prepare and keep proper books of account as are necessary to give a true and fair view of the state of the companies' affairs and to explain its transactions. The Act further requires companies to present a Profit and Loss Account and a Balance Sheet each year during the Annual General Meeting and prescribes in detail what should be included in the Profit and Loss Account and in the Balance Sheet. The Kenyan audit industry is regulated by the Institute of Certified Public Accountants of Kenya (ICPAK) which is established by Part II of the Accountants Act of 2008. The institute is charged with the following tasks: a) promote standards of professional competence and practice; promote research into the subject of accountancy and finance and related matters; promote the international recognition of the Institute; advise the Examination Board on matters relating to examinations; advise the Minister on matters relating to financial accountability in the economy; carry out any other functions prescribed for it under any of the other provisions of this Act or any other written law; and to do anything incidental or conducive to the performance of any of the preceding functions.

[17]Conducted an investigation into application of strategic management accounting in organizations by focusing on a case study of Kenya Literature Bureau and concluded that the level of adoption of strategic management accounting practices were low. However, he failed to focus on SMEs use of accounting services. [18]Did a survey of the behavioural factors influencing the choice of financing methods by SMEs by focusing on a case study of Ruiru municipality and concluded that level of education and financial literacy significantly influenced the choice of financing methods. However, she failed to address the reasons for the poor use of accounting services by Kenyan SMEs. [19] 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 to the challenge of SME financial access.

One of the important attributes of auditing is related to audit quality in a way that audit-firms lower the information risk by providing the firm-specific financial reports integrity and improving its quality. Users of entities financial information such as investors, government, organization and the general public, rely on the external auditor to present an unbiased and independent audit report. When an organization is confronted with a financial wrong doing the question will be why didn't the auditor discover it? The auditor's main job is to judge the accuracy of financial statements and report back to the board. This is achieved through examining some typical transactions and review internal controls, accounting procedures and financial reporting systems. An examination of the annual financial report of an organization usually includes a balance sheet, a profit and loss account, a cash flow statement, stating the accounting policies applied and a report by directors of the organization. An external auditor does not play any part in the day-to-day running of the organization and must not be controlled by the management of the organization and thus have limited information on the transaction of the organization.

There have been concerns about audit quality in the present audit environment, where severe audit failures have come to light. It has been found that the perceived reliability of audited financial information has declined, while the perceived relevance of audited financial information has increased [20].Thus, it is evident that there is a need for further research on determinants of financial G small and medium enterprises.

1.2 Statement of the problem

The objective of the independent auditor's examination of financial statements is the expression of an opinion as to whether they present fairly the financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles (GAAP). The auditor must state whether the examination was made in accordance with generally accepted auditing standards (GAAS).The auditor may give an opinion which may not reflect true and fair view of the organization financial statements and thus may mislead the external users of the financial report. The auditor becomes liable to external users for his report. Several studies have been conducted in a few advanced countries to search for the problems encountered in auditing a small company (United States, United Kingdom and Canada). Throughout the studies, the main problem facing the auditor was the implementation of the Auditing Standards that normally apply to large company rather than small company.

The problem with the Kenyan SME setting is that SMEs in Kenya rarely use the services of a qualified accountant**.** This is demonstrated by the [2] who argued that their results showed that book keeping practice of the SMEs in Kisii Municipality is not adequate and this may negatively affect the financial performance. Weaknesses in corporate governance practices, lack of pressure from the users of financial statements for high-quality information, and the general absence of transparency in the corporate sector, pervade the corporate financial reporting regime in Kenya. The fact that a number of banks failed in the late 1990s, and the audited financial statements did not provide early warning signals about these failures, has raised concerns among the general public about the quality of accounting and auditing in the country. Against this backdrop, this review of accounting and auditing practices in Kenya is intended to provide inputs on appropriate measures to improve the financial reporting regime. This study therefore seeks to investigate the determinants of financial audit in Small and Medium Enterprises in Kenya.

1.3 Objectives of the study

1.3.1 General Objective

To investigate the determinants of financial audit in small and medium enterprises in Kenya

1.3.2 Specific Objectives

1) To examine whether internal control system affects financial audit in SMEs
2) To determine the effects of audit evidence on financial audit in SMEs
3) To determine whether compliance with accounting standards affects financial audit in SMEs

1.4Research Questions

1) To what extent does internal control systems affects financial audit in SMEs?
2) To what extent does audit evidence affects financial audit in SMEs?
3) To what extent does compliance with accounting standards affects financial audit in SMEs?

1.5 Significance of the Study

Users of financial information such as investors, government, organization and the general public, rely on the external auditor to present an unbiased and independent audit report. The primary role of external auditor is to express an opinion on whether entity financial statements are free of material statements and whether they reflect true and fair view.

1.5.1 Management

Thus the findings of this study will provide the audit firms with better insights on the determinants of poor audit performance in SMEs and facilitate the development of strategies to enhance their performance.

1.5.2Policy Makers

The results of the study will also be importance to businesses in the small and medium scale category with limited access to the long-term finance that rely more heavily on owner financing, trade credit and short-term bank loans to finance their needed investment. The study will aid policymakers in designing more effective strategies targeted at increasing the levels of quality audit in SMEs.

1.5.3 Financial Analyst

The findings of the study will also be of significance to the accountancy sector and other business sectors of the economy as they will be able to appreciate the importance of auditing in SMEs since SMEs are important force in development of Kenyan economy.

1.5.4 Researchers

This study will contribute to the growing body of literature on financial audit. The conceptual framework developed in this study will provide a cohesive basis for conducting further Study to provide empirical evidence that will enhance understanding the determinants of financial audit in SMEs. A further research can be conducted to highlight other determinants of financial audit in small and medium enterprises in Kenya.

II. Introduction

In this chapter, literature, which is related to and consistent with the objectives of this study, is reviewed. Important theoretical and practical problems are brought out, relevant literature on the aspects pertaining to determinants of financial audit in small and medium enterprises in Kenya.

2.2 Theoretical Literature

There are several different theories that may explain the demand for audit services. Some of them are well known in research and some of them are more based on perceptions. There are four audit theories according to [1]

2.2.1 Policeman's Theory

This theory claims that the auditor is responsible for searching, discovering and preventing fraud. In the early 20th century this was certainly the case. However, more recently the main focus of auditors has been to provide reasonable assurance and verify the truth and fairness of the financial statements. The detection of fraud is, however, still a hot topic in the debate on the auditors' responsibilities, and typically after events where financial statement frauds have been revealed, the pressure increases on increasing the responsibilities of auditors in detecting fraud. [1].

2.2.2 Lending Credibility Theory

[21]Developed the Lending Credibility theory which is seen from the management point of view where the author suggested that the management of an entity uses their audited financial statements to enhance the stakeholder's faith in the management. Stakeholders along with others sometimes have to make their judgment based on the financial statements and are therefore obliged to have faith that the audited financial statements is fair and trustful in the matter of the economic situation of the company they want to invest in. However there are other theories such as the "efficient market theory" that states that the Lending Credibility theory and the information that the auditor gives in the financial statements do not necessarily form as a primary basis for investors' investment decisions [21]. The stakeholders have needless to say certain expectations from the Auditors to maintain a certain quality in their audit report and in order for the auditors to fulfill these expectations, there are certain safeguards carried out by different professional bodies such as IFAC and their framework which is establishment by ISA 220 and ISQC 1.

2.2.3 Theory of inspired confidence

This theory was developed in the late 1920s by the Dutch professor Theodore Limperg. [22]Addresses both the demand and the supply for audit services. The demand for audit services is the direct consequence of the participation of third parties (interested parties of a company) in the company. These parties demand accountability from the management, in return for their investments in the company. Accountability is realized through the issuance of periodic financial reports. However, since this information provided by the management may be biased, and outside parties have no direct means of monitoring, an audit is required to assure the reliability of this information. With regard to the supply of audit assurance, [22] suggests that the auditor should always strive to meet the public expectations. According to [23], the principles of Limperg's theory are especially relevant in this phase of the development of the audit function. "We have a particular need in our current environment to try to understand and to appreciate the social significance of auditing and the implications concerning in which way an audit should be performed."

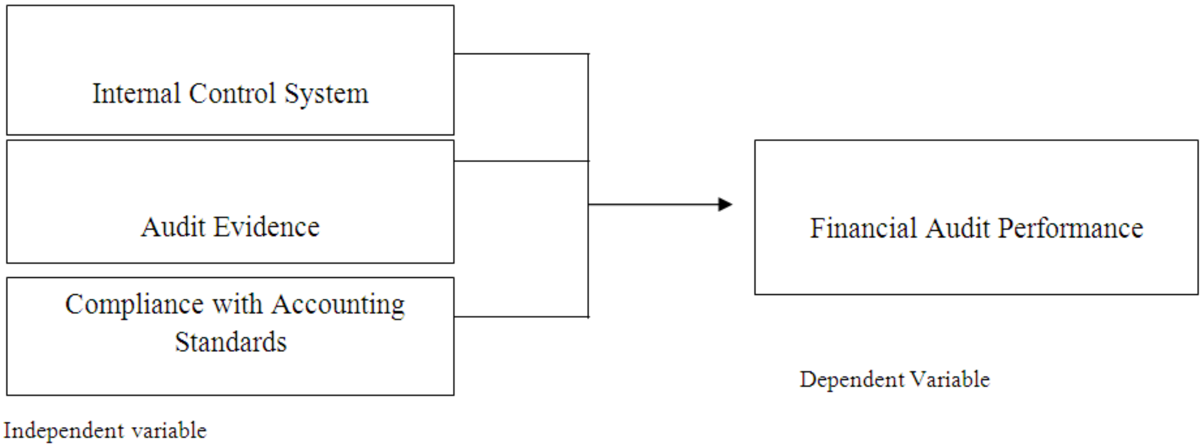
2.2.4 Agency theory

[24], [25] and [26] suggests that the auditor is appointed in the interests of both the third parties as well as the management. A company is viewed as a web of contracts. Several groups (suppliers, bankers, customers, employees etc.) make some kind of contribution to the company for a given price. The task of the management is to coordinate these groups and contracts and try to optimize them: low price for purchased supplies, high price for sold goods, low interest rates for loans, high share prices and low wages for employees. In these relationships, management is the agent, which tries to gain contributions from principals (bankers, shareholders, employees etc.).

2.3 Conceptual Framework

This study on the determinants of financial audit can be conceptualized in a framework explaining the relationship between the independent variables-factors and dependent variable outcomes.

Fig 2.3 Conceptual framework



2.4 Review of Determinants of Financial Audit

In this section we review the effects of each determinant (i.e. internal control system, Audit evidence and Compliance with accounting standards) on financial audit in small and medium enterprises.

2.4.1 Internal Control System

Internal control is defined as the integration of the activities, plans, attitudes, policies, systems, resources and efforts of the people of an organization working together to provide reasonable assurance that the organization will achieveits objectives and mission. Thus, internal control is focused on the mission of the organization, and this mission must be kept in mind when evaluating the appropriateness of specific internal control practices. Internal control system also serves as a process that guides an organization towards achieving its established objectives ([27]; [28]; [29].

In the private sector, company directors are responsible for determining policy, monitoring performance and taking corrective action if either policy or its implementation is defective. Internal control provides a means of assurance that corporate objectives are being achieved. Thus the directors are responsible for internal control. The Institute of Internal Auditors defines internal control as a process within an organisation designed to provide reasonable assurance regarding the following primary corporate objectives: the reliability and integrity of information, compliance with policies, plans, procedures, laws and regulations, the safeguarding of assets, the economical and efficient use of resources and the accomplishment of established objectives and goals of operations or programs. Internal control systems are therefore fundamental to the success and survival of organisations. They keep the organisation on the rails. But organisations sometimes go off the rails. This was the problem (US corporate failure) that resulted in the report of the Treadway Commission (on fraudulent financial reporting) and in the formation of the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

The application of internal control is dynamic, and practices that fit past circumstances may need to be adjusted as those circumstances change. Internal control helps bring order, direction and consistency to our organizations. Internal control system can vary widely among organizations but the standards for a good system are generally the same. The quality of an organization's internal control system has significant impact on the accuracy of management guidance, likewise firms that disclose ineffective internal controls system have larger tendency of experiencing management errors in their operation than those firms that report effective internal controls system [30]. Therefore, it is the responsibility of management of an organization to ensure that effective internal control system is put in place that will ensure the achievement of organizational established objectives. This is because establishment and supervision of effective internal control systems are the responsibility of management, not auditors [31]. Effective internal controls systems are fundamental drivers toward earnings quality [32].

The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel.

[33]Points out the importance of internal control systems. He notes that the external auditors find it difficult to rely on internal control systems of small and medium scale enterprises. This is so because such business entities have not established elaborate systems of internal controls, there is no adequate segregation of duties and there are no assurances as to the completeness of recording business transactions. Ongoing monitoring activities of small entities are more likely to be informal and typically performed as part of the overall management of the entity's operations [34].[35]Found that effectiveness of internal control system helps external auditors to rely on the work of internal auditors and thereby improve their effectiveness. Therefore, internal control systems are integral component of the management processes of Small and medium enterprises which should be establish in order to provide reasonable assurance that the operations are carried out efficiently and effectively.

The major problem in SMEs is inadequate internal controls or they might not be available at all. Strong internal controls will help to reduce risk, to ensure regulatory compliance and expenditure control. It is the management responsibility to ensure that controls are put in place. That responsibility is delegated to each area of operation which must ensure that internal controls are established, properly documented and maintained. [36] Every employee has some responsibility for making this internal control system function. Therefore all employees need to be aware of the concept and purpose of internal controls. The audit role is to assist management operating responsibility through independent audits and consultations designed to evaluate and promote the systems of internal control. Many SMEs are unwilling to establish the standard internal control system. They believe that establishing internal control system is a high cost method, which will bring heavy burden to the enterprise and maybe without significant results. Lack of internal controls makes the work of an auditor to be difficult since there may be a lot of misappropriation of information without the auditor to discover them and thus affects the audit performance.

2.4.2 Audit Evidence

Audit evidence is information that provides a factual basis for the audit opinion. It is the information documented by the auditors and obtained through observing conditions, interviewing people, examining records, and testing documents [37] and [38]. This information can come in many different forms such as documents or oral information, from many different sources such as the accounting system of organisation which is being audited, and may be obtained in several different ways such as observation or inspection [39].

In 2010, the International Auditing and Assurance Standards Board (IAASB) updated two standards in relation to audit evidence [40].These two standards are: International Standard on Auditing No. 500 'Audit Evidence' and International Standard on Auditing No. 501 'Audit Evidence-Additional Considerations for Specific Items' [40]. The ISA 500 requires the auditors to meet an expected minimum standard in relation to the audit evidence that they gather and base their professional opinion upon [40]. The second standard, ISA 501 provides additional guidance to support ISA 500 so that auditors have examples along with defined testing criteria for specific items [40]. The specific items discussed in ISA 501 include evidence for financial statements account balances and disclosures [40].

Audit evidence is dependent on information that provides a factual basis to enable the auditor to develop an audit opinion. [37]Statesthat, auditors' document a range of information types that provide evidence to support their opinion. It is the information documented by the auditors and obtained through observing conditions, interviewing people, examining records, and testing documents [37]. Auditors should have or obtain knowledge of the business of the entity to be audited which is sufficient to enable them to identify and understand the events, transactions and practices that may have a significant effect on the financial statements. The objective of an audit of financial statements is to enable auditors to give an opinion on those financial statements taken as a whole and thereby to provide reasonable assurance that the financial statements give a true and fair view and have been prepared in accordance with relevant accounting requirements. (Institute of internal auditors) To achieve this objective the auditor has to carry out procedures designed to obtain sufficient and appropriate audit evidence in accordance with Auditing Standards, to determine with reasonable confidence whether the financial statements are free from material misstatement.

An auditor's opinion is based on both internal evidence and external evidence that support his assessment of the propriety of financial statement representations. "To be competent, evidence must be both valid and relevant". According to [41], the auditor must collect appropriate amount of reliable evidence concerning the fairness of the financial statements and their conformity with the Generally Accepted Accounting Principles (GAAP). Empirical auditing studies e.g., [42]; [43] and professional standards such as ISA 500 have addressed the relationship between the quantity of audit evidence and its reliability and they found that the quality of audit evidence is influenced by its amount. For example, ISA 500 indicates that the quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence [40]. [42] concluded that the greater number of witnesses, the greater the persuasiveness of evidence. However, in some cases the high amount of evidence provides a limited amount of persuasiveness [43].

[44]Studied the effect of material risk on the amount of audit evidence, and found that the auditors tend to collect more evidence when they find high-risk on balance accounts.

Audit evidence needs to support the auditors opinion in the auditor‘s report and the audit file should indicate how the auditor has arrived at their audit opinion.

The relevance of the audit evidence should be considered in relation to the overall audit objective of forming an opinion and reporting on the financial statement [45].

It is the management and not the auditor which determines the accounting treatment and disclosure practices adopted in the financial statements. Management is in the best position to know the affairs of their company, to maintain its records and to prepare its accounts. Auditors should be independent of and separate from the management and supervisory boards of their clients. Their duties would therefore seem quite distinct. They should state whether, in his view, the financial statements have been prepared in accordance with the law and whether they show a true and fair view.

2.4.3 Compliance with Accounting Standards

GAAP which is the overall guidelines for auditing establishes the framework within which an auditor decides the necessary action to take in preparing for the examination of financial statements, in performing the examination and in writing the report.

[46]View auditing standards as a measure used in determining the ability of the auditor in the performance of the procedures and the objectives to be attained by the use of the procedures undertakes. However, [47] states the objectives of IAS, to include: harmonizing the development of the auditing profession to follow development in business, bridging the gap between the auditors in the world, ensuring standards are of an acceptable level of quality of professional activity, being keystone in evaluation of auditor's performance and providing guidance about auditor's responsibility and due professional care.

In general, standards are necessary to organize any profession and to promote measure and improve the members' performance. [48], observe that standards set the minimum level of performance and quality that auditors are expected by their clients and the public to achieve. According to the auditing profession, auditing standards offer the following benefits: A reduction in the difference, which currently exists between audit reports therefore enabling used to better understand the message the auditor wishes to convey, a set of principles which will help professional judgment, to choose the relevant audit tasks to perform and an aid in persuading clients that the procedures which the auditors wish to carry out is necessary [49].

[50] These standards should be related to the relevant objectives of the audit. Accounting standards provide guidelines on how accounting information should be prepared and presented in order to enhance the value of its contents and facilitate through understanding. The financial statements must "present fairly" the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

IAS 1 requires an entity whose financial statements comply with IFRSs to make an explicit and unreserved statement of such compliance in the notes. Financial statements cannot be described as complying with IFRSs unless they comply with all the requirements of IFRSs (which includes International Financial Reporting Standards, International Accounting Standards, and IFRIC Interpretations and SIC Interpretations).

In 1998, the Council of the Institute of Certified Public Accountants of Kenya (ICPAK) made a historic decision to adopt International Financial Reporting and Auditing Standards for use in Kenya. Accordingly therefore, all companies were required to prepare financial statements based on International Accounting

Standards (IAS) for periods beginning 1 January 1999 while the audits of all financial statements for period ending 31 December 1999 were to be carried out based on International Standards on Auditing (ISA).

Prior to this, ICPAK had issued Kenyan Accounting and Auditing Standards that were largely adopted from the IAS and ISA modified to suit the Kenyan environment. The decision to adopt international reporting standards fully was made at a time when the Kenyan business scene was reeling from numerous bank failures in the 1980s and 1990s.These failures raised questions as to the reliability of audited financial information and particularly the fact that the financial statements of these banks did not provide any early warning signs about these bank failures.

Since the adoption of international standards, there have been various benefits. There has been enhanced comparability of financial statements and the provision of better financial information that facilitates analysis and decision-making by various users. The stock market has witnessed increased activity and there has also been increased cross border investments. The use of international reporting and auditing standards provides safeguards to the public and generally increases public confidence in financial reporting.

In Kenya, the vast majority of companies can be considered to be SMEs. They are largely owner managed or controlled with financial statements produced largely for use by banks and tax authorities. In most cases, they lack a well-developed finance function and do not employ qualified accountants due to lack of resources. Since they are managed by their owners, SMEs are not motivated to adhere to the reporting requirements of IFRS. Indeed the more complex the standards the higher the levels of non-compliance.

III. Research Design And Methodology

The study used descriptive design. The target population will be from Auditing Firms in Mombasa, while the study population concentrated on Accounting and Auditing Staffs in their Firms. The total population of the study was sixty five (65).From the target population of 65, the sample size was 56 respondents. This sample will generate information on the determinants of financial audit in SMEs.The researcher used simple stratified sampling procedure to select a sample that represents the entire population. Stratification was based on employees of Audit firms, whom were classified in Accounting and Auditing department.Structured questionnaire was a key instrument for collecting data for the study. Each respondent received the same set of questions in exactly the same way. The secondary data was obtained from audited financial statements and audit files.Quantitative data was collected using structured questionnaires, which was analyzed using the Statistical Package for Social Scientists (SPSS) version 17, while qualitative data was organized according to answers to open ended questions in the questionnaire and analyzed through content analysis. Presentation of quantitative data was performed using Statistical Package for Social Science (SPSS Version 17) and the information generated was presented in form of Tables, Pie-charts and Bar graphs only where it provides successful interpretation of the findings. Descriptive data will be provided in form of explanatory notes. A multiple regression model was conducted. The dependent variable is the financial audit performance while the independent variables are audit evidence, internal control systems and capital compliance with accounting standards.

The model specifications are as follows:

$Y=\beta_0+\beta_1X_1+\beta_2X_2+\beta_3X_3+e$ …………………. (1)

Where Y=financial audit performance.

X_1=internal control systems.

X_2=Audit evidence.

X_3=Compliance with accounting standards.

β_0=Regression constant

β_1, β_2 and β_3= Regression Coefficients

e= error term signifying the regression significance level (f- significance)

IV. Research Findings And Discussions

4.1Regression Analysis

Table 4.1.1 Descriptive Statistics

	Mean	Std. Deviation	N
Financial audit	3.7098	1.20017	56
Internal control system	3.5536	1.17620	56
Audit Evidence	3.0179	1.37746	56
Compliance with accounting standards	4.0536	.90292	56

Table 4.1.1 above shows the summary of the mean for the dependent variable financial audit and the dependent variables internal control systems, audit evidence, and compliance with accounting standards for the 56 computed variables which were used for regression analysis.

Table 4.1.2 Correlations

		Financial audit	Internal control	Audit evidence	Compliance with accounting standards
Pearson Correlation	Financial audit	1.000	.982	.928	.914
	Internal control	.982	1.000	.945	.919
	Audit evidence	.928	.945	1.000	.789
	Compliance with accounting standards	.914	.919	.789	1.000
Sig. (1-tailed)	Financial audit	.	.000	.000	.000
	Internal control	.000	.	.000	.000
	Audit evidence	.000	.000	.	.000
	Compliance with accounting standards	.000	.000	.000	.
N	Financial audit	56	56	56	56
	Internal control	56	56	56	56
	Audit evidence	56	56	56	56
	Compliance with accounting standards	56	56	56	56

The correlation analysis Table 4.1.2 shows the relationship between the independent variables, internal control systems, audit evidence, and compliance with accounting standards and the dependent variable financial audit. The analysis indicates the coefficient of correlation, r equal to 0.982, 0.928 and 0.914 for internal control systems, audit evidence and compliance with accounting standards respectively. This indicates a very strong positive relationship between the variables.

Table 4.1.3 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.983[a]	.966	.964	.22786	.966	491.284	3	52	.000

Predictors: internal control system, Audit evidence, compliance with accounting standards;
Dependent variable: financial audit.

Table 4.1.3 shows the regression model summary indicating the coefficient of determination R Square as 0.966. This means that 96.6% of the relationship is explained by the identified three determinants of financial audit in SMEs. The rest 3.4% is explained by other determinants. In summary the three determinants studied namely, internal control systems, audit evidence, and compliance with accounting standards explains or determines 96.6% of the relationship while the rest 3.4% is determined by other factors.

V. Summary And Conclusion

5.1 Summary

This section summarizes the findings of the study and it has been grouped into sections.

5.1.1 How internal control systems affects financial audit in SMEs

The findings showed that internal control systems is essential on financial audit in SMEs through maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company, provision of reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, integrating controls into the information system and using it to monitor and control the business and information processes, periodic evaluations of internal control performed with appropriate scope and frequency can strengthen the ICS of an organization.[35]found that effectiveness of internal control system helps external auditors to rely on the work of internal auditors and thereby improve their effectiveness.[32]found that effective internal controls systems are fundamental drivers toward earnings quality The findings also showed that there were positive correlations between some of the variables.

5.1.2 How audit evidence affects financial audit in SMEs

The finding showed that audit evidence can exert influence on financial audit in SMEs through Obtaining sufficient and reliable information as a major source of evidence to the auditor, obtaining knowledge of the business of the entity to be audited which is sufficient to enable the auditor to identify and understand the events transactions and practices that may have a significant effect on the financial statements, proper management of company's documents and book of account, An auditor's opinion is based on both internal evidence and external evidence that support his assessment of the propriety of financial statement representation.[42] concluded that the greater number of witnesses, the greater the persuasiveness of evidence. However, in some cases the high amount of evidence provides a limited amount of persuasiveness [43].[44]Studied the effect of material risk on the amount of audit evidence, and found that the auditors tend to collect more evidence when they find high-risk on balance accounts.The findings also showed that a positive correlation existed between the variables.

5.1.3 How compliance with accounting standards affect financial audit in SMEs

The findings showed that compliance with accounting standards is essential for financial audit in SMEs through accounting standards which provide guidelines on how accounting information should be prepared and presented in order to enhance the value of its contents and facilitate through understanding, updating accounting standards used by SMEs aimed at providing information to those who provide capital to SMEs, noncompliance of the accounting standards by management will create difficulties to the auditor in giving opinion as to whether the financial statement reflect true and fair view, IFRSS are difficult to apply to SMEs due to the cost that they should incur in obtaining professionals.[48]) observe that standards set the minimum level of performance and quality that auditors are expected by their clients and the public to achieve.The findings also showed that there were no correlation existed between the variables.

5.2 Conclusions

The objective of the independent auditor's examination of financial statements is the expression of an opinion as to whether they present fairly financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles (GAAP).The auditor must state whether the examination was made in accordance with generally accepted auditing standards (GAAS), which consist of ten generally accepted standards and interpretations of these standards as expressed in statements on auditing standards (SAS).

Compliance with the requirements will require a considered approach. This will involve proper planning, adherence to laws and regulations, proper keeping of records, availability of key personnel and compatibility with existing procedures. Companies should discuss their approach with the auditors at the audit planning stage.

The communication between management and the auditor should be freely to help them undertake the audit work smoothly. Through information provided the auditor should be able be able to give assurance on the amount disclosed in the financial statements. Audit of SMEs becomes challenging and thus affect the quality of the audit work and it becomes difficult to achieve the audit objective.

5.3 Recommendations

External auditors must gather evidence regarding the design and operations effectiveness of the company's internal controls and determine whether the evidence supports management assessment of the effectiveness of the company internal controls.

SMEs should adopt the IFRS for SMEs in preparation of financial statement which will boost confidence to the financial users. Employing of qualified personnel to reduce the risk of transactions and ensure proper keeping of records. The auditors rely heavily on management to provide information and documents and it is the right of an auditor to access all materials aspects which are relevant to the give an opinion on the financial statements.

SMEs should understand their duties and the duties of the auditor. They should understand that the auditor is a spot check of information, not exhaustive review of all financial transactions. Further, the auditor is charged with determining the accuracy of the financial statements only in all material aspect.

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