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Influence of Financial Reporting Requirement on Formalizing Small and Medium Enterprises in Kenya

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Abstract
This research article sought to establish the influence of financial reporting requirement in formalizing small and micro enterprises in Kenya. The study took the form of a descriptive survey design which is an efficient method of collecting original data and systematic information from a wide range of respondents. The target population was 1200 SME's operating in Nairobi Central Business District and registered with the Nairobi County government. The sample size was 369 respondents, calculated using Yamane Sampling Formula. The study employed stratified and systematic random sampling to select SME's from 4 different sectors and also incorporated commercial banks and microfinance institutions in the sampling distribution. Data was collected by use of open and close-ended questionnaires supplemented by an interview schedule and an observation checklist. The researcher used descriptive and inferential statistics such as mean, standard deviation, correlation and multiple regression analysis. The study findings showed that availability of financial records eliminate information asymmetry thus allowing for better monitoring. Further, availability of quality and credible financial information enhances business access to loan facilities and better credit terms. The study recommended that the SMEs need to formalize their operations to ease credit access from lenders hence realize growth and improved performance.
Key Words: SMEs, Credit Access Requirements, Formalization

Introduction

The European Union defines SMEs (Small and Medium Enterprises) as businesses which employ less than 50 employees and with turnover of less than US$10 million (World Bank, 2014). In Kenya, the concepts; informal economy, SMEs and Jua Kali are often used interchangeably (Maengwe, 2014). The SMEs account for 98% of all registered businesses in Kenya (Mage, 2012) majority of whom operate informally.

Financing constraint is one of the biggest concerns impacting potential entrepreneurs around the world (Kerr and Nanda, 2009; Brown et al, 2011). A World Bank Enterprise Surveys on 130,000 firms in 135 countries identified access to finance as one of the major obstacles of SMEs growth (World Bank, 2014). In Kenya, over 60.4% SMEs do not have access to credit markets (Mwangi & Ouma, 2012). Lack of proper books of accounts, collateral requirements, low-income, problems in filing tax repayment reports and unsound business plans are some of the major reasons for the unwillingness of the formal bank's lending credit, to majority of entrepreneurs who own small and medium enterprise (SMEs) (Sacerdoti, 2005; Gichuki, Njeru & Tirimba, 2014).

The Basel II requirements compel banks to precisely measure the risk of their applicants. The SMEs need to meet specific requirements in order to access Business Development Services (BDS) and credit services offered by financial institutions (Bosibori, 2012) but rarely meet the conditions (Gichuki *et al*., 2014). Consequently, informality comes at a price to both firms and governments. Most firms suffer from adverse selection by lenders due to their informality, hence limiting their growth. Governments on the other hand experience both from lack of formal entrepreneurship that can steer economic growth and the shortfall of tax revenues to provide for public goods and services. Currently, there are concerted efforts to make it easier for firms to formalize through various policy and regulatory reforms (Bruhn and McKenzie, 2014).

The study was prompted by the current need to organize the ever growing informal economy so that the workers thereof can benefits such as inclusion into financial and social protection system. The government too stands to gain from increased revenue through expansion of the tax base into the informal economy who are generally described to operate 'under the radar'. The study results and recommendations will also benefit trade unions whose membership in the formal economy has shrank and in dire need to organize the informal workers and extend its decent work agenda.

1.2 Statement of the Problem

Globalization has accelerated the growth of the informal economy worldwide. It now consists the bulk of the workforce in many countries, particularly the developing world. In Kenya the informal economy, which is characterized by Small and Medium Enterprises (SMEs), is the biggest employer accounting for over 83% of the labor force and contributing about 34% of Kenya GDP (Republic of Kenya, 2015). Despite their significance, past statistics indicate that 3 out of 5 businesses fail within the first few months of operation and those that continue, 80 percent fail before the fifth year (Republic of Kenya, 2007; Gichuki and others (2014).

One of the most significant challenge is the negative perception towards SMEs (Republic of Kenya, 2007; Mwobobia, 2012). The informal economy is sometimes criminalized and termed as "illegal", "black market" or even "hidden economy" (Kuria, 2013). The businesses in it may include counterfeit products, illegal arms and drugs. It is also a social challenge because informal employment is often associated with low earnings, low-quality jobs and poverty (Jütting & de Laiglesia, 2009; OECD, 2012).

Informality is also an economic concern, as it affects public revenues and firm productivity. Taxation gives professionals and entrepreneurs a major incentives to work "under the radar" (UNIDO, 2008). In spite of the informal economy growing at a very fast rate in Kenya, the collection of taxes has been a great challenge. Generally, if these businesses remain untaxed, and as more people transition into the economy, the government is likely to continue losing billions of shillings. Such a scenario will impact on government's ability to meet its income targets and consequently affect its service delivery (IEA, 2012).

Lenders in Kenya are very cautious of the perceived high credit risk of SMEs, hence they impose certain credit access requirements such as collateral, group guarantee, audited financial statements among other. A similar study by Chepkorir (2014) concluded that strength and quality of financial statements was a vital attribute for SME lending. In addition, Gichuki and others (2014) observed that failure to meet the lender's credit access requirements as a result of informality intensifies SME's credit constraint. However, none of the reviewed studies considered the role of these requirements in formalizing the SMEs in their quest to access credit.

It was therefore imperative to explore financing as an approach that can heighten formalization of this sector so that it's players can benefit from sustainable growth and decent work arrangements. For that reason, the researcher sought to find out whether financial reporting, a credit access requirement imposed by financial institutions, had a role in transitioning the informal enterprises to formal.

1.3 Research Objective

To determine the influence of financial reporting on formalization of small and medium enterprises in Kenya.

1.4 Research Hypothesis

H_i: There is no significant influence of financial reporting on formalization of small and medium enterprises in Kenya.

2.1 Theoretical Framework

The severity of the financial crisis which first became apparent in 2007 provoked widespread public discussion about the structure and behavior of the financial sector (Dowla, 2010). The term moral hazard has been used for over two centuries in discussions of insurance to refer to the likelihood the insurer would support the insured party to take on extra risk in a way which could not effectively be monitored. Moral hazard is also a concept which is employed in mainstream analysis which focuses on rational behavior, usually with respect to information

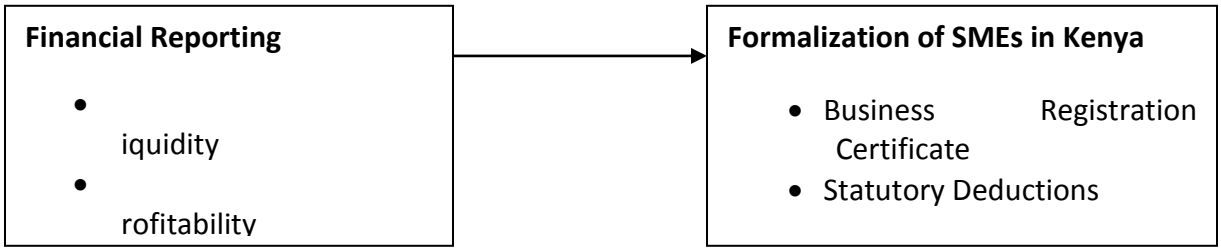
asymmetry. The core concepts of the moral hazard theory are perverse incentives, negative precedents, norms, and provocation (Westover, 2005).

It is opportunistic actions which takes advantage of a chance for personal gain even if it is at the expense of others. Moral hazard therefore involves the risk that an individual or group will behave immorally, flouting moral conventions and breaching trust (Dowla, 2010). Banks and other financial intermediaries earn profits by having better information about investments than their depositors. Problems of getting people to choose hidden actions appropriately are called moral hazard while the problems of getting people to share hidden information honestly are called adverse selection. Under Basel standards, loans to small businesses and individuals are considered risky and entail maximal capital charges unless "securitized" (Myerson, 2012).

Asymmetric information leads to higher costs of borrowing – both in the interest rate and in collateral requirements. Self-financing may be the best option for some borrowers where credit is costly. Asymmetric information leads to higher costs of borrowing both in the interest rate and in collateral requirements. Dowla (2010) observes that moral sentiments are not the only sentiments governing behavior; behavior may for example be governed by greed, responding to monetary incentives. But the argument here is that commercial society cannot function without the operation of some moral sentiments such that there is some foundation of trust in commercial relations. In other words, it is inappropriate to assume that behavior is opportunistic, driven by monetary incentives.

2.2 Conceptual Framework

The objective of the study was to determine the influence of financial reporting on formalization of SMEs in Kenya.



2.3 Review of Literature on Variables

2.3.1 Financial Reporting

Keeping records of accounts is necessary for all business operations but small businesses neglect due to insufficient, incorrect or non-existent books. In regard to accounting standards, Karugu, (2013) asserts that SMEs tend to have little accounts or records and engage few or no professionals unlike major companies. Additionally, Fatoki (2014), observe that SMEs are the most informational opaque due to their lack of track recording. Such firms find it costly and beyond their capacity and skills to comply with standard recordkeeping requirements (World Bank & DFID, 2007). Asymmetric information leads to adverse selection and moral hazard, which are two causes of credit rationing. A study by Calice and others (2012) stated that

amongst Kenyan banks, the lack of quality information was the biggest SME-specific hindrance and obstacle to SME lending.

Financial statement lending involves underwriting loans based on the strength of a borrower's financial statement (Fatoki, 2014). Lenders analyze financial statements to measure a firm's present performance and capacity of a business to effect repayment of credit, general credit risk and predict future performance (Kitindi *et al*., 2007). The credit selection model used by lenders utilizes financial history to forecast a firm's going concern thus segment prospective creditors based on a probability risk of default. Moreover, SMEs that have more fixed assets tend to utilize higher financial leverage because they can borrow at lower interest rates as their loans are secured with these assets serving as collateral (Bradley, *2009;* 1984; Abdulsaleh & Worthington, 2013).

In their study, Okello (2005), Kimaru and Jagongo (2014) affirm that the inability of SMEs to maintain books of accounts for their transactions has hindered uptake of the turnover tax system that was introduced by KRA in 2007. This is a presumptive taxation based on turnover or gross income which obliges SMEs to keep some basic books and records. The SMEs below the VAT threshold of 5 million Ksh (US$ 71,500) are subject to a presumptive tax at a rate of 3% on declared turnover in case the business maintains accounts and 3% of Ksh 5 million if a business does not keep accounts (World Bank and DFID, 2007). Even when available, the financial information provided by SMEs may not accurately reflect their current financial position and overall business performance (Beck *et al.,* 2008; World Bank, 2014). Moreover, for a firm to qualify for a government tender under the Access to Government Procurement Opportunities (AGPO) program, SMEs are expected to submit audited books of accounts as evidence of financial capacity (Orido, 2015).

2.3.2 Formalization of SMEs in Kenya

Neoclassic approach defines informal economy as one that lack formal registration while neo-structuralism approach emphasize its multiple deficiencies especially lack of capital (UNIDO, 2008). Informal economic transactions are those productive activities that are undeclared – or inadequately accounted for – in a country's public accounts. Businesses which have failed to be registered under laws that govern business operations in a country are sometimes termed as "illegal", "black market" or even "hidden economy" (Kuria, 2013).

Registration practices in Kenya are often unnecessarily bureaucratic and may involve multiple agencies, and multiple crosschecks; complex due to the different laws, norms, documents and forms required; expensive, and time-consuming. Delays in business registration, which often involves multiple government institutions including the tax administration, can be a significant impediment to business formation and particularly harmful to the small entrepreneur with limited start-up cash reserves (Simiyu, 2013). For example, local authority issues a daily license for Kenyan shilling (Ksh) 100 and is often shown to council askaris or regular police upon demand as proof of legal business. However, the daily receipts do not bear entrepreneurs' names, the kind of job they do, nor the category of business they are engaged in (Kinyanjui, 2010).

Several studies reveal that reducing compliance costs related to business registration can be a major factor facilitating the formalization of SMEs (UNIDO, 2008). Kenya has successfully reduced the bureaucracies for starting and operating a small business by harmonizing all formalities required for registering and operating SMEs. The Huduma Centre model is an inter-institutional framework between various state departments such as; Registrar of companies, KRA, NSSF and NHIF providing a single window for business formalization. The Huduma centers, which are located in all major towns, provide one-stop shop services for registration and tax payments and other business support services to entrepreneurs. The model has also proven highly effective in the formalization process.

3.1 Research Methodology

The study adopted both a qualitative and quantitative approach. Data analysis was undertaken by means of standardized statistical procedures. Questionnaires were used to capture qualitative and quantitative data from owners of SMEs under consideration. Guided interviews were used in cases where owner's education background makes it difficult respond to questionnaires. An observation checklist was important to capture physical evidence of formalization. In addition, an interview schedule was used for key informants from financial institutions; banks and micro-finance. The researcher used a cross-sectional survey research design to determine the influence of credit access requirements on formalizing SMEs in Kenya. The design allowed the researcher to undertake a cause-effect tests for the study variables, thus enabled the research to test whether financial reporting requirement influences formalizing SME's.

The target population for the study was drawn from all small and medium enterprises registered with the Nairobi Central Business District Association (NCBDA). There are 1,200 SME's registered within the central business district (Morange, 2015). Financing institutions especially banks and micro-finances were included to ensure consistency with the objectives of the study. This is because the study sought to determine the role of credit access requirements, which are imposed by financial institutions, in formalizing SMEs. The study used stratified random sampling technique to proportionately select a sample of 369 respondents from the sub-units namely; commercial and trade, Services, Pharmaceuticals, and food and beverage. The Statistical package for social sciences (SPSS) was the main tool of analysis. Information was then presented diagrammatically by use of tables, bar charts, graphs and pie charts.

4.1 Results and Discussions

4.1.1 Response Rate

The researcher targeted to collect data from a sample of 369 SMEs in Nairobi. However, the study did not achieve a response of 100 % as there were some non-response incidences where the researcher could not access all the respondents or the information given was found insufficient to be utilized in the study. Out of the 369 responses targeted, 292 gave adequate information through answering the questions completely. However, 77 respondents did not give response to the study making a non-response of 21 %. Thus, the study realized a response

rate of 79 % (292 / 369). According to Mugenda and Mugenda (2003) a response rate of 50 % is adequate, 60 % is good and above 70% is very good.

4.1.2 Diagnostic Test on the Instrument

Factor analysis was performed for each variable and it's indicators. From factor analysis, factor loadings were extracted and used as the basis of retaining or expunging observed indicators. All the indicators measured had factor loadings greater than 0.4 and were retained except one which was thus expunged and not considered in computation of the latent variable formalization. The factor scores were computed and used to compute latent variables that were used for inferential analysis to test hypothesis and draw conclusions.

4.1.3 Instrument Validity

The researcher used the results from factor analysis to measure and test the construct validity of the instrument. The average variances extracted (AVEs) from the observed indicators of the latent variable can be used to test the validity of the indicators to measure the latent variables. The AVEs above 0.5 implies convergent validity. All the variables of the study had AVEs above 0.5 from the observed indicators used to measure them. This implies convergent validity of the instrument used to collect data.

To measure and test discriminant validity, the researcher used a comparison of the AVEs and the squared correlations. Discriminant validity confirms that the constructs that are not supposed to be related are actually not related. The squared correlations of the latent variables generated were computed and the results compared with the AVEs. All the variables had AVEs greater than the respective square correlations implying discriminant validity of the instrument.

The Kaiser-Meyer-Olkin (KMO) measure of sampling adequacy and the Bartlett's test of sphericity were used to test the reliability of the factor analysis results. The KMO statistic was found to be 0.958 which is greater than 7 and the Bartlett's chi-square has a p-value of 0.000 which is less than 0.05. This implies that the factor analysis results can be trusted.

4.1.4 Reliability of Constructs

The instrument was tested for the reliability by computation of Cronbach alpha statistics of reliability. According to the findings, all the variables had Cronbach's Alpha coefficients that were all greater than the 0.7 threshold thus confirming all the indicators for the variables were reliable measurements and thus the questionnaire was suitable for data collection for the study.

4.2 Preliminary analysis

4.2.1 Demographic Characteristics of the Respondents.

According to the study results majority of the respondents (66.8%) were male. The female respondents were the least representing 33.2%, a contradiction from Locke (2007) who noted that SMEs are predominantly owned by women but in line with the findings of Aga and Reilly (2013) who determined that the male respondents were the majority in their study. With

regard to the respondents' age groups, 2.4% were aged below 21 years, 14.7% were aged between 21 - 30 years and 65.8% were aged between 31 - 40 years whereas 17.1% were aged above 40 years. The findings also show that, majority (62%) of the respondents had achieved secondary education as the highest level of academic whereas 38% had post-secondary education. Further, 50% of the respondents had no technical training related to this business while 41.1% had on-the-job training and only 8.9% had technical training. Further, Abdulsaleh and Worthington (2013) in their study determined that majority of the respondents were experienced and those in managerial positions were aged more than 40 years. However, in contrary to the findings of this study, the majority of respondents were aged 31-40 years.

Majority (34.6%) of the respondents to the study were employees of the business, 31.8% were family relatives of the business owners, 19.9% were joint-owners of the businesses and 13.7% were the owners of the businesses. The findings of the present study agree with the findings obtained by Samreen, Zaidi and Sarwar (2013) and Ndunda, Ngahu and Wanyoike (2015) who determined in their studies that growth from micro to small and medium enterprises is mainly indicated by employment creation.

4.2.2 Source of Business Finance

The findings revealed that the main source of business finance for the SMEs was bank/ microfinance loans accounting for 79.5%. Other sources were personal savings at 64.7%, 43.5% from family and friends, 40.1% from selling of personal assets and 39.7% from the women enterprise fund/ youth fund. The least source given was the chamas/ROSCAs at 37%. The findings obtained agree with those posited by Feakins (2005) and Fatoki (2014) who claim that commercial banks are one of the major sources of finance to SMEs in Kenya.

4.3 Descriptive analysis and discussions on the study variables

4.3.1 Financial Reporting

Financial reporting was used as an independent variable in the third objective of the study. On average, there is agreement in the perception that financial reporting enhances availability of business information thus better track recording. Secondly, respondents had an average perception that availability of financial records eliminates information asymmetry thus allowing for better monitoring. There was an agreement in the perception that availability of quality credible financial information enhances business access to lending facilities. The key respondents also agreed that financial reporting fosters the ability of the business to access better credit terms.

On the impact of professionally audited financial records on corporate image, respondents pointed out that proper books instill a better image of the going concern view of the firm and also enables a business to be conscious of its liquidity levels. Quality financial reporting mechanism was also observed to enhance the firm's capacity to undertake seamlessly its tax obligations hence opening up the business to opportunities such as government tendering.

The study results revealed that keeping records of accounts is crucial for all business operations; however small firms fail to obtain credit because of inadequate, incorrect or non-existent books. The findings agreed with those posited by Calice *et al.* (2012) who reported that

amongst Kenyan banks, the absence of valuable data on SMEs was a particular deterrent and hindrance to SME lending. In addition, the study confirms the observation made by Chepkorir and others (2014) that the most common credit access requirement by lenders in Kenya is a certified financial statement.

4.3.2 Formalization

Findings indicated that all the businesses were found to have a business permit/ operation license. Similarly, all the businesses studied were registered with line authorities. Of the businesses, 75% had enacted formal structures to support financial information recording and reporting. The findings as well show that 92.8% of the businesses studied were registered with statutory bodies such as NSSF and NHIF. A keen observation of the SMEs against the checklist of general indicators of formalization revealed a high level of formality. Consequently, majority of the studied SMEs recorded that they had accessed external credit financing. These results are in line with Gichuki and others (2014) who observed that an increase in the level of SME formality reduces credit constraints.

4.4 Results of the Interviews

The study sought to examine the availability of credit to the SMEs as facilitated by the financial institutions. There was a general view that improved credit accessibility to SMEs is essential for it affects the ability of the firms to grow and eventually formalize.

According to the discussion with the loan managers in the commercial banks, the study established that financial institutions in Kenya valued the SMEs since majority of entrepreneurs fall under this category. The banks confirmed that they had special loans for the SMEs with attractive packages and simple selection process. The study clearly established that SMEs in Nairobi have the opportunity to invest more through securing loan facilities available in the financial institutions. However, the SMEs are expected to meet certain requirements for them to access the credit facilities offered. The requirements were observed to include business registration certificate, proper books of accounts among other documents.

According to the findings, small and medium enterprises are the major loan users in all financial institutions in Kenya. However, ability of the businesses to access credit facilities is affected by the level of formalization of businesses as evidenced by certain required operational tools. The study findings show that formal businesses have greater access to credit facilities since they meet the set criterion given by the banks. The ability of any borrower to access loan facilities is greatly influenced by the ability of the borrower to meet the credit requirements. The common requirements for the SMEs to qualify for a loan were stated to be; collateral especially fixed assets, guarantors, financial reports and managerial skills.

From the findings, financial reporting is vital for the SMEs to assess the credits for further investments. Since the businesses require funding, they strive to prepare the financial reports which show their business performance and how the cash flow has been managed. The requirement therefore facilitates formalization since preparation of financial reports is a move towards formalization of the business operations.

4.5 Inferential Analysis Findings

The inferential analysis involved determination and checking whether there is any relationship between financial reporting requirement and formalization of SMEs. Inferential analysis also involved the estimation of models to determine the influences of the independent variables on the dependent variable formalization of SMEs. Under inferential analysis, the study conducted analyses using the unobserved latent variables that were generated from factor analysis dimension reduction.

4.5.1 Correlation Analysis

To determine the relationship between the independent variables and the dependent variable, Correlation coefficients were computed as presented in table 4.15 The Pearson correlation coefficient was used as the latent variables generate for inferential analysis were on a continuous scale. The correlation coefficients were computed and 2-tailed test p-values used for testing significant relationships at the 5% level of significance. The strength of association was determined through the Pearson Correlation Scale where a correlation of values between 0.0 – 0.3 is an indication of no correlation, 0.3 – 0.5 is a weak correlation, 0.5 – 0.7 is a moderate correlation and a correlation coefficient of value of 0.7 and above is an indication of a strong correlation between the variables.

Table 4.15 also presents the study findings on the correlation between financial reporting requirement and formalization of SMEs. According to the findings, there is a strong relationship between financial reporting requirement and the formalization of SMEs($r = 0.736$; $p = 0.000 < 0.025$). The correlation coefficient was also significant at the 5% level of significant. The findings of Arthur (2009) and Kitindi *et al*. (2007) agree with the present study findings as the studies determined that there was a positive link between financial reporting and formalization of companies.

Table 4. 1 Correlation matrix

		SME formalization	Asset collateralization	Joint liability	Financial reporting	Tax Compliance
SME formalization	Pearson's ρ	1	.917**	.687**	.736**	.782**
	2-tailed Sig.		0.000	0.000	0.000	0.000
	N	292	292	292	292	292
Financial reporting	Pearson's ρ	.736**	-0.056	0.009	1	-0.003
	2-tailed Sig.	0.000	0.342	0.874		0.954
	N	292	292	292	292	292

**. Correlation is significant at the 0.01 level (2-tailed).

4.5.2 Regression between Financial Reporting and Formalization of SMEs

The study objectives also sought to determine the influence of financial reporting on formalization of small and medium enterprises in Kenya. A bivariate regression model was fitted as analysis for this objective. The model summary statistics for the model are presented in table 4.22. The analysis found that the variation in financial reporting explained 54.2% of the variance in formalization of SMEs in the model. This is explained by the R-square statistic which was found as 0.542. The results imply that other factors not included in the study contribute to 45.8% (1 – 0.542 = 0.458) in formalization of SMEs.

Table 4. 2 Model Summary for Financial Reporting

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.736a	0.542	0.541	0.374

a. Predictors: (Constant), Financial Reporting

The findings shown in the coefficients table 4.24 indicate that financial reporting had a positive and significant influence on SMEs formalization. According to the results, financial reporting showed a significant influence on formalization of SMEs with the coefficients (β = 1.081, t = 18.529, p=0.003<0.05) indicating a positive effect on SMEs formalization. The p-value of the estimated coefficient was found to be 0.000 which is less than 0.05 level of significance. The significance of the coefficient estimate implies that financial reporting has a significant influence on formalization of SMEs. Increasing financial reporting would result into a 0.830 increase in levels of SME formalization. These findings are in line with other scholars' findings that there exists a positive significant relationship between financial reporting and SMEs formalization across different sectors (Abdulsaleh & Worthington, 2013; Kimaru and Jagongo, 2014). The equation formulated from the analysis is given by;

$$\text{Formalization} = 1.081 + 0.830\text{Financial Reporting}$$

Table 4. 3 Regression Coefficients for Financial Reporting

		Unstandardized Coefficients	Std. Error	Standardized Coefficients	T	Sig.
1	(Constant)	1.081	0.173		6.264	0.000
	Financial Reporting	0.830	0.045	0.736	18.529	0.000

a. Dependent Variable: Formalization

The resulting equation from the model is given by;

$Y = 0.728 + \ 0.257X_1$

Table 4. 4 Multiple regression Coefficients

		Unstandardized Coefficients	Std. Error	Standardized Coefficients	t	Sig.
1	(Constant)	0.728	0.077		9.502	0.000
	Financial Reporting	0.257	0.026	0.228	10.002	0.000

a. Dependent Variable: Formalization

4.6 Model Diagnostic Tests

Diagnostic tests were undertaken in this study to verify whether data used had met the assumptions underlying the use of ordinary least squares (OLS) regression analysis for model estimation. The diagnostic tests included the test of collinearity to check the independence of predictors, normality of the residuals, non-autocorrelation of the residuals and homoscedasticity of the residuals. The model fitted for the study data was tested for normality of the residuals.

To confirm normality of the residuals, a statistical test was used to test whether the residual follow a normal distributions. The Kolmogorov-Smirnov test was applicable as the sample size was greater than 30. According to the test as shown in table 4.31, the p-value of the K-S statistic is 0.200 which is greater than 0.05 implying a significant normal distribution of the residuals.

Table 4. 5 Normality test

Kolmogorov-Smirnov[a]			Shapiro-Wilk		
Statistic	Df	Sig.	Statistic	Df	Sig.
0.028	292.000	.200*	0.997	292.000	0.931

4.6.1 Homoscedasticity

A homoscedastic variable is one that has a constant variance. OLS estimation assumes that the residuals of the estimated model are homoscedastic as they have a constant variance. A graphical presentation of a scatter plot of the standardized residuals against the predicted values is shown in figure 4.3. The figure shows a scatter plot with no pattern of an increasing or decreasing function. The line of best fit from this scatter plot is a line of y=0 with no slope. This is a sign of homoscedasticity.

To confirm that the residuals are not heteroscedastic, a Breusch-Pagan test was carried out on the residuals. The B-P statistic computed follows a chi-square distribution thus a chi-square test was done on the B-P statistic to confirm homoscedasticity of the residuals. The p-value of the B-P statistic was found to be greater than 0.05 implying that the residuals have a constant variance and are therefore homoscedastic.

Table 4. 6 Homoscedasticity Test Results

BP statistic	Df	Sig.
5.140	292	0.061

4.6.2 Autocorrelation

Autocorrelation of a variable also termed as serial correlation is a scenario where the variable can be predicted from an autoregressive process of itself. OLS estimation assumes that the residual term is not auto correlated. To confirm non-auto correlation of the residuals, a Durbin-Watson test was carried out on the residuals of the fitted multiple regression model. The calculated D-W statistic was then compared with tabulated D-W statistics. The calculated D-W statistic was found to be greater than the upper limit of the tabulated D-W value implying non-auto correlation of the residuals.

Table 4. 7 Durbin-Watson

Durbin-Watson statistic	Tabulated lower limit	Tabulated Upper limit
1.8516	1.78371	1.83773

4.7 Hypothesis Testing

Having tested and found that the multiple regression model fitted well the assumptions of OLS as used for estimation, the study proceeded to use the results of the multiple regression of table 4.29 to test hypotheses and draw conclusions on the objectives.

H_{01}: There is no significant influence of financial reporting on formalization of small and medium enterprises in Kenya.

From the model, the t-statistic for financial reporting was found to have a p-value of 0.000. With the p-value of 0.000 being less than 0.05, the null hypothesis is rejected and a conclusion drawn that there is a significant influence of financial reporting on formalization of small and medium enterprises in Kenya.

Table 4. 8 MMR Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. F Change
1	.957[a]	0.916	0.915	0.161	0.916	783.577	4	287	0.000

a. Predictors: (Constant), Financial Reporting,

b. Dependent Variable: Formalization of SMEs

Table 4.34 also presents the regression coefficients of the MMR models with credit access requirement (financial reporting) as the independent variable and the business formalization of SMEs (dependent variable). The table gives the coefficients and the significance test statistics at 0.05 level of significance. The All model one coefficients are significant with p-values less than 0.05 as earlier discussed in the multiple regression section.

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The model generated an equation given by;

$$Y = 0.728 + \ 0.257X_3$$

5.1 Summary of the Study Findings

The study findings illustrated that financial reporting enhances availability of business information thus better track recording. In addition, the results indicated that availability of financial records eliminate information asymmetry thus allowing for better monitoring. Audited financial records were observed to instill a better image and also reflect a going concern view of the firm. The findings showed that elaborate financial reporting enables the business to be conscious of its liquidity levels. It is also clear that having quality financial reporting mechanism enhances the firm's capacity to meet tax obligations. Moreover, elaborate financial reporting opens up the business to opportunities such as government tendering. Consequently, availability of quality and credible financial information enhances business access to loan facilities and better credit terms.

According to the correlation test results, there is a moderate positive and significant correlation between the financial reporting requirement and formalization of SMEs in Kenya. The null hypothesis which stated that there is no positive significant influence of financial reporting on formalization of small and enterprises in Kenya was rejected and the alternative accepted. Further, the study established a positive and significant relationship between financial reporting requirement and formalization of SMEs whereby an increase in the financial reporting requirement would result to a positive change in business formalization.

5.2 Conclusions

According to the study findings, financial reporting eliminates information asymmetry thus allowing for positive screening and hence increased access to loan facilities and better credit terms. It is also clear that having quality financial reporting mechanism opens up the firm to business opportunities such as government tendering. Statistical tests reveal a moderate positive and significant correlation between the financial reporting requirement and formalization of SMEs in Kenya. This implies that financial reporting requirement by financial institution results to a significant effect on formalization of SMEs.

5.3 Recommendations

Based on the findings of the study and in line with the research objectives, the following recommendations were made;

Since credit access requirements were confirmed to have a significant influence in formalizing SME, the study gives recommendations for policy improvement towards acceleration of the transition from informal to formal businesses in Kenya. Credit access requirements imposed by government financing schemes such as the Youth and Women Enterprise Development Funds and the Government Procurement Opportunities (AGPO) have been observed to increase formalization of SMEs. It is therefore imperative that the government builds the capacity of such initiatives to increase their coverage so that as they increase accessibility to financing, the level of formalization of business will be enhanced.

Professional bodies such as the Institute of Certified Public Accountants of Kenya could also collaborate with informal groups to offer training on basic book keeping skills and general compliance. These will also facilitate the formalization strategy as the members would be required to be formally registered as business operators and also comply with other credit access requirements for them to enjoy the privileges of the group.

The government need to institute a policy framework which would require financial institutions to peg credit selection criterion on business formalization. In return, both the county and national governments will realize economic growth, increase tax revenue, enhance job creation, reduced unemployment, improve social protection and significantly eradicate poverty. Further, there is a need to establish more business incubation centres to offer training to the entrepreneurs on basic book keeping concepts in order to reduce information asymmetry which is rated adversely by lenders. In such centres, SME operators should also be sensitized on the importance of formalizing their businesses in order to facilitate financial inclusion, growth and sustainability.

The government should review business formalization structures such as the business registration to encourage compliance. These reforms include; fewer and simple formalizing documents, accessible offices and reduced bureaucracies. The Huduma 'one stop shop' model should be devolved in all counties to ease registration and remittance of statutory dues by SMEs.

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