Effect of Tax Audit on Turnover Tax Compliance among Small and Medium Enterprises in Langata Sub-County, Nairobi, Kenya

Leonard Juma Oringo[1], Dr. Benard Baimwera PhD[2] & Dr. Daniel Kirui PhD[3]
[1]Master in Tax Administration, Moi University
[2]Deputy Commissioner, Kenya School of Revenue Administration
[3]Lecturer, School of Business and Economics, Moi University
Corresponding email: leonardjuma7@gmail.com

Abstract

Purpose: The implementation of turnover tax compliance (TOT) in Kenya was aimed at enhancing revenue collection and improvements in the tax system, the effectiveness of tax administration, and lowering the collection costs in the SME sector. However, over the past decade**,** the KRA has visibly struggled to implement the tax regime as well as collecting the returns. One of the major shortfalls of the TOT has been its collection due to its dependence on the goodwill among the affected taxpayers. Therefore, the main aim of the study was to establish the effect of tax audit on turnover tax compliance among small and medium enterprises in Langata sub-county, Nairobi, Kenya. The study was anchored on the Economic Deterrence theory.

Methods: The study adopted an explanatory research design. The sample size for this study was 353 derived from 3,061 registered SMEs of the population using Yamane (2012) formulae and the responses by owners/managers of the firms. The study targeted 353 questionnaires with each target firm, 268 respondents managed to fill and return the questionnaires showing a 76% response rate.

Results: The analysis of the hierarchical model found that tax audit has a significant positive effect on TOT compliance (B = 0.373, p = 0.006). In a nutshell, the study found that there is a significant relationship between tax audit and TOT compliance among small and medium enterprises in Langata Sub County, Nairobi, Kenya.

Conclusion: The study recommends conducting frequent tax audits to enhance Turnover tax compliance.

Keywords: Small & Medium Enterprises, Tax Audit, Turnover tax compliance

1. Introduction

Tax compliance is the ability and willingness of taxpayers' to comply with the tax laws, declare the correct income tax for each year and paying the right amount of taxes on time (Ibne, Naeem, & Sidra, 2021). Fany, Giri, Engelwati, & Gatot, (2020) defined tax compliance as the accurate reporting of income and expenses according to applicable tax. Further, it indicates the willingness of taxpayer to obey tax laws and their extent of obedience to such laws of their land for a country's economic equilibrium. OECD (2016) defined tax compliance as activities

focusing on delivering tax returns or other reports by taxpayers to meet their tax obligations. Gideon & George, (2023) defined tax compliance as the extent to which a taxpayer complies with the laid tax laws in a country such as disclosing correct income and submitting and paying the correct return on time.

Turnover taxes are prevalent in developing countries as a simple form of presumptive taxation of businesses being levied on their sales and not profit. (Feng & Jean, 2024). According to Feng & Jean (2024), countries where voluntary compliance with tax laws is strained by a lack of Taxpayer knowledge and capacity, a turnover tax can be a useful policy to reduce informality and reduce tax non-compliance. In Kenya, a turnover tax was proposed by Finance Act 2007 and was implemented in 2008. Turnover tax is anchored in the Income Tax Act Cap. 470, Sec 12C, Turnover Tax regulations of 2007, and the third schedule which set out the tax rate. The tax system was later suspended during the national budget reading for the financial year 2018/2019. However, it was re-introduced during the budget reading for the financial year 2019/2020 to commence 1st January 2020. The ITA Sec 12C states that Turnover tax shall be payable by any resident person whose turnover (Sales) from the business is one million shillings and does not or is expected to exceed 25 Million shillings during any year of income, with the exclusion of income from Rental, management and professional fees, and income subject to a final withholding tax KRA (2023).

The tax audit process is important, this is because it assists the government in collection of taxes necessary for government projects, as well as maintaining economic and financial order to promote tax compliance among Taxpayers (Ojo, 2023). Kennedy and John (2014), alluded that the key primary purpose of conducting tax audits is to preserve confidence and maintain the integrity of ther tax system.

Small and Medium Enterprises contribute to the economy by creating opportunities for employment, hence contributing to attune of about 25% of the country's GDP (KNBS 2013). According to Odongo & Munene. (2023), Small and Medium Enterprises comprehensively formed the key taxpayers in the Kenyan economy through innovation and job creation. According to KAM (2021), the SMEs are the backbone of Kenyan economy through job creation and as a stepping stone to achieving shared prosperity. They are innovators, generating new business ideas and developing the most interesting concepts resulting in contributions to the community and country economy at large.

1.1 Problem Statement

According to annual revenue generation report of KRA (2023), in the financial year 2022/2023 for instance, the projected income tax was Ksh 1,007,585Tr, during this period, KRA collected Ksh 758,798Bn representing 75.30% of the target, resulting in a revenue gap of Ksh 248,787Bn. The target for turnover tax for the same period set by KRA was Ksh 128,114, 921. Out of this target, KRA managed to collect TOT of Ksh 112, 653,556 resulting in a revenue shortfall of Ksh 15,461,365 representing 87.93% of the target amount. The above statistical data clearly shows the trend in which KRA has been missing its revenue collection targets. Hence this study was conducted to determine the effect of tax audit on the determinants of Turnover tax compliance among SMEs in Langata Sub-County Nairobi Kenya.

2. Literature Review

2.1 Economic Deterrence theory

Deterrence theory of tax compliance initially was proposed by Casey and Scholz in 1991. The deterrence theory of tax compliance offers details into addressing challenges by exploring tax

enforcement mechanisms that can either deter tax non-compliance or complement the taxpayer's morality towards tax laws (Philip, Adeduro, Akinadewo, & Akinadewo 2024). According to Philip et al. (2024), the deterrence theory is primarily employed to examine tax evasion, which is being implemented through various approaches both punitive and persuasive. The approaches include increasing the likelihood of detection, through tax audits, and imposing harsh penalties.

The economic deterrence theory of tax compliance was developed by Allingham and Sandmo (1972) and Srinivasan (1973), that was created on economic crime model, which states that the government will try to prevent tax evasion by undertaking some actions such as tax audits and penalties (Gideon & George, 2023; Jesse, 2022). The model places tax compliance as an element of three hindrance variables; the likelihood of detection, tax rate, and tax audit.

Deterrence theory of tax compliance offer a framework for addressing tax evasion by considering detection mechanisms such Taxpayer audits. Hence it is complimented by insights from social and psychological models for addressing tax compliance challenges. Therefore, this theory is highly relevant to this study because it tries to address the fundamental economic factor that affects SME tax compliance. SMEs in Langata Sub-County, just like any businesses elsewhere make rational decisions based on economic factors like compliance cost and Tax audit, which significantly impact their decision to comply with tax laws. Hence the theory supports Tax Audit.

2.2 Empirical Review

According to Wenty, TriHesti and Achmad, (2023). Tax audit is the process and series of activities carried out by tax authorities/ or evidence carried out objectively and professionally to collect, process data and test compliance with relevant tax laws. The tax audit process is carried out or implemented as a means of enforcement for taxpayers who have decided not to fulfill their tax obligations. A study was conducted by Wenty, Tri, and Achmad, (2023) to determine the effect of tax collection, Tax audit, and taxpayer compliance on corporate income tax revenue in Indonesia. The finding showed that Tax audits had a significant positive effect on corporate income tax revenue. However, the study focused on Corporate companies and used secondary data presenting methodology gap.

In Tanzania, Eddie & Disckson.(2022), conducted a study on determinants of tax compliance among small and medium enterprises. The study used tax audits as indices to measure institutional factors affecting tax compliance. The researcher concluded that tax audits had a positive significant effect on tax ancompliance from the informal sector. The study was conducted in Tanzania.

Ilala Municipality thus geographical gap. Gideon & George (2023), looked at the effects of tax audits on tax compliance of small and medium enterprises in Nairobi County, Kenya. The study surveyed samples of 399 using a structured questionnaire. The data obtained were analysed through descriptive and regression analysis. The study established that tax audits had a positive significant influence on TOT tax compliance. The study focused on Tax audit as the only independent variable thus presenting a conceptual gap.

2.3 Conceptual Framework

Miles and Huberman (1984) define conceptual framework as the current version of the researcher's map of the territory being investigated. Implied that conceptual framework may evolve as research evolves. This study had two main types of variables namely; predictor

(independent) variables and response (dependent) variables. The predictor variable is Tax audit and the response variable is Turnover tax compliance:

Tax Audit
- Desk Audit
- Field Audit

Turnover Tax Compliance
- Payment
- Return Filing

Independent Variable   **Dependent Variable**
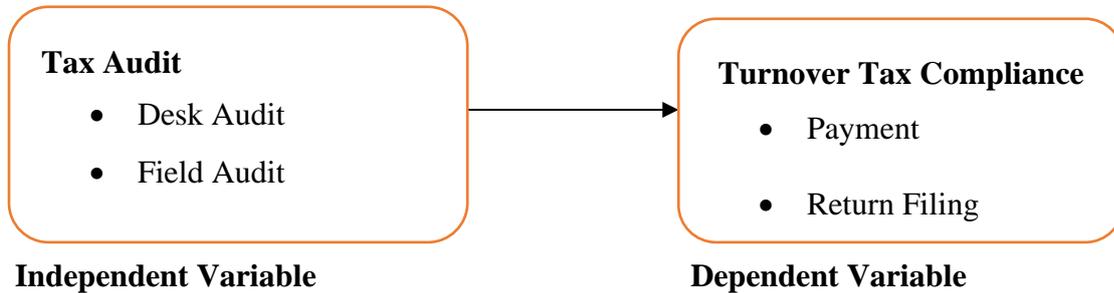
Figure 1: Conceptual Framework

Source: Researcher, (2024)

3. Methodology

A research design is an outline or approach that a study takes to address the various research objectives. It is the framework within which the research is carried out systematically (Kothari, 2017). This study used an explanatory research design. The design helped to define the research phenomenon by analyzing the independent variable (Tax Audit) and how its variation makes changes in the dependent variable (turnover tax compliance). The study had a target population of 3,061 business owners/ Managers. The study targeted 353 questionnaires with each target firm, 268 respondents managed to fill and return the questionnaires showing a 76% response rate. Given the prejudices that taxpayers normally harbor towards tax compliance questions, this rate was commendable. The response rate is as shown below:

Figure 2 Response Rate

(Source: Research 2024)

Dennick (2011) defined reliability test as the measure of the degree to which study instruments produce consistent results after repetitive tests. Table 1 shows that turnover tax compliance has a Cronbach's alpha of 0.920 while tax audit has a Cronbach's alpha of 0.934, The results indicate that the Responses are reliable.

Table 1: Test of Reliability of Questionnaire

Factor	Number of Items	Cronbach Alpha score	Conclusion
Tax Audit	7	0.934	Acceptable
TOT Compliance	5	0.920	Acceptable

Source: Researcher, (2024)

4. Results and Discussion

4.1 Descriptive statistics

4.1.1 Descriptive Statistics Tax Audit

Table 2 shows**: that** KRA allows self-assessment as part of the audit process is composed of a mean score of 3.98, Std. Deviation 0.852. Second KRA Audit always unearth non-compliance is composed of a mean score of 3.93, Std. Deviation 0.869. Third, I feel the self-assessment approach encourages voluntary compliance composed of a mean score of 4.21, Std. Deviation 8.23. Fourth, the self-assessment approach reduces the administrative burden on the tax authority and is composed of a mean score of 3.90, Std. Deviation 0.844. Fifth, the possibility of an audit motivates me to comply with tax regulations composed of a mean score of 4.03, Std. Deviation 0.859. Sixth, I believe that tax enforcement actions by the authorities are necessary to ensure compliance composed of a mean score of 4.05, Std. Deviation 0.875. Lastly, I would be less likely to comply with tax laws if enforcement were less stringent. is composed of a mean score of 4.14, Std. Deviation 0.854.

Table 2: Descriptive Statistics Tax Audit

	N	Mean	Std. Deviation	Skewness	Kurtosis
KRA allows self-assessment as part of the audit process	268	3.98	.852	-.250	-.784
KRA Audit always un earth non-compliance		3.93	.869	-.138	-1.113
I feel the self-assessment approach encourages voluntary compliance.		4.21	.823	-.155	-1.128
The self-assessment approach reduces the administrative burden on the tax authority.		3.90	.844	-.137	-1.239
The possibility of an audit motivates me to comply with tax regulations.		4.03	.859	-.193	-1.289
I believe that tax enforcement actions by the authorities are necessary to ensure compliance.		4.05	.875	-.264	-1.261
I would be less likely to comply with tax laws if enforcement were less stringent.		4.14	.854	-.188	-1.345
Mean		**4.03**			

(Source: Research 2024)

4.1.2 Descriptive Statistics Turnover Tax Compliance

Our business always meets deadlines on filing TOT is composed of a mean score, of 3.94, Std. Deviation 0.871. Our business file return on time as required by law is composed of a mean score of 4.03, Std. Deviation 0.846. We pay our Turnover tax on Time as required by law is composed of a mean score of 4.15, Std. Deviation 0.830. Our business keeps Turnover tax records as required by the law composed of a mean score of 4.07, Std. Deviation 0.832. I usually file my returns and make payments accurately composed of a mean score of 3.91, Std. Deviation 0.827.

Table 3: Descriptive Statistics Turnover Tax Compliance

	N	Mean	Std. Deviation	Skewness	Kurtosis
Our business always meets deadlines on filing TOT	268	3.94	.871	-.146	-1.172
Our business file return on time as required by law		4.03	.846	-.217	-1.069
We pay our Turnover tax on Time as required by law.		4.15	.830	-.082	-1.446
Our business keeps Turnover tax records as required by the law.		4.07	.832	-.060	-1.459
I usually file my returns and make payments accurately.		3.91	.827	-.111	-1.167
Mean		**4.02**			

(Source: Research 2024)

4.2 Correlation Analysis

The correlation analysis was conducted to determine the strength significance and direction of the relationship between variables. Table 4. showed that Tax audit and TOT Compliance indicated a positive and statistically significant relationship of 48.6% and p-value = $0.000<0.05$.

Table 4: Correlations Statistics of Independent and Dependent Variable

	TOT Compliance	Tax Audit
TOT Compliance	1	0.486[**]
Tax Audit	0.486[**]	1

Correlation is significant at the 0.05 level (2-tailed).

Source: Researcher, (2024)

4.3 Regression Analysis

The results in Table 5 indicated that Tax Audit had a positive correlation with TOT compliance up to 4.86% or (R= 0.486). The results reveal that Tax Audit caused a variation of 23.6% or (R^2=0.236 and adjusted R^2 =0.229) on TOT compliance.

Table 5: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.486[a]	.236	.229	.45630

a. Predictors: (Constant), Tax Audit _mean

Source: Researcher, (2024)

Analysis of variance was used to determine the significance of the model. Table 6. shows the ANOVA with an F statistic of 159.890, and p-value <0.05, which implies that the variation caused by Tax Audit on TOT Compliance was significant.

Table 6: Analysis of Variance

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	118.159	1	118.159	159.890	.000[b]
	Residual	196.751	266	0.739		
	Total	314.91	267			

a. Dependent Variable: TOT compliance

Tax Audit has no significant effect on TOT Compliance among small and medium enterprises in Langata Sub-County.

Table 7: Regression Coefficient

Model		standardized Coefficients B	Std. Error	Unstandardized Coefficients Beta	t	Sig.
1	(Constant)	1.375	.292		4.709	0.000
	Tax Audit	.373	.060	.355	6.217	0.006

a. Dependent Variable: TOT Compliance

(Source: Research 2024)

4.4 Discussion of the Findings

The study identified a positive and significant correlation between tax audit and TOT compliance, r=0.373, and a p-value of 0.000 indicating that more frequent or thorough tax audits are associated with higher TOT compliance. With a p-value of 0.006, which is less than 0.05, we reject the null hypothesis. This indicates that tax audits have a significant effect on TOT compliance among small and medium enterprises in Langata Sub-County. The finding of this study agreed with a study conducted by Wenty, Tri, & Achmad (2023), to determine the effect of tax collection, Tax audit, and taxpayer compliance on corporate income tax revenue in Indonesia. The finding showed that Tax audits had a significant positive effect on corporate income tax revenue. However, the study conducted in Nigeria, Ekiti State by Philip, Adeduro, Akinadewo, & Akinadewo (2024), on Determinants of Tax Compliance Among Small and Medium-Scale Enterprises in Ekiti State, Nigeria concluded that Tax audit had no significant effect on Tax compliance among small and Medium Enterprises.

5. Conclusion

The study concluded that more tax audits enhanced compliance with turnover tax obligation, implying that emphasis on regular internal and external tax audits has a positive impact on better compliance.

6. Recommendations

The study concluded that more tax audits enhanced compliance with turnover tax obligation, implying that emphasis on regular internal and external tax audits has a positive impact on better compliance.

Comparative studies should be conducted on TOT compliance among SMEs in different regions or sectors to identify unique challenges and best practices.

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