EFFECT OF FINANCIAL REPORTING QUALITY ON PERFORMANCE OF COMPANIES LISTED AT THE NAIROBI SECURITIES EXCHANGE

BY

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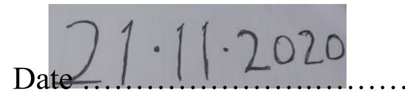
DECLARATION

I declare that this research Project is my original work and has not been presented in any learning institutions for the award of any degree or for other considerations



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This research project has been presented for examination under my authority as a university supervisor

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I wish to dedicate this project to one Mr. Fredrick N. Oyugi for being with me and providing me with financial support throughout the academic period, my parents for laying the foundation on my education and instilling the virtue of hard work from my early years of education. Thanks to my siblings for their love, prayers and moral support throughout the entire academic period.

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ABBREVIATIONS AND ACRONYMS

FP: Financial Performance

FRQ: Financial Reporting Quality

ROA: Return on Assets

ROCE: Return on Capital Employed

ROE: Return on Equity

ABSTRACT

Companies with better quality of financial information are associated with subsequent higher performance in the literature. Currently, the many accounting scandals and financial crises that happened in numerous distinguished firms have undermined investors ‘trust concerning the financial reports and have introduced several criticisms about financial reporting quality (FRQ). Generally, Accountants are aware of the limitations of the information contained in the financial reports and have thus attempted to address this shortcoming by enhancing the scope of the generally accepted accounting principles and financial reporting standards. This study thus sought to ascertain the effect of financial reporting quality on financial performance of companies listed at the Nairobi Securities Exchange. Specifically, the study will sought to examine the effect of earnings qualityon financial performance of companies listed at the Nairobi Securities Exchange, establish the effect of accounting conservatism on financial performance of companies listed at the Nairobi Securities Exchange and determine the effect of accruals quality on financial performance of companies listed at the Nairobi Securities Exchange. Premised on Agency theory, Normative Approach Theory and Positive accounting theory, the current study targeted 68 firms listed at the NSE. With a response rate of 51.47% response rate, the study established that there was a statistically significant positive relationship between financial reporting quality and firm financial performance of firms listed at the NSE. The study therefore recommends that companies should ensure they enhance performance by having sound financial reporting mechanisms. Provisions for accruals especially leading to earnings management should be proscribed. The study also established a positive relationship between liquidity and financial performance calling for having sound working capital policies amongst the firms which enhances firm value. Given that the relationship between leverage and performance is negative, the foregoing study calls for establishment of optimal levels of gearing in the firms that enhance shareholder wealth. The study recommends further studies to increase the scope, the variables and eve explore other nonlinear regression models like the vector error correction models.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Generally, companies with better quality of financial information are associated with subsequent higher performance as advanced by García-Lara et al. (2010) Ahmed and Duellmand (2011), Bushman and Smith (2001) Bens et al. (2002) and Gunny (2005). The foregoing argument is based on the fact that the market positively assesses those companies which are more committed to the issuance of good information for shareholders and other stake-holders, aiming to reduce or avoid information asymmetries between market participants.

The study will be anchored on three theories. First is the Agency theory that was advanced by Jensen and Meckling in (1976) which postulates the principal and agent relationships. The Normative Approach Theory advanced by Chambers and Ijir (1975) developed accounting principles with a concern on accounting issues such as recognition and measurement. Positive accounting theory advanced by Ball and Brown (1968) includes accounting research of capital markets and accounting choices research. The theory is useful for explaining and predicting actual accounting practices.

Akeju and Babatunde (2017) contextualized that many accounting scandals and financial crises that happened lately in numerous distinguished firms have undermined investors‘ trust concerning the financial reports and have introduced several criticisms about financial reporting quality (FRQ).

Fung (2014) opine that it has commonly been recognized that the key frustration give rise to these financial crises arise instantly from the dearth of quality financial disclosure and insufficient governance practices. In Kenya, Kariuki and Jagongo (2013) note that just as practiced globally, Accountants are aware of the limitations of the information contained in the financial reports and have thus attempted to address this shortcoming by enhancing the scope of the generally accepted accounting principles and financial reporting standards.

1.1.1 Financial Reporting Quality

Financial reporting quality can be defined as the faithfulness of the information conveyed by the financial reporting process (Martínez-Ferrero, 2014). According to Jonas and Blanchet (2000), financial reporting is a process and not only a final output whose quality depends on each part, including disclosure of the company's transactions, information about the selection and application of accounting policies and knowledge of the judgments made. Financial information issued by a company has become an essential resource for any market participant, since it provides a reduced amount of information asymmetries between managers, investors, regulatory agencies, society and other stakeholders.

Choi and Pae (2011) explain that the goal of financial reporting is to provide useful information for decision making. However, even though companies may generate financial statements in accordance with generally accepted accounting principles, these statements may present differing levels of quality.

Chen, et al. (2011) asserts that high quality accounting information is a valuable means of counteracting information asymmetry. Jonas and Blanchet (2000) and Lu et al. (2011) advance that the main characteristics required in financial reporting quality are relevance, reliability, transparency and clarity. Martínez-Ferrero (2014) contextualize that FRQ requires companies to voluntarily expand the scope and quality of the information they report, to ensure that market participants are fully informed in order to make well-grounded decisions on investment, credit, etc. This high quality information facilitates greater transparency and this greater transparency reduces the information asymmetries and satisfies investors and stakeholders' needs.

1.1.2 Financial Performance

Financial performance relates to profitability, which is a key component of performance. Profitability is a measure of firms performance in a given time period. According to Helfert (2002), profitability is the effectiveness to which management has utilized the total assets and net assets from a company's balance sheet. Financial performance is normally measured with the aid of the financial ratios such as ROCE, return on firm's assets (ROA), return on company equity (ROE), Tobin Q market share among others. The ROA is given by net income divided by average total assets. Thus the measure indicates how management is utilizing its real investment resources to generate profits. It is also an important measure used to determine a company's efficiency and operational performance through the returns accruing from assets employed by the firm. The second profitability measure is Return on equity (ROE); which is a measure that shows how management of a company can turn shareholders' equity into net profit. High ROA and

ROE figures means high managerial efficiency and vice versa. Return on asset proxy is the most frequent measure of firm's performance (Mwaniki and Omagwa, 2017).

The financial performance of firm involve measuring how the respectful manager in place exploit the available resources to effectively and efficiently accomplish the goals set by the organization thereby satisfying the stakeholders (Pierre, Yip, & Devinney, 2009). It entail the way an organization in question performs vis-à-vis the other related organization in the industry not only on traditional financial indicators of performance but on important non-financial indicators as well (Khatri& Ng, 2000). Ramanujam and Venkatraman (1987) describe firm performance as, how well or badly a firm is performing both financially and non-financially. It has the actual output of the firm as compared to its intended outputs (Ongeti, 2014). According to Mahapatro (2010), it comprises the capacity of the company to accomplish its stipulated mission and vision, good management practices, strong governance, sound management and a tenacious rededication to achieving of results.

The measurements of firm performance entail the sum of economic results of the activities conducted by the firm which usually give a detailed expression of the strategic objectives. Globally, managers are required to grow productivity and firm performances of their respectful organizations in the period of dire uncertainty and shrinking resources (Stacey, 2003). There are two yardsticks of performance ranging from financial and non-financial parameters which both relate to the outcome of the firm strengthening its market standing and the future business prospects (Johnson et al., 2005).

The non-financial measures entail the fit between internal and external capabilities; increased effectiveness in achieving strategic goals, increased commitment among line managers shared vision, and consideration of the future implications of decisions (Banna, 2008). On the other hand, financial perspective employs indicators on whether company's strategy, implementation and execution are affecting the bottom line enhancement. The financial measures of a company's performance comprise of profitability, shareholder value and growth (Kaplan & Norton (1992).

1.1.3 Financial Reporting Quality and Performance

Numerous advantages of providing high quality information have been cited in academic studies. Lambert et al. (2007) opine that FRQ reduces information risk and liquidity. Chen et al. (2011) underscore that FRQ prevents managers from using discretionary power for their own benefit and helps them make efficient investment decisions. Rajgopal and Venkatachalam (2011) propose that one of the main benefits of better FRQ is based on the minimization of asymmetric information problems that arise from conflicting agency. In Jo and Kim (2007), the Companies that report higher quality financial information give to the various markets' agents' better information on it, allowing them to act in the market with better conditions and a higher level of information.

Lambert et al. (2007) emphasize that the quality of accounting information can influence the cost of capital, both directly, by affecting market participants' perceptions about the distribution of future cash flows, and indirectly, by affecting the real decisions that alter

the distribution of future cash flows. Chen et al. (2011) explain that FRQ positively affects private firms' investment efficiency in emerging markets and that this effect enhances bank financing and decreases incentives to minimize earnings for tax avoidance purposes.

1.1.4 Companies Listed at the Nairobi Securities Exchange

Initially, NSE membership was open to brokers but they were registered under the societies act in 1954 and was incorporated into the Kenyan company's act as a limited company in 1991. The NSE has subsequently been demutualized and listed at the exchange itself. Currently, there are 68 firms listed at the NSE. The traded securities include equities, bonds, preference sahres, ordinariy shares and financial derivatives (Ouma, 2017).NSE has classified the listed firms into ten sectors namely; services and commercial, agricultural, banking, technology and telecommunication, insurance, accessories and automobiles, construction and allied, real estate investment trust, investment services, manufacturing and allied and exchange traded funds (NSE, 2017).

The IFRS adoption in Kenya is in phases. Between 1973 to 2000, International Accounting Standards Committee introduced 41 accounting standards. At the end of the period IASC was replaced by International Accounting Standards Board (IASB). The new board was aimed at enhancing and filtering the accounting standards for a period of 8 years starting from 2000 to 2008 there was a significant reduction of the accounting standards from 41 standards to 28 by end of 2008. Primarily these standards are geared towards providing reliable, relevant and timely for corporation investors and creditors in accordance to the IASB's accounting framework.

It is a mandatory requirement for companies listed in Kenya to be IFRS compliant. These development coupled by lack of the literature regarding the effects of IFRS, having been made mandatory for use in reporting by the listed companies, this study aims to establish whether there is evidence to suggest improvement in quality of financial reports.

1.2 Research Problem

Financial reporting of desirable quality is important for the effective distribution of resources in the capital markets. Nature or quality of financial reporting does mean income or stock value changes. It is a multi-faceted term needing far reaching measures of value accounting information (IASB, 2008). As documented in Jonas and Blanchet (2000), the information in financial reports is not merely a final outcome. The quality of financial reporting system depends on disclosure of the firm's dealings, information about the choice and application of accounting rules and information about the judgments made. Over time, financial figures issued by a firm have become a vital resource for market participants, as it gives a reduced volume of information asymmetries amongst investors, managers, society, regulatory agencies and other stakeholders.

Globally, Klai and Omri (2011) advocate that extensive failure in financial disclosure has generated the demand by investors, regulators, and other stakeholders to enhance the financial information quality. Fung (2011) argue that this will allow boards of directors to assess management's effectiveness and to take timely correctional actions, when essential, to tackle failure in the financial condition of firms. As noted in Schnackenberg (2009), it is crucial that all public firms present a comprehensible, inclusive and reliable depiction of their financial performance.

Generally, as noted in Muhammad (2019), scandals like WorldCom, Enron, and A-hold have triggered a lot of public consideration to focus on the firm's quality of financial reporting. Kariuki and Jagongo (2013) allude to the goal of adopting IFRS as that of improving on the quality of financial reports.

Martínez-Ferrero (2014) observed that companies that report financial statements with better information quality enjoy higher financial performance. Ferrero (2014) also established a statistically significant positive relationship between financial reporting quality and corporate performance. Nnadi (2013) however documented an inverse relationship between financial reporting quality and financial performance noting significant differences on quality of financial reporting that signaled that there are possible differences depending on the regions where a company is listed.

Paiva and Luaranco (2010) note a significant negative relationship between absolute discretionary accrual and firm size, audit size, disclosure level, cash flows and growth was found. They also show a significant positive relationship between absolute discretionary accrual and leverage, earnings issue and sales turnover was found. In the global context, Scaltrito (2015) note that one of the key problems is how to measure the so called FRQ. As noted in Lang and Lundholm (2000), the quality of the information is not always simply and instantly comprehended. Diverse methods are applied in the previous studies to measuring FRQ thus the conflicting findings.

In Nigeria, Onalo, Lizam and Kaseri (2014) revealed that there was a significant marginal influence of financial reporting quality to value relevance, which ultimately reduced possibilities of capital markets fraud. In Ghana, Mensah (2015) established significant relationship between leverage, shareholders concentration, board ownership, independent directorship and quality of financial reporting.

Here in Kenya, Kingwara (2015) established that financial reporting quality had a significant influence on performance though there was no justification to warrant exclusion of financial service companies in the sample. Naghshbandi and Ombati (2014) argued that their adoption of IFRS has been inhibited by skill and competence levels in developing economies amongst other challenges.

Generally, global, regional and local studies have not concluded on the role that finical reporting quality play on financial performance as some studies suggest a positive relationship, others a negative relationship while others point to an inverse relationship. Therefore, one of the main research questions is on how does the quality of financial reporting affect the subsequent performance of a company?.

1.3 Research Objective

The general objective was to ascertain the effect of financial reporting quality on financial performance of companies listed at the Nairobi Securities Exchange. Specifically, the study will sought to:

i. Examine the effect of earnings qualityon financial performance of companies listed at the Nairobi Securities Exchange
ii. Establish the effect of accounting conservatism on financial performance of companies listed at the Nairobi Securities Exchange
iii. Determine the effect of accruals quality on financial performance of companies listed at the Nairobi Securities Exchange

1.4 Significance of the Study

The study is of immense benefits to Policy Makers. The informational output of this study helps the policy makers in formulation of sound policies to enhance performance and growth of companies that are listed at the Nairobi Securities Exchange. The formulated policy in turn enables the firm to improve its operational activities in order to enhance its performance and live up to the shareholders' objective of "wealth maximization"

The study also benefits the Management by furnishing them with pertinent information on the influence of financial rreporting quality on financial performance of listed companies at the Nairobi Securities Exchange which can help them in designing appropriate policies and management strategies to maximize the business. The study also helps the management with knowledge on the effect of financial reporting quality on performance and the best way to design the reporting structure and systems to maximize shareholders wealth. The study also benefits Scholars and Future Researchers as it provides basis for conducting future studies.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter contains comprehensive theoretical and the empirical studies on the "association between financial reporting quality and performance of companies listed at the NSE". The chapter also contains conceptual framework and lastly it highlight summary of literature review.

2.2 Theoretical Review

The chapter will review the several theories in trying to give explanation of the influence of financial reporting quality and performance of firms listed at the NSE. The theories that will be reviewed include; agency theory, Normative approach theory and Positive accounting theory.

2.2.1 Agency Theory

Agency theory was "advanced" by Jensen and Meckling in (1976). According to the theoretical "idea" by Jensen and Meckling (1976), managers are self-seeking agents and they act in their "own interest" with little or no regard to the "interest and ambitions" of their principals unless they are closely monitored and controlled. Managers are hired by the owners to run their business as agents on their behalf and the owners in turn avail resources to them and grant them full authority on how to expend resources in creation of wealth. Because of their numbers, lack of managerial skills and time constraints, shareholders usually appoint the managers to act as their agents in the execution of their business activities.

The shareholders entrust managers with ample resources and believe that the managers will act in the best interest in management of the resources and maximize their wealth. However, according to this theory, managers will always act in their own interest and misallocate company resources for their own betterment unless they are closely controlled and monitored by the shareholders. In this context, the shareholders incur agency costs of employing corporate governance layer of control in addition to other control mechanisms in order to match the concerns of the managers with their own interest which erodes the company profits (Jensen and Meckling, 1976).

2.2.2 Normative Approach Theory

Chambers and Ijir (1975) are among the theorists that have developed accounting principles with a concern on accounting issues such as recognition and measurement. The theorists ask questions including: whether the changes in market prices are to be recognized and how they are to be used in financial statements preparation. The theories prescribing particular actions are referred to as normative theory. Normative theories of accounting are neither evaluated on their true reflection nor because they are not necessarily based on observation. Normative theory will be appropriate for the study since there is need for accounting information to be faithful representation of the true status in a specific company.

Whereas normative accounting theories tend to suggest what ought to be done, Positive Accounting Theories try to give explanation and envisage actions such as which accounting policies firms will choose and why (Scott, 2000). Normative theories relates

to the Choice of accounting policies on the basis of the available standards. Gao (2015) explain that Normative research is of interest to theoreticians of accounting recognition and measurement of specific issues in accounting.

2.2.3 Positive Accounting Theory

As explained by Ball and Brown (1968), the theory is for explaining and predicting accounting practices that are actual. Positive accounting theory includes accounting research of capital markets and accounting choices research. PAT provides importance to research on stock prices, accounting numbers, returns as well as determinants of accounting choice and their association, hence representing a major shift in accounting paradigm.

In Watts and Zimmerman (1986), empirical observations form the basis of positive theories. There are other theories not based on observation but on what the researcher believes should occur in certain circumstances. The theory is appropriate for the study since the accounting reports must strive to give the relevant information and should be easily understood and opens for any comparative analysis. Moreover, those tasked with preparing the books of accounts ought to append their signatures on time to minimize possibilities of accounting manipulations.

2.3 Determinants of Financial Performance

This section contains discussions on critical determinants of financial performance. Some of the determinants of financial performance captured includes; asset quality. Capital structure and firm size.

2.3.1 Financial Reporting Quality

As explained in Gajevszky (2015), according to IASB, the essential principle of assessing the financial reporting quality is related to the faithfulness of the objectives and quality of disclosed information in a company‘s financial reports. These qualitative characteristics enhance the facilitation of assessing the usefulness of financial reports, which will also lead to a high level of quality. To achieve this level, financial reports must be faithfully represented, comparable, verifiable, timely, and understandable. Thus, the emphasis is on having transparent financial reports, and not having misleading financial reports to users; not to mention the importance of preciseness and predictability as indicators of a high financial reporting quality.

As it is defined in the Conceptual Framework for Financial Reporting of the FASB and the IASB, there are agreed upon elements of high quality financial reporting. The qualitative characteristics of financial reporting quality include: relevance, faithful representation, understandability, comparability, verifiability, and timeliness. They are divided into fundamental qualitative characteristics and enhancing qualitative characteristics. A theoretical explanation for each of these terms emphasizes

their importance as qualitative characteristics, and also indicates what qualities are considered fundamental among different frameworks (Herath and Albarqi, 2017).

2.3.2 Capital Structure

Capital structure describes "the financing choices of the business establishment which include the choice of debt finance, equity funds or the mix of the two sources". In other words, capital structure denotes the mix of different financing sources which a firm employs in funding its operational and capital expenditures (Muhammad *et al.,* 2014). According to Romano *et al.*, (2000), capital structure comprises of the four components namely; family loans, capital finance, debt finance, retained earnings and equity while Gibson (2002) argued that capital structure consist of five financial sources for the firm namely; bank loan, shareholders equity, trade credit, associated personal debt and other debt or equity finances such as government loans, trade credit or even business venture capital. According to trade off theory, capital structure has an important repercussion on the value of the firm. Accordingly, firm's managers should employ optimal capital structure by continuously balancing the benefits and associated costs of employing debt.

Capital structure is a critical variable in financial management choices since it has fundamental ability and influence to manipulate returns and risks (Mwangi*et al.,* 2014). The central focus of the financial management choices is to enhance the "shareholders wealth" by attaining maximum value of the entity. However, to realize maximum wealth of the firm, management need to invest in positive NPV projects which require sufficient finances from either debt, equity or the mixture of them. By doing so, the firm needs to

set up the best capital structure in their financing structure that maximizes value. Best capital structure denotes the level of gearing that seeks to minimize the general cost of capital and augment on firm's value. Cost of capital is an important input factor in establishing optimal capital structure for the entity (Brigham &Daves, 2004).

2.3.3 Firm Size

Firm's size is measured by takinglogarithm of its total assets. It is common exercise to take company'ssize as determinant variable of financial performance, FRQand as well as determinant of economic. Larger companiesare motivation to show thepositive impact on financial performance (Prior et al., 2008; Surroca et al., 2010). Additionally, the company's sizehas been used widely in numerous research projects onFRQ, but this effect of size is uncertain.

2.4 Empirical Review

This section discusses the empirical studies related to the question under concern. The empirical studies have been organized as global studies, regional and local studies respectively.

2.4.1 Global Studies

Martínez-Ferrero (2014) examined the consequences of Financial Reporting Quality (FRQ) on Corporate Performance. The study results show that companies that report financial statements with better information quality (associated to better earnings quality, accounting conservatism and better accruals quality) enjoy higher financial performance,

measured by market measures which are more adequate in order to observe if investors are able to identify the CSR entrenchment practices. Along with the rest of market measures, the study reflects the trust that stakeholders have not only in the company at present, but also in the past and the future. Regarding the moderating factors of the relationships, the results highlight that the direct relationship between financial reporting quality (FRQ) and financial performance is moderated by the level of corruption perception and the adoption of IFRS in the country of origin of the company, the international accounting system to which it belongs and the economic cycle.

Ferrero (2014) studied the nexus between corporate financial reporting and financial reporting quality. Quality reporting was operationalized as earnings quality, conservatism and accruals quality while corporate performance was market to book ratio. The study adopted panel research design and a sample of 1960 non – financial listed firms in 25 countries in 2002 to 2008 were considered. Regression analysis through Generalized Methods Moments (GMM) showed a positive relationship which was significant between financial reporting quality and corporate performance.

In China and Hongkong, Nnadi (2013) investigated the effect of quality of financial reporting on financial performance. In the study, financial reporting standards were evaluated over a ten year period using earnings management metric approach. The study reported an inverse relationship between financial reporting quality and financial performance. Moreover, there were significant differences on quality of financial

reporting reported which signaled that there are possible differences depending on the regions where a company is listed.

Paiva and Luaranco (2010) investigated the determinants of quality financial reporting in European Union. The study hypothesized that there were chances of earnings management and other financial performance indicators if the companies adopted quality financial reporting. Panel secondary data retrieved form financial statements of companies listed in the period ranging from 2006 to 2008. Multiple regression analysis was fitted on audit quality, a dummy variable on whether a company was audited by big four or not, firm size, disclosure level, earnings level, turnover, growth, cash flows and leverage. A significant and a negative relationship between absolute discretionary accrual and firm size, audit size, disclosure level, cash flows and growth was found. In contrast, a significant and positive relationship between absolute discretionary accrual and leverage, earnings issue and sales turnover was found. It would have been appropriate to adopt panel research design and carry out panel diagnostic test prior to fitting the regression model.

Beest, Braam and Boelens (2009) investigated qualitative determinants of the quality of financial reporting. The study hypothesized that financial statements must be accurate, verifiable, understandable and timely. The study adopted a 21 research instrument to test for the adherence to these qualities from a sample of listed companies drawn from United States, United Kingdom and Dutch from 2005 to 2007. From the study findings, annual financial statements were found to be understandable, comparable, reliable and timely.

2.4.2 Regional Studies

In Nigeria, Onalo, Lizam and Kaseri (2014) examined the influence of financial reporting quality and banking quality information. Earnings management, timely reporting of losses and valuation approaches followed were used as measures of quality of financial reporting. An investigation of 20 banks within a six year period revealed that there was a significant marginal influence of financial reporting quality to value relevance, which ultimately reduced possibilities of capital markets fraud.

In Ghana, Mensah (2015) studied the determinants of the quality of financial reporting. The study hypothesized that financial reporting quality was influenced by independent directorship, ownership concentration, firm size, profitability, liquidity and leverage. Cross sectional data was collected from audited financial statements for the year 2012. Results of the study revealed that the average voluntary disclosure was 63%. Multiple regression analysis revealed significant relationship between leverage, shareholders concentration, board ownership, independent directorship and quality of financial reporting.

2.4.3 Local Studies

Kingwara (2015) studied the effect of financial reporting quality on performance with a sample of listed companies from 1994 to 2003. The sample excluded banking and insurance companies. A comparative analysis was carried out before and after implementation of IFRS and the findings revealed that financial reporting quality had a significant influence on performance. Despite the findings, there was a gap which was

not addressed as there was no justification to warrant exclusion of those companies which were listed in the banking and the insurance sector.

Tarus, Muturi and Kwasira (2015) investigated the determinants of the quality of financial statements among listed commercial banks. The study was premised on positive accounting theory, agency theory, stakeholder's theory and signaling hypothesis. Descriptive research design was adopted and 164 respondents were drawn using simple random sampling from employees working in commercial banks. Results of the study revealed significant relationships between computerized accounting, professional development and internal skills development within commercial banks and quality of financial reporting. From the findings, it was recommended that there is need for continuous skills development through seminars and workshops.

Naghshbandi and Ombati (2014) investigated issues and challenges affecting financial reporting quality in Kenya. They argued that their adoption has been inhibited by skill and competence levels in developing economies, perceptions from developing countries that they are European or politically mitigated, different levels of compliance and regulatory policies, cultural and structural differences and ownership structures of various business enterprises. Although these challenges may lead to slowness in adoption of IFRS, the anticipated benefits in regard to voluntary and mandatory disclosure triggers higher acceptance levels.

2.5 Summary of Literature Review

The review of empirical studies carried out locally and globally on the subject matter reviews mixed and conflicting results which necessitate the need for a further study. In agency theory, financial reporting may be affected by principal agent conflicts. In Normative theory, accounting information should be faithful representation of the true status in a specific company. The Positive Accounting theory is useful for explaining and predicting accounting practices that are actual within a company.

From the literature, some studies allude to a direct positive relationship between financial reporting quality and financial performance, other studies allude to a direct negative relationship between financial reporting quality and financial performance while some other studies favor an inverse relationship. Possibly, the direct relationship between financial reporting quality and financial performance is moderated by other variables including the level of corruption perception and the adoption of IFRS in the country of origin of the company, the international accounting system to which it belongs and the economic cycle. Despite the findings, a category of the studies exclude certain firms from the analysis with no proper justification to warrant the exclusion especially of financial services companies.

Table 2.1: Summary of Studies and Knowledge Gaps

Author	Objective	Findings	Knowledge Gap
Martínez-Ferrero (2014)	Examined the consequences of Financial Reporting Quality (FRQ) on Corporate Performance	Direct relationship between FRQ and financial performance is moderated by the level of corruption perception and the adoption of IFRS in the country	How does regions with prevalent adverse corruption indices fare in FRQ
Ferrero (2014)	Examined the relationship between corporate performance and financial reporting quality	A significant positive relationship exists between financial reporting quality and corporate performance.	How does FRQ influence FP in a developing country context
Nnadi (2013)	Analyzed the effect of quality of financial reporting on financial performance.	An inverse relationship between financial reporting quality and financial performance.	What are the causes of differences in FRQ based on regions of firm listing
Paiva and Luaranco (2010)	Investigated determinants of quality financial reporting in European Union	A significant and a negative relationship between absolute discretionary accrual and firm size, audit size, disclosure level, cash flows and growth.	Explanation of significant positive relationship between absolute discretionary accrual and sales turnover

Author	Objective	Findings	Knowledge Gap
Beest, Braam and Boelens (2009)	Investigated qualitative determinants of quality of financial reporting.	Annual financial statements were found to be understandable, comparable, reliable and timely.	How does the financial statements quality relate with financial performance.
Onalo, Lizam and Kaseri (2014)	Examined influence of financial reporting quality and banking quality information	There was a significant marginal influence of financial reporting quality to value relevance	How does the relationship replicate in a study locally
Mensah (2015)	Studied determinants of the quality of financial reporting	Financial reporting quality was influenced by independent directorship, ownership concentration, firm size, profitability, liquidity and leverage.	How does the financial statements quality relate with financial performance.
Kingwara (2015)	Studied the effect of financial reporting quality on performance	Financial reporting quality had a significant influence on performance.	There was no justification to warrant exclusion of financial companies
Naghshbandi and Ombati (2014)	Investigated issues and challenges affecting financial reporting quality in Kenya.	Adoption has been inhibited by skill and competence levels in developing economies	How does adoption affect levels of FP

2.6 Conceptual Framework

The conceptual framework outlines the nature of association among the study concepts. In this conceptual framework, financial performance is the dependent variable while audit quality and capital structure are the independent variables as shown below:

Independent variable   Dependent variable

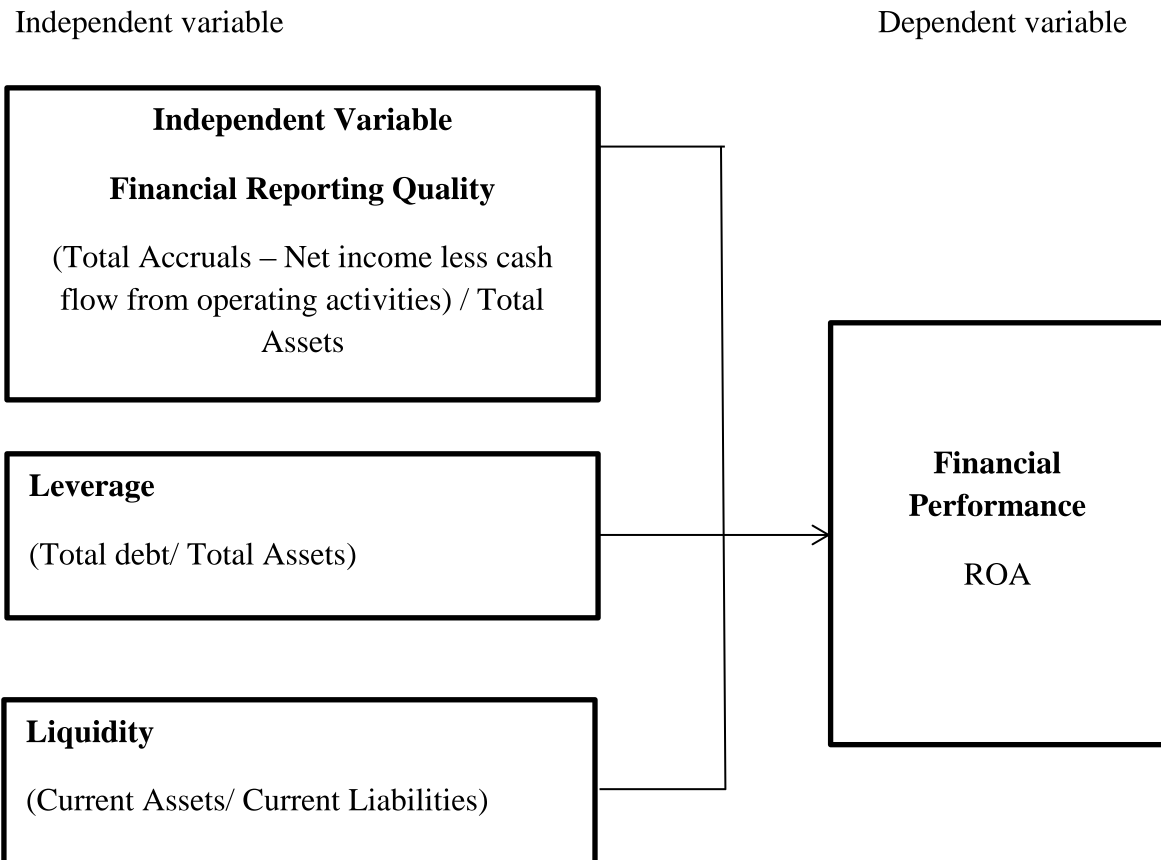

Figure 2.1: Conceptual Framework

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the methodological and procedural approach that was adopted in the execution of the empirical study on the relationship between financial reporting quality and performance of firms at the NSE. The chapter is structured as follows; research design, population, data collection and data analysis.

3.2 Research Design

Research design is a comprehensive plot of the proposed study which postulates the plan to be adopted in proffering solutions to the problem in question (Groenewald, 2004). This research study adopted a descriptive–survey design because it provides an objective approach of testing the formulated hypotheses and falls broadly within the positivist school of thought which posits that the best way to comprehend reality is through the application of the quantitative approaches, scientific and statistical procedures.

3.3 Population

Population refers to a collection of a group of people and firms of prime interest to a researcher (Creswell, 2002). The study population comprised of all the68 firms that are listed at the NSE trading bourse.

3.4 Data Collection

Data collection techniques refer to the systematic approaches of collecting data for the study (Craddick *et al.,* 2003). The study applied secondary data in executing the study.

The secondary data on Accruals, Profits, Total assets, Current assets, Current liabilities and Total debt were mined from financial statements for the period 2014-2019 with a data collection sheet as attached in appendix two. The primary data from the financial reports included the financial reporting quality attributes.

3.5 Data Analysis

Data analysis denotes a procedure of attaching meanings to the collected data (Shamoo and Resnik, 2003). The study employed Cross sectional data in seeking answers to the research questions. Both descriptive and inferential statistical analysis were applied. Descriptive statistics was applied in summarizing the observable characteristics of the group in question using metrics such as means, standard deviations, variance, kurtosis and skewness.

3.5.1 Diagnostic Tests

Secondary data collected was subjected to normality test to ensure that it`s normally distributed. To make sure that the data within the given period of time has some correlation, that is a relationship between current variable and the past variables, lagging test wasdone. The statistical errors identified in the analysis were checked by performing diagnostic tests. The study used Q-Q plot, multicollinearity, homogeneity of variance and pre-regression analysis to test the statistical errors.

3.5.2 Analytical Model

Inferential statistical analyses such as multiple linear regressions were used in testing the constructed statistical study hypothesis. T test, f-test and p-value were used in testing for the research hypotheses. The findings were revealed using tables. The following model was applied in estimating the relationship implied by the hypotheses;

$Y= \beta_0+ \beta_1X_1+ \beta_2X_2 +\beta_3X_3+\varepsilon$

Where Y= Performance (ROA)

X_1=Financial reporting quality (Total Accruals/ Total Assets)

X_2= Leverage (Total Debt/ Total Assets)

X_3 = Liquidity (Current Assets/ Current Liabilities)

B_1-B_3 = Regression Coefficients

$\varepsilon_{t\,=}$ Error term (White noise)

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND FINDINGS

4.1 Introduction

The study sought to establish if there is a relationship between financial reporting quality and financial performance of companies listed at the Nairobi securities exchange. This chapter presents the analysis with respect to response rate, Data descriptive statistics, Correlation analysis and Regression analysis.

4.2 Response Rate

Primary data was collected from 35 out of the 68 listed firms at the NSE. The response rate for the primary data was thus 51.47% of the target population which was considered representative enough to conduct the study.

4.3 Descriptive Statistics

Table 4.1 below presents the descriptive statistics for the study variables. As indicated in the table, performance had a mean value of 0.0483 with a minimum of -0.096 and a maximum of 0.0483. Financial reporting quality had a mean value of -0.0403 with a minimum of -1.03 and a maximum of 0.65.

Table 4.1: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Perf	175	-.96	1.10	.0483	.16952
FRQ	175	-1.03	.65	-.0403	.21315
LIQ	175	.03	25.17	2.6792	3.36377
LEV	175	.00	6.88	.5272	.57572
Valid N (listwise)	175				

In table 4.1 above, Liquidity had a mean value of 2.679 with a minimum of 0.03 and a maximum of 25.17. Leverage had a mean value of 0.5272 with a minimum of 0.00 and a maximum of 6.88.

4.4 Diagnostic Tests

In order to test for the normality of the study data, PP plots were developed for each and every variable and observed on the normal trend data. Figure 4.1 below illustrates that performance data is normally distributed as data lies on both sides of the normal trend line. Figure 4.1 below also presents that financial reporting quality data is normally distributed as data lies on both sides of the normal trend line.

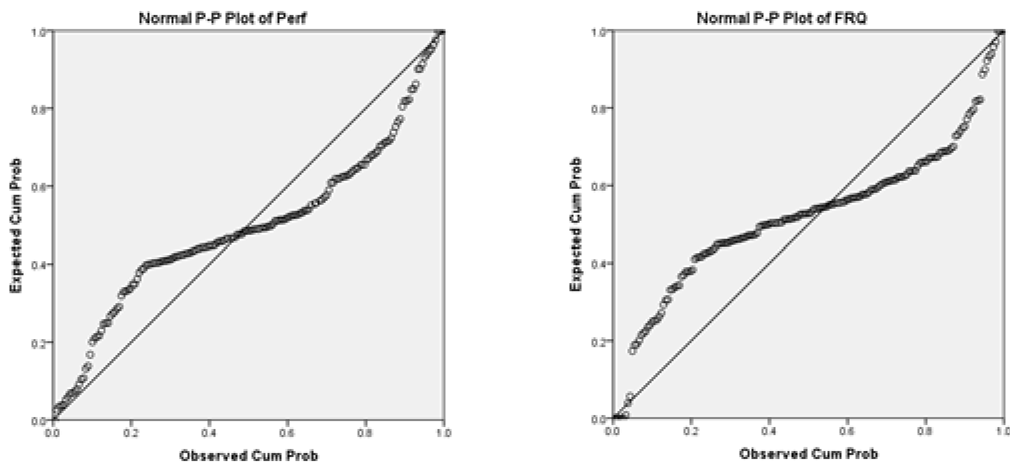

Figure 4.1: Performance and Financial reporting Quality P – P Plot

Figure 4.2 below presents that liquidity data is normally distributed as data lies on both sides of the normal trend line.Figure 4.2 below also presents that leverage data is normally distributed as data lies on both sides of the normal trend line.

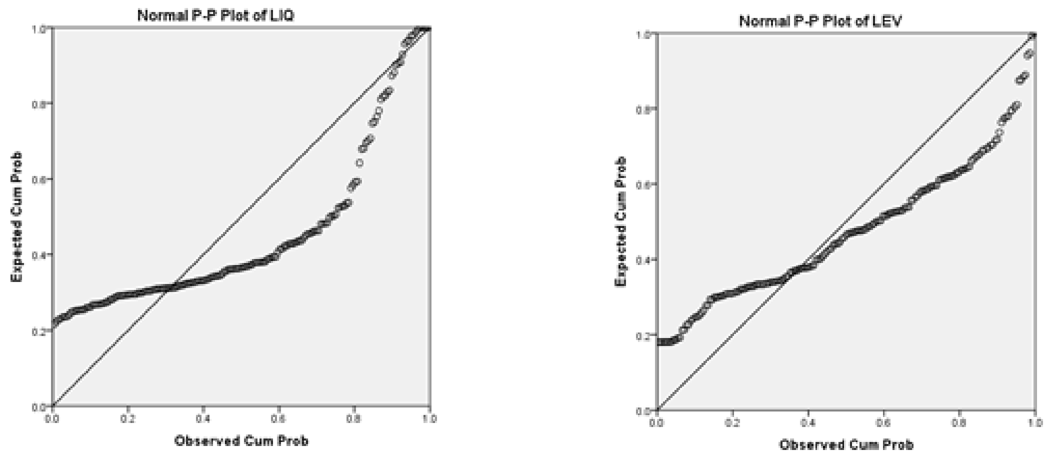

Figure 4.2: Liquidity and Leverage P – P Plot

The study data was tested for collinearity using the Variance Inflation Factor (VIF) as presented in table 4.2 below, all the variables had a VIF exceeding 1 and less than 2. Since the VIF are in the range of 1, it is inferred that the predictor variables are not correlated with the other variables.

Table 4.2: Coefficients[a]

Model		Collinearity Statistics	
		Tolerance	VIF
1	FRQ	.945	1.059
	LIQ	.903	1.107
	LEV	.901	1.109
a. Dependent Variable: Perf			

4.5 Correlation Analysis

As presented in table 4.3 below, financial reporting quality has a statistically significant strong positive association with performance (r=0.606), liquidity has weak but statistically significant positive associations with performance (r=0.205) and financial reporting quality (r=0.185) respectively. Leverage has weak but statistically significant negative associations with performance (r=-0.207), financial reporting quality (r=-0.191) and liquidity (r=-0.280).

Table 4.3: Correlations

	Perf	**FRQ**	**LIQ**	**LEV**
Perf	1			
FRQ	.606**	1		
LIQ	.205**	.185*	1	
LEV	-.207**	-.191*	-.280**	1

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

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

4.6 Regression Analysis

As presented in table 4.4 below, 37% of variations on performance amongst the NSE listed firms are explained by variations in the three predictor variables namely; Leverage, Financial reporting quality and Liquidity. 63% of variations in performance are thus explained by other variables out of the scope for the current study.

Table 4.4: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.617[a]	.381	.370	.13455
a. Predictors: (Constant), LEV, FRQ, LIQ				

In table 4.5 below, the study establishes that the analytical model is statistically significant in explaining the relationships between the study variables (F, 35.067, P<0.05).

Table 4.5: ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1.905	3	.635	35.067	.000[b]
	Residual	3.096	171	.018		
	Total	5.000	174			
a. Dependent Variable: Perf						
b. Predictors: (Constant), LEV, FRQ, LIQ						

In table 4.6 below, it is presented that the positive relationship between financial reporting quality and performance is statistically significant (β=0.577, t=9.321, P<0.005). This infers that a unit increase in financial reporting quality leads to an increase in performance by up to 0.577 units amongst the firms listed at the NSE. Table 4.6 below also presents a non-statistically significant positive relationship between liquidity and performance (β=0.077, t=1.210, P>0.005). The finding infers that a unit increase in liquidity results into increase in performance by up to 0.077 units among the firms listed at the NSE.

Table 4.6: Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.068	.018		3.815	.000
	FRQ	.459	.049	.577	9.321	.000
	LIQ	.004	.003	.077	1.210	.228
	LEV	-.022	.019	-.076	-1.192	.235

a. Dependent Variable: Perf

As presented in Table 4.6 above, leverage has a non-statistically significant negative relationship with performance (β=-0.076, t=-1.192, P>0.005). This implies that a unit increase in leverage leads to a decline in performance by up to 0.076 units for the firms listed at the NSE. The resultant regression model can be summarized as:

$$Perf = 0.068 + 0.577 (FRQ) + 0.077 (LIQ) – 0.076 (LEV) + \varepsilon.$$

4.7 Interpretation of Findings

The statistically significant weak positive association between financial reporting quality and liquidity as established in the correlation analysis matrix confirms the proposition by Lambert et al. (2007) opinion that FRQ reduces information risk and liquidity. In Chen et al. (2011), FRQ positively affects private firms' investment efficiency as that also enhances the financing and decreases incentives to minimize earnings for tax avoidance purposes. As in Chen et al. (2011), better FRQ prevents managers from using discretionary power for their own benefit and helps them make efficient investment decisions.

The strong statistically significant positive association between financial reporting quality and corporate performance as established in the correlation analysis and regression analysis models are consistent with the arguments established in the empirical literature. Martínez-Ferrero (2014) noted that companies that report financial statements with better information quality enjoy higher financial performance. Ferrero (2014) established a positive relationship which was significant between financial reporting quality and corporate performance. The findings are also consistent with Kingwara (2015) revelation that financial reporting quality has a significant influence on performance. The finding is however a departure from Nnadi (2013) who established an inverse relationship between financial reporting quality and financial performance with a qualification that there are possible differences in FRQ depending on the regions where a company is listed.

The statistically significant weak negative association between leverage and performance, leverage and financial reporting quality, leverage and liquidity confirms the assertions in Rajgopal and Venkatachalam (2011) that one of the main benefits of better FRQ is based on the minimization of asymmetric information problems that arise from conflicting agency. As documented by Jo and Kim (2007), companies that report higher quality financial information give to the various markets' agents better information on it, allowing them to act in the market with better conditions and a higher level of information.

The negative statistically significant association between leverage and financial reporting quality confirms Lambert et al. (2007) emphasis that the quality of accounting information can influence the cost of capital by first affecting market participants' perceptions about the distribution of future cash flows, and secondly, by affecting the real decisions that alter the distribution of future cash flows. As explained by Onalo, Lizam and Kaseri (2014) value relevance of financial reporting quality ultimately reduced possibilities of capital markets fraud.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The main goal of the study was to establish the effect of financial reporting quality on financial performance of companies listed at the Nairobi Securities Exchange. This chapter gives an overview of the results from the previous chapter, conclusions, and limitations faced. Moreover, it recommends policies that policy makers can use. Additionally, the chapter gives recommendations for future researchers.

5.2 Summary of Findings

This study sought to ascertain the effect of financial reporting quality on financial performance of companies listed at the Nairobi Securities Exchange. Specifically, the study sought to: examine the effect of earnings qualityon financial performance of companies listed at the Nairobi Securities Exchange, establish the effect of accounting conservatism on financial performance of companies listed at the Nairobi Securities Exchange and determine the effect of accruals quality on financial performance of companies listed at the Nairobi Securities Exchange.

The study response rate was51.47% of the target population which was considered representative enough to make generalizations. The study established that financial reporting quality has a statistically significant strong positive association with performance, liquidity has weak but statistically significant positive associations with both performance and financial reporting quality as well. Leverage exhibited weak but

statistically significant negative associations with performance, financial reporting quality and liquidity.

The study also established that 37% of variations of performance among the NSE listed firms are explained by variations in financial reporting quality, Leverage and Liquidity. Therefore, 63% of the variations in performance are explained by other variables. The study notes a statistically significant positive relationship between financial reporting quality and performance which infers that a unit increase in financial reporting quality leads to an increase in performance by up to 0.577 units amongst the firms listed at the NSE. The finding thus confirms the arguments in literature by Chen et al. (2011), Martínez-Ferrero (2014), Ferrero (2014) and Kingwara (2015) that FRQ adoption increases firm performance.

The study also established a non-statistically significant positive relationship between liquidity and performance inferring that a unit increase in liquidity results into increase in performance by up to 0.077 units among the firms listed at the NSE. The non-statistically significant weak negative relationship between leverage and financial reporting quality confirms Lambert et al. (2007) emphasis that the quality of accounting information can influence the cost of capital by affecting market participants' perceptions about the distribution of future cash flows, and also by affecting the real decisions that alter the distribution of future cash flows. As explained by Onalo, Lizam and Kaseri (2014), value relevance of financial reporting quality ultimately reduces possibilities of capital markets fraud.

5.3 Conclusions

The research used secondary data obtained from published annual reports to carry out inferential analysis such as regression and Pearson correlation. Hence the conclusion that the independent variables namely; financial reporting quality, liquidity and leverage used in the foregoing study could be used as determinants of firm financial performance at the Nairobi securities exchange especially given that they recorded variance inflation factor values between 1 and 2 thereby implying that they did not have multi collinearity issues.

The study concluded that financial reporting quality has a statistically significant strong positive association with the level of performance among the listed firms at the Nairobi Securities Exchange. Levels of liquidity has a positive relationship with performance which is however not statistically Significant. Firm leverage has negative relationship with performance which is not statistically significant but infers that leverage especially cost of debt financing affects firms profitability in the long run especially in the context of emerging financial markets.

The study also concluded that the chosen variables for the study namely financial reporting quality, leverage and liquidity explain up to 37% of variations in performance among the firms listed at the Nairobi Securities Exchange. It is also concluded that these variables as a combination significantly affect the levels of performance given the P value (0.000) in the ANOVA summary table. Variables not included in the analytical model explain 63% of the variations.

5.4 Recommendations

The study concluded that financial reporting quality with a mean value of -.0403 significantly affect the levels of financial performance amongst the firms listed at the Nairobi Securities Exchange. Financial markets policy makers and investment protection legislation should therefore safeguard the quality of financial reporting in the markets and instill punitive measures for violation especially on incidences of earnings management.

The finding that liquidity positively influence levels of financial performance with a mean value of 2.679 underscore the importance of working capital decisions for firm performance and sustainability. The research therefore recommends that the listed firms should have in place proactive working capital policies that support organization shareholder wealth maximization.

Capital structure and firm financing decisions dominate corporate finance literature. The study established that firm leverage with a mean value of 0.5272 negatively influence the levels of firm performance. The mean leverage suggest that on average, NSE listed firms are not highly geared. To ensure god corporate performance, managers of the NSE listed firms should attempt to attain an optimal level of debt financing at which the corporations do not lose value and performance.

5.5 Limitations of the study

The research solely relied on secondary data to reach at the conclusions. Secondary data was employed because it is deemed reliable as an aggregate of experts data consolidated

for the public, investors and regulators consumption. However, an assessment of the same study using primary data and consulting with experts at NSE could possibly lead to a different set of outcomes. Additionally, the study period was five years covering 2015 to 2019. The findings may vary with an extension of the research period and scope.

The research used day of 35 out of 68 listed firms at the NSE. Lack of balanced data limited the research being done on all the listed firms. In data analysis, the research used multiple linear regression models with a presumption that the relationships are linear. Linear regression models have notable limitations such as misleading outcomes when variables value shift that leads to change in values. This is so because in instances that additional data is progressively added to the regression model, the hypothetical linkage in variables may not remain the same due to the additions.

Finally, firm performance may be affected by various factors and not only financial reporting quality, leverage and liquidity. The findings may not be generalizable in different countries contexts where levels of leverage are controlled and financial reporting standards are either regulated or non-regulated.

5.6 Suggestions for Further Research

The research used multiple linear regression models to explain the linkage in the variables under observation. Linear regression models have limitations such as being sensitive to outliers and being restricted to linear conditions even when variables may have relationships which are nonlinear. The paper therefore recommends that much

further studies should utilize other models beyond the linear regression models. For example, the Vector error correction models can be employed to explain relationships in variables because unlike linear regression models, the model includes error correction features to the vector auto regression.

The study focused on a five year period (2015 to 2019) owing to the fact that it is the most recent data for companies listed at the NSE. Further studies in this area may use data for longer periods for confirming or rejecting the outcomes of this study. Utilizing longer period’s data is vital as such data is exposed to capturing the effects of rare but important events which a shorter period may not capture.

The research was centered on financial reporting quality and financial performance of firms listed at the NSE. The study solely depended on secondary data. A research study in which primary data collection tools such as structured interviews and in depth questionnaires are employed for the NSE listed firms is suggested as a complement for this paper. This recommendation is raised because primary data may yield different results owing to the data coming directly from the respondents and it having bot been sifted as is the instance with secondary nature data.

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APPENDIX 1: DATA COLLECTION SHEET

Name of Company…………………………………………………………………………

	2015	**2016**	**2017**	**2018**	**2019**
Accruals					
Total Assets					
Net Profits					
Total Debt					
Current Assets					
Current Liabilities					