

**THE EFFECT OF ADOPTION OF INTERNATIONAL FINANCIAL  
REPORTING STANDARDS ON QUALITY OF FINANCIAL REPORTING BY  
COMPANIES LISTED AT NAIROBI SECURITIES EXCHANGE.**

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## **Declaration**

This management research project is my original work and has not been presented for a degree in any other university.

Signature..... Date.....

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**(D61/72336/2011)**

This management research project has been submitted for examination with my approval as the University Supervisor.

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## **DEDICATION**

This proposal is dedicated to my lovely wife Scolastica to whom I owe so much. I

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## **ABBREVIATIONS;**

**AAEA;** Association of Accountants in East Africa

**CPA;** Certified Public Accountant

**FASB;** Financial Accounting Standards Board

**GAAP;** Generally Accepted Accounting Principles.

**HDI;** Human Development Index

**HGB;** Handelsgesetzbuch German Accounting Rules.

**IAS;** International Accounting Standards.

**IASB;** International Accounting Standards Board

**IASC;** International Accounting Standards Committee.

**IASIC;** International Accounting Standard Interpretation Committee.

**ICPAK;** Institute of Certified Public Accountants of Kenya

**IFRS;** International Financial Reporting Standards

**IMTA;** Institute of Municipal Treasurers and Accountants.

**KAS;** Kenya Accounting Standards.

**KASNEB;** Kenya Accountants and Secretaries National Examination Board

**KBII;** Kenya Business Indicator Index

**NSE;** Nairobi Securities Exchange

**UNCTAD;** United Nations Conference on Trade and Development

**UNDP;** United Nations Development Programme

## **ABSTRACT**

Accounting is shaped by economic and political forces. It follows that increased worldwide integration of both markets and politics driven by reductions in communications and information processing costs makes increased integration of financial reporting standards and practice almost inevitable. International Financial Reporting Standards (IFRS) is a standard format of financial reporting that is gaining momentum worldwide and is a single consistent accounting framework and has become predominant Generally Accepted Accounting Practice (GAAP). The aim of this study is to try and established the quality of financial reporting of companies who are adopting the international financial reporting standards.

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background of the Study

The adoption of International Financial Reporting Standards (IFRS) heralded a new era in financial reporting. From 2005 onwards, publicly traded firms in more than 100 countries have been progressively required to prepare consolidated financial statements under IFRS (IASB, 2011). This is due to realization of the anticipated benefits to be derived as a result of the change from national generally accepted accounting principles (GAAP) to IFRS in terms of improved quality of financial reporting being the core motive of the proponents of general adoption of IFRS. The Supporters of IFRS adoption argue that benefits will flow from expanded financial statement disclosures, improved measurement and recognition practices, and the narrowing of differences in company reporting arising when a variety of national GAAP is used (Schipper, 2005; Whittington, 2005). The acceptance is also based on the concept of convergence of accounting standards to minimize areas of differences in reporting formats across international borders.

The International Accounting Standards Board (IASB) is the body that publishes International Financial Reporting Standards (IFRS), and was established in 2001 as a successor to the International Accounting Standards Committee. In 2002 a meeting between IASB and FASB in Norwalk agreed that the two international organizations decided to work towards establishing uniformity between IFRS and U.S. GAAP. A Memorandum of Understanding issued by the two organisations in 2006 stated that the duo would seek convergence by 2008 (Hoti and Nuhiu, 2011).

Accounting Framework has been shaped by International Financial Reporting Standards (IFRS) to provide for recognition, measurement, presentation and disclosure requirements relating to transactions and events that are reflected in the financial statements. IFRS was developed in the public interest to provide a single set of high quality, understandable and uniform accounting standards. Users of financial statement worldwide require sound understanding of financial statement but this can only be made possible based on Generally Accepted Accounting Practice (GAAP). With globalization of finance gaining ground, convergence with IFRS will enable the world to exchange financial information in a meaningful and trustworthy manner (Ikpefan and Akande 2012).

International Financial Reporting Standards adoption by Kenya has been in phases, however, IFRS remains as a standard with high quality accounting reporting framework. Thus, the users of financial statements can easily compare the entity's financial information between countries in different parts of the world. Implications of adopting IFRS mean adopting a global financial reporting language that would create that a company globally understands financial statement.

This study sets out to examine whether the adoption of International Financial Reporting Standards (IFRS) in Kenya has improved the quality of financial reporting with regard to companies listed at NSE. Kenya adopted IFRS, and then referred to as International Accounting Standards (IAS), in 1999 through a resolution by the Council of the Institute of Certified Public Accountants of Kenya (ICPAK), the legally mandated accounting institute in Kenya. The study compares changes in the quality of accounting between the pre-adoption period from 1995 to 1999 and the post adoption period from 2000 to 2014. The study specifically tests whether there is less earnings management, more timely loss recognition and higher value relevance in the

adoption period as opposed to the pre adoption period. It also takes a global perspective to the IFRS question in relation to quality.

Since their inception, International Accounting Standards have been produced by two bodies. The first, the International Accounting Standards Committee (IASC) came up with 41 accounting standards between 1973 and 2000. The IASC was replaced by the International Accounting Standards Board (IASB) in the year 2000. The new Board embarked on a review processes aimed at refining the standards. The result was a reduction in the number of standards from 41 in the year 2000 to 28 by the year 2008. By 2011, 13 standards had been issued by the board as International Financial Reporting standards (IFRS). According to IAS Plus (2010), IFRS refers to the entire body of IASB pronouncements including standards and interpretations approved by IASB, IASC and their interpretations produced by the Accounting Standards Interpretations Committee (IASIC). IFRS or IAS have also been described as a set of standards stating how particular types of transactions and other events should be reflected in financial statements, issued by IASC and IASB (ACCA 2008). The primary objective of the accounting standards is to enable corporations to provide investors and creditors with relevant, reliable and timely information which is in line with the IASB's accounting framework for the preparation and presentation of Financial Statements. The concept of accounting quality is based on the IASB framework where relevance, reliability, understandability and comparability (IFRS 2006) are key components and therefore, assumed that financial statement with the four qualitative characteristics have better quality. Chen et al. (2010) has simply described accounting quality as the extent to which the financial statement information reflects the underlying economic situation. In simple terms, this study seeks to establish if the adoption of IFRS has improved qualitative characteristics of

the financial reporting in Kenya, where such improvement would be regarded as improvement in quality.

The institutional framework of accounting in Kenya refers to the way the accounting profession is organized in the country. It focuses on five areas namely; the legal framework( Company's Act Cap 486), the Accountants Act(Incorporates the Institute of Certified Public Accountants of Kenya (ICPAK, Kenya Accountants and Secretaries National Examination Board (KASNEB) ) and the regulators ( Capital Markets Authority, The Central Bank, Insurance Regulatory Authority and the Stock Exchange.

Although ICPAK was established over 37 years ago (1977), as at Nov 2009, 18,000 people had passed KASNEB administered Accountancy (CPA) examination but only 6,000 had become ICPAK members (World Bank 2010). This implies that accountants who have passed exams, but have not registered with ICPAK, are not receiving appropriate Continuous Professional Education and the guidance required to conduct the functions of accounting thereby, diluting the quality of accounting. IFRS is a critical component of the accounting quality process as it forms the basis of professional practice in any country. In spite of this, slightly over ten years since IFRS was adopted in Kenya, the Accountants Act has not been explicit on ICPAK issuing IFRS. This has led to a situation where there is no legal basis upon which reinforcement can be effected by ICPAK, the other Act relevant to accounting in Kenya is the Companies Act known as cap 486 which was modelled alongside the UK Companies Act of 1948. This Act requires all limited liability companies to keep proper books of accounts, the act has been amended through the Companies Act of 1985 and 1989 by incorporating the requirements of the UK accounting standards. In fact, the Kenya Companies Act is not harmonized with the Accountants Act (1977

and 1998). According to UNCTAD (2005) the requirements of the Act do not recognize the institute's authority to oversee and prescribe the financial reporting framework. The Act has also been criticized for not defining what true and fair view is. Moreover, an important requirement such as cash flow provided for in the Standards is not prescribed in the Act. These inconsistencies make it difficult to enforce IFRS.

### **1.1.1 International Financial Reporting Standards (IFRS)**

International Financial Reporting Standards (IFRS) are a set of accounting standards developed by the International Accounting Standards Board (IASB) that is becoming the global standard for the preparation of public company financial statements. It is an independent variable in this study.

The main impetus for the standard setting programme was to reduce the wide variety of accounting practices companies employed. It was believed that Principles' destroyed comparability between the accounts of one business and another and that the standard setters is to carry out a careful investigation of existing practices and to identify best practices and try to help those companies employing inferior procedures so as to improve their published reports. This would allow some flexibility and attempt to justify the favoured procedure with the argument that it is better to have second rate figures that are comparable than to allow choices to be made.

Compliance with accounting standards has also been shown to be an effective defence for auditors faced with accusations of misconduct based on alleged failure to ensure that accounts show a true and fair view. It is acknowledged that standards fulfil a valuable role in the short run by ensuring that all companies adopt the best procedures currently used, but it is believed in some quarters that they may prove detrimental in

the long run. Over the years, considerable improvements have been made in the form and content of published accounts and much of this has occurred as the result of free market experiment and innovation.

### **1.1.2 Quality of Financial Reporting**

This is a dependent variable in this study and the results of their measurement are improve transparency, lower preparation cost, more efficient investment decision, lower cost of capital, enhance comparability, reduce need for supplementary information, expand financial statement disclosure and improve measurement and recognition, understandability, reliability and relevance.

The concept of improving the quality of IFRS financial statement has taken the back seat to matters of compliance. Enhancing the quality of such statement is one of the key factors that add value to an IFRS conversion compared to a basic compliance approach. This highlights qualitative aspects within the preparation of IFRS financial statements and improves the quality of those statements beyond the level obtained by simply complying with the standards.

The qualitative characteristics of information in financial statements are relevance and faithful representation. Relevant information has confirmatory or predictive value. Faithful representation means that the information reflects the real world economic phenomena that it purports to represent.

### **1.1.3 IFRS and Qualities of Financial Reporting.**

The international financial reporting standards may have a number of qualities one being Understand ability. This is an essential quality of useful financial information that should be presented in a way that is readily understandable by users. The users



are assumed to have a reasonable knowledge of business, economic activities and accounting and are willing to study the information diligently.

Relevance is another quality, it influences the economic decisions of users. Relevant information is when it fulfils a predictive role or a confirmatory role which are obviously interrelated.

For any financial information to be useful, it must also possess the characteristic of reliability. It is judged to be reliable if it is free from material error and bias and can be depended upon by users to faithfully represent events and transactions. This information in the financial statements must be complete within the bounds of what can be considered to be material in relation to the cost of producing the information.

Comparability as a quality has two dimensions: one is comparability over entities and the other is comparability over time. The later requires the application of the consistency concept so that users are able to identify trends in its financial position and performance, its presentation and classification of items in the financial statements should remain unchanged from one period to the next, unless a significant change in the nature of the enterprise's operations, or a review of its financial statement presentation demonstrates that the change will result in a more appropriate presentation or classification; or a change in presentation is required by a new or amended accounting standard .

#### **1.1.4 Companies Listed At Nairobi Securities Exchange (NSE).**

The NSE was constituted as a voluntary association of stock brokers registered under the societies act in 1954 and was incorporated into the company's act of Kenya as a limited company in 1991 by guarantee and without a share capital.

The market has seen an increase in the number of stockbrokers, investment banks, establishment of custodial institutions and credit rating agencies. There are 60 listed firms in the NSE whose shares are currently trading. The securities which are traded include, equities, bonds, preferred shares and ordinary shares ([www.nse.co.ke](http://www.nse.co.ke)).

The NSE has classified its listed companies into eleven sectors; agricultural, commercial and services, automobiles and accessories, insurance, banking, telecommunication and technology, construction and allied, investment, manufacturing and allied, energy and petroleum, growth and enterprise market segment (NSE,2014).

The ownership structure of the listed firms in terms of which shares are traded at securities market differs, the shares can be preferential or ordinary shares. An increase in the share price denotes an increase in both a company's value and shareholders wealth (Wedinger and Plats, 2012). NSE (2013) defines market capitalization as an estimation of the value of a business that is obtained by multiplying the number of shares outstanding by the current price of a share. What baffles most investors in the NSE is the quality of financial reporting of firms that adopt the IFRS and how they relate to their impressive performance in the market. The NSE had a market capitalization of ksh 1.61trillion by the end of 2013.

## **1.2 Research Problem**

As evident from the foregoing, a good number of studies carried out in different countries have highlighted the benefits of having single set of financial reporting standards across the globe in supporting the adoption of IFRS globally. Few of the studies had given contradictory views questioning the relevance of IFRS adoption in developing and emerging economies. The effect of the adoption of IFRS on quality of

financial reporting has also been examined but the effect on the financial statement and cost management has not been empirically investigated thereby creating a research gap in this area which this paper intends to fill.

In comparing domestic standards to IFRS, some studies have shown that there are no significant differences in accounting results with the implication that the adoption of IFRS does not result in better accounting quality. Studies in Germany by Tendeloo and Vanstraelen (2005) and Hung and Subramanyam (2007) did find similarities in earnings management and value relevance in comparing results of the national and international standards. Paananen (2008) reports no quality increases in the Swedish case and Elbannan (2011) reports mixed findings in Egypt.

On this basis, it is also hypothesized that the adoption of IFRS in Kenya as compared to KAS given mandatory adoption and KAS framework being similar to IASB's may yield mixed results. In 2009, the Kenya Business Indicator Index (KBII) gave the country a score of 6.48 out of 12 and ranked it at 71 out of 100 countries (Standards Forum 2009). Similarly, the country was ranked 72 out of 100 in the 2009 E-standards forum index. The key objective of the E-standards forum and the KBII indices is to monitor a country's economic, financial and political performance so as to provide investors, policy makers, donors and other stakeholders with the country risk profile and conformity with best practices. From these two indices, it is clear that Kenya's compliance is quite low. These indices send mixed signals about Kenya's business climate as well as the fact that in spite of the challenges of implementing the standards, many things are on track. The low human capital index is also interesting as Kenya suffers an acute shortage of highly skilled manpower in key professional areas such as accounting and finance which therefore, affects the quality of activities in the economy. The shortage of manpower is collaborated by the UNDP; Human

Development Index (HDI) for 2010 of 0.470 ranks Kenya as number 128 out of 177 (UNDP 2010) countries. Furthermore, the training of accountants in universities in Kenya has not met the industries demands and ICPAK estimates that although 30,000 accountants are required in Kenya, less than 5000 are actively involved with the institute. Manpower at the faculty level is also scarce and unofficial statistics indicate there are less than five Doctorates in Accountancy in the entire country with three of them past retirement.

The study will try to ask the following question; firstly what are the effects of IFRS adoption where the market structures and managerial behaviours are distinct from developed world where most of the studies are based. Secondly what is the quality of financial reporting and value relevance using Kenyan sample.

### **1.3 Objective of the Study**

#### **1.3.1 Main Objective.**

The study tried to establish the effect of adopting IFRS on quality of financial reporting by companies listed at Nairobi securities exchange.

#### **1.3.2 Specific Objective**

- (i) To evaluate the effect of adopting IFRS on the published financial statements of listed companies at Nairobi securities exchange.
- (ii) To compare the extend of the financial reporting quality and value relevance using companies listed at Nairobi securities exchange.

### **1.4 Value of the Study.**

The study of IFRS at NSE is of great value in policy formulation. It is of high importance to the firms listed at NSE. The study will assist the management of capital

market Authority with information on how to use IFRS as a tool for Quality of financial reporting and thus be able to spot problems and uncover opportunities.

The study will contribute to the existing body of knowledge on IFRS and generate interests among academicians, scholars' and researchers. It will also form as an in depth information in terms of literature review and a reference point in examining different aspects of IFRS.

The findings should enable regulators and other key player to gauge the effectiveness of the financial reporting system in place such as training and development for practitioners and new members, due diligence for Accounting standards and the overall institutional and professional organization conducive for effective standards application. The study will be part of a vetting process for IFRS by IASB. Should the results indicate that there is positive impact, then that will go towards confirming IFRS as a quality standard. Should the results indicate that there are no quality improvements, and then the findings would highlight the missing link why IFRS is not delivering the promised benefits?

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

In this chapter, the researcher reviewed other literatures done on IFRS. The literature covers relevant research on the subject.

#### **2.2 Theoretical Framework**

Accounting is a human activity and will consider such thing as people's behaviour and people's needs as regards financial information, or the reason why people within organizations might select to supply particular information to particular stakeholder group. Different researchers have different perspectives of the role of accounting theory. Some researchers believe that the principal role of accounting theory should be to explain and predict particular accounting related phenomena. Other researchers believe that the role of accounting theory is to prescribe particular approaches to accounting based on a perspective of the role of accounting.

##### **2.2.1 Normative Approach Theory**

The normative theorist had been pre occupied with developing accounting principles and their primary concern had been recognition and measurement issues in accounting. The questions asked by these theorists include: whether to recognize changes in market prices if the entity is not a party to the transaction and on what basis either historical cost or market value to be used in preparing financial statements (Chambers and Ijir, 1975).

Theories that prescribe particular actions are called normative theory. Normative theories of accounting are not necessarily based on observation and therefore cannot be evaluated on whether they reflect actual accounting practice or not. The conceptual framework of accounting is an example of a normative theory of accounting which relies on various assumptions about the types or attributes of information useful for decision making.

### **2.2.2 Positive Accounting Theory. (PAT)**

This theory seeks to explain and predict actual accounting practices. Positive accounting emerged with empirical studies that proliferated in accounting in the late 1960s. (Ball and Brown, 1968).

Positive theories tend to be based on empirical observation, there are other theories based not on observation but rather on what the researcher believes should occur in particular circumstances. It examined some assumptions underlying normative approach and undermined the claim that earning numbers were meaningless because they were computed using multiple valuation bases (Watts and Zimmerman, 1986).

Positive accounting can be associated with the contractual view of the firm. The firm is viewed as “a nexus of contracts” and accounting one tool to facilitate the formation and performance of contracts. Under this view, accounting practices evolve to mitigate contracting costs by establishing ex ante agreement among varying parties.

The contractual view of positive accounting puts it in tension with value relevance studies in accounting, and contends that accounting’s primary role is to value the firm, and thus practices like conservatism are sub-optimal. The value relevance school emphasizes the usefulness of accounting information to equity investors in contrast to

its usefulness in contracting exercises. The criticisms are; firstly it does not provide any prescription, it does not state what ought to happen, rather explains and predicts what would happen, which is the aim of positive accounting theory and this is insufficient. Secondly, it is not value free because it only explains and predicts what people might do, ignoring altogether on what they should do. Lastly, it assumes that every managers' and owners action have a self-interest motive. With the main view of maximizing their own wealth without considering the adverse.

Ball and brown (1968) suggested that PAT includes both capital market based accounting research and research in accounting choices. In the last four decades PAT has been one of the most influential accounting researches. It spawned a great deal of empirical research on the association between accounting numbers, stock prices, returns and determinant of accounting choice, thus representing a major shift in accounting paradigm.

### **2.2.3 Events Approach Theory**

George (1969) developed the event theory and defined it as providing information about relevant economic events that might be useful in a variety of decision models. The events approach leaves the user to aggregate and assign weights and values to the event. The accountant would only provide information on the economic event to the user; he would not assume a decision model. Thus the event approach income statement would not indicate financial performance in a period but would communicate events that occurred during the period without any attempt to determine a bottom line.



### **2.3 Determinants of Quality of Financial Reporting.**

The benefits of standardized and high quality financial reporting are: lower preparation costs, improve measurement and recognized, high degree of required transparency by regulators, enhanced analytical capabilities and most important of all is enhancement of informed and efficient investment decisions.

No one can ignore the importance of transparency in financial reporting, because people make big decisions regarding the investments based on financial reporting. Investors want more transparent information about the financial data of the company. In fact, it is the quality of report, which helps investors in making certain investment decision.

Investors as well as other stakeholders heavily rely on a company's financial statements. It is an important source of information that is readily available to them at a relatively low cost.

Since information has an objective, there are usually periods within which these objectives operate. Good information neither is produced too frequently nor is it compiled after it is needed most. For instance, information that reaches a decision-maker after the decision is of limited use in the context of the decision-making process.

### **2.4 Empirical Studies**

IFRS represent a single set of high quality, globally accepted accounting standards that can enhance comparability of financial reporting across the globe. This increased comparability of financial information could result in better investment decisions and ensure a more optimal decision. (Archives of Business Research (ABR) Vol.2, Issue 2, April-2014). Allocation of resources across the global economy (Jacob and Madu,

2009), Cai and Wong (2010) conjectured that having a single set of internationally acceptable financial reporting standards will eliminate the need for restatement of financial statements, yet ensure accounting diversity among countries, thus facilitating cross-border movement of capital and greater integration of the global financial markets. Meeks and Swann (2009) revealed that firms adopting IFRS exhibited higher accounting quality in the post-adoption period than in the pre-adoption period.

In a study of financial data of firms covering 21 countries, Barth (2008), confirmed that firms applying IAS/IFRS experienced an improvement in accounting quality between the pre-adoption and post-adoption periods. Latridis (2010), concluded on the basis of data collected from firms listed on the London Stock Exchange that IFRS implementation has favourably affected the financial performance (measured by profitability and growth potentials). IFRS compliant financial statements has the tendency to make comparability and company performance assessment across nations easier and result of such assessment more acceptable by stakeholders and highly reliable.

Marjan Petreski (2006) described the impact of IFRS adoption on the financial statements for the company and its influence on decision making by the management. This study used credible and comparable attitude as independent variables. Interview test instrument was used. The results showed that, information disclosure on financial statements was full and credible and comparability of financial statements across nations resulted in better decision making by management. The adoption of IFRS leads to a more restricted set of accounting measurement methods and, with fewer measurement rules to deal with, analysts can more easily master the existing set (Ashbaugh and Pincus, 2001). Tan et al. (2011) confirmed this result and found that mandatory IFRS adoption improves foreign analysts' attraction and forecast accuracy,

particularly those from countries that are simultaneously adopting IFRS along with the covered firm's country, and those with prior IFRS experience.

Proponents of accounting harmonization believe that comparability of financial statements worldwide is necessary for the globalization of capital markets. They suggest that there are many potential benefits that may arise from the use of one common set of accounting standards throughout the world. These include improved transparency, comparability and quality of financial reporting that lead to lower preparation cost, more efficient investment decisions and lower cost of capital for companies (Choi & Meek, 2005).

Street and Gray (2001) examined the 1998 financial statements for 279 firms that referred to use of IFRS in their financial statements. The study revealed that, in many cases, disclosed accounting policies were inconsistent with IFRS. Schultz and Lopez (2001) suggest that uniform international accounting standards may not result in de facto uniformity among nations, particularly when the standards allow for significant discretion (ambiguity). Various accounting items exhibit high value relevance in common law countries that have effective judicial systems, better investor protection, and higher quality of accounting practices including more transparent reporting and auditing systems compared with code law countries. It is expected that the smaller the deviation of a domestic practice from the IFRS, the higher the value relevance of that practice.

In a study on financial data of public listed companies in 15 member states of the European Union (EU) before and after full adoption of IFRS in 2005, Chai et al (2010), found that majority of accounting quality indicators improved after IFRS adoption in the EU. According to Jones and Ratnatunga (1997), larger firms report to

a greater concentration of external users who can influence the allocation of scarce resources. Given that financial statements have greater economic consequences for larger firms, larger firms are expected to be more susceptible to the financial reporting impacts of IFRS.

Archives of Business Research, 2. Spiceland et al, (2001) brought out that useful accounting information derived from qualitative financial reports help in efficient allocation of resources by reducing dissemination of information asymmetry and improving pricing of securities. According to Barth (2007), the adoption of a common body of international standards is expected to have the following benefits: lower the cost of financial information processing and auditing to capital market participants as users, familiarity with one common set of international accounting standards instead of various local accounting standards by Accountants and Auditors of financial reports, comparability and uniformity of financial statements among companies and countries making the work of investment analysts easy, attraction of foreign investors in addition to general capital market liberalization. The adoption of uniform standards cut the costs of doing business across borders by reducing the need for supplementary information. They make information more comparable, thereby enhancing evaluation and analysis by users of financial statements (Adekoye, 2011).

Cai & Wong (2010), in a study of global capital markets demonstrated that capital markets of countries that had adopted IFRS recorded high degree of integration among them after their IFRS adoption compared with the period before adoption. According to Barth et al. (2007), IASB's goal of developing an internationally acceptable set of high quality financial reporting standards also meant allowable accounting alternative and accounting measurements that better reflect economic position and performance. Ashbaugh and Pincus (2001) argue that limiting

alternatives can increase accounting quality because doing so limits managements' opportunistic discretion in determining accounting amounts. Therefore, accounting amounts that reflect a firm's underlying economics can increase accounting quality because investors will have access to better information for their decision making. Other accounting literature in this area also argues that more rigorous enforcement of adoption can also lead to better accounting quality. On this basis, this study hypothesizes that accounting amounts reported on IFRS basis in Kenya are of higher quality than those of the domestic standards known as Kenya Accounting Standards (KAS).

The problem with this hypothesis is that IFRS could be of lower quality thus, limiting managerial discretion relating to measurements that are more reflective of the firm's economic position and performance. Closely associated with this is the question of flexibility in principle based standards which could lead to better opportunities for a firm to manage its earnings thus, decreasing accounting quality (Barth et al. 2007; Chen 2010). Another argument associated with this hypothesis has been the so called label and serious adopters by Daske et al. (2008) debate whereby, some firms, referred to as label adopters, claim that they have adopted IFRS while the degree of adoption could be nil or low and sometimes enforcement of such standards would be nonexistent.

Accounting literature has operationalize accounting quality on the basis of earnings management, timely loss recognition and value relevance metrics. The arguments follow then that firms with higher quality earnings exhibit less earnings managements, more timely loss recognition and higher value relevance and this study hypothesizes the same for Kenya. Earlier studies on the voluntary adoption of IFRS primarily investigate the distinguishing economic characteristics of firms that switch to IFRS.

El-Gazzar et al. (1999) report that firms voluntarily adopting IFRS are those seeking to access foreign capital, to improve customer recognition or reduce political costs. As noted by Lang et al. (2003), firms electing to adopt IFRS early, are more likely to be those firms with fewer reconciling items.

The most closely related studies to the present study are those that examine samples from one country. An early paper by Kinnunen et al. (2000) exploits a unique market setting in which foreign investors are restricted in their trading of certain shares. This permits the authors to examine the relative value relevance of Finnish GAAP and voluntarily adopted IFRS between two investor groups. They find IFRS improves the information content for foreign investors but not for domestic investors. Another Finnish study by Niskanen et al (2000), examines components of reconciliations to IFRS for 18 Finnish firms voluntarily using IFRS over the period 1984 to 1992. They report the aggregate earnings difference is insignificant in explaining returns but that untaxed reserves adjustments and consolidation differences are value relevant.

Since these papers examine voluntary adopters the results may be affected by self selection bias and they use a data set of accounting rules that are over 20 years old. Using a price 'levels' regression Dan HU (2004) reports that Chinese GAAP is more value relevant than IFRS using a sample of 252 firm. This finding is supported by Eccher and Healey (2003), who investigate a sample of 83 Chinese firms that are required to provide two sets of accounts using Chinese GAAP and IFRS; finding that earnings under Chinese GAAP are more closely associated with returns than earnings under IFRS.

Hung and Subramanyam (2007) use a sample of 80 German firms voluntarily adopting IFRS over the period 1998-2002 that provide accounts under German and

IFRS GAAP for the same period. Using price 'levels' models, they find that total assets and book value of equity, as well as variability of book value and net income, are higher under IFRS than under German Accounting Rules (HGB). They also find that book value of equity and net income under IAS are no more value relevant than the amounts under HGB. Further, they report that earnings and equity under IFRS are incrementally value relevant to German GAAP. Both coefficients are highly significant but the earnings coefficient sign is negative which they suggest is consistent with more measurement error in the IFRS earnings than in the German earnings. Their relative value relevance results contrast with Bartov et al. (2005) who also compare German HGB with IFRS (and U.S. GAAP). They find that IFRS is more value relevant than German HGB in its ability to explain returns as opposed to prices used by Hung and Subramanyam, 2007. They also find little difference in the value relevance of U.S. GAAP earnings and IFRS earnings after self selection bias is controlled.

Leuz (2003) also examined the value relevance of accounting numbers and report that neither that trading spread nor the trading volumes were significantly different for the companies that choose the IFRS or U.S. GAAP voluntarily.

Bartov et al. (2005) examine firms in the cross section rather than the same set of firms as do Hung and Subramanyam (2007). The present study also examines the same firms with the added advantage that firms must adopt IFRS rather than voluntarily. Although Hung and Subramanyam (2007) control for self selection bias, the possibility remains that the bias in the IFRS accounts due to the effects of early voluntary adoptions may explain the conflicting results, as Barth et al. (2005) have noted. Different models might be another reason, which motives us to estimate both a price level model and a returns model.

Controversies always existed over the suitability of applying IFRS in developing countries with researchers such as Singh and Newberry (2008) as well as Chen et al. (2010) arguing that there exist two schools of thought in this area. The first supports a single set of global standards as being suitable for application. The second opposes the use of IFRS in developing countries by arguing that the characteristics of local business environments and institutional frameworks determine the form and contents of accounting standards.

Kenya and many developing countries are characterized by weak institutions and volatile economic and political environments which are not very conducive to assimilation of IFRS. In spite of the arguments, many countries and companies have adopted IFRS and the need to evaluate their impact has been overwhelming. Barth et al. (2007) indicate that accounting amounts results from interaction of features of the financial reporting system which include accounting standards, their interpretations, enforcement, and litigation and this obviously leads to obtaining different results from application of the same standards. Ball et al. (2003) by extension argue that high quality standards like IFRS may also lead to low quality accounting information depending on the incentives of the preparers. It is these contradictions that led Ball et al. (2003) and others to conclude that poor preparer incentives, underlying economic and political factors influence manager and auditors incentives as opposed to accounting standards.

Many factors have also been cited as impacting financial reporting practices such as effective enforcement of standards and strong corporate governance. There is very little information on the background of accountancy in Kenya, an indication that a clear track which could be a pointer to the strengths of the profession over the years has not been kept. In a publication celebrating ICPAK's 30 year anniversary



(Accountant 2008, May), the writer described the pre-independence days of the accountancy profession as an expatriate affair with no Kenyans, neither Africans nor Asians. This was a communication of racism which by extension implied that the quality of accounting during the pre independence period and early post independence was biased and therefore, could not have been quality driven.

The early post independence period extends to 1977 when the Institute of Certified Public Accountants was promulgated. This period was characterized by inadequate institutions to train accountants locally and bridge the gap of diversity. Prior to the commencement of ICPAK, most accountants were members of institutes in the UK and India and, amazingly, there was little government involvement in the profession. Through to the sixties and seventies, accountants in Kenya mainly sat for the Chartered Accountants exam in the UK and it is difficult to understand how such external exams were tailored to the Kenyan environment in areas such as taxation, finance, and even financial reporting. Among the earliest accounting exam in Kenya was the Institute of Municipal Treasurers and Accountants (IMTA) which was modified to suit Kenya's situation. The first known accounting association in Kenya was the Association of Accountants in East Africa (AAEA) from which accountants could articulate their professional challenges, foremost being concerns about the quality training. While these efforts were commendable, the association came up with accounting exams but not formal qualifications.

Furthermore, in these early years, accountancy was governed by the Accountants Designation Act (Cap 524) and the Companies Act (cap 486). Ironically, these acts provided for the appointment and recognition of accountants only if they were members of English, Scottish or Irish designations.

The vacuum days saw all kinds of experiences with organizations and businesses having several sets of financial reports; one for tax, one for bank financing and one for the owner where real reporting was actually reflected (The Accountant 2008). This practice persisted for many years, even up to recent times, even though on a declining basis.

## **2.5 Summary of the Literature Review**

The prediction that IFRS will improve quality may still not come true. Barth et al. (2007) explains the reasons could be due to IFRS being of lower quality than local standards, principle based standards could be interpreted either way or some features of financial reporting system other than standards could eliminate improvements in quality.

Critiques of IFRS such as Barth et al. (2007) and Bartov et al. (2005) argue that there is no conclusive evidence that standards have contributed to improvements in accounting quality. Although, the objective of this study is similar to those of previous studies, it departs has departed in the following ways; It addresses the peculiarities discussed above with a view to coming up with a more valid and reliable outcome on the extent of the impact of IFRS on accounting quality.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter describes the methods that were used in the collection of data pertinent in answering the research questions. It contained research design, population and sample size, data collection, data analysis methods and data validity and reliability.

#### **3.2 Research Design**

This research studied IFRS and quality of financial reporting in companies listed at NSE in Kenya. The study used a descriptive survey. This enabled the researcher to obtain sizeable and substantial data from the population. This was done through the use of a questionnaire, which is an economical, effective and easy way of obtaining and analyzing data (Saunders, 2002).

#### **3.3 Population and Sample Size**

The population was the 61 companies listed at NSE and sample size of 11 companies each from the eleven categories of NSE. The actual respondents involved directors, finance managers and Accounting Officers specifically among others. The study concentrated on companies with their headquarters in Nairobi area. The choice of Nairobi as a study area is due to the fact that it's convenient in terms of accessibility, time and financial constraints (Kothari, 2004).

#### **3.4 Data Collection**

The source of data was primary data collected using a questionnaire. The questionnaire was divided into two parts. The first part was on the background

information about the respondent and company listed at NSE, while the second part was on IFRS and quality of financial reporting of companies listed at NSE. The questionnaire was given to the selected respondents and collected later.

### **3.5 Data Analysis.**

Data analysis is the process through which primary data is arranged and organized in to make sense giving required information. Before proceeding, the data collected was examined to check completeness, consistency and comprehensiveness. Descriptive statistic was used to described and analysed data through the use of statistical package for social science (SPSS). This program assisted in interpreting information through graphs, charts and tables. Analysis of variance (ANOVA) was used to determined the significance relationship of the variables. The study used regression analysis to determined the extent to which adoption of IFRS will improve quality of financial reporting.

#### **3.5.1 The Analytical model**

The study adopted a linear regression model to test the relationship between the variables in the quality of financial reporting of firms listed at NSE. The empirical model is thus:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \epsilon$$

Where Y= Quality of financial reporting.

$\beta_0$  = intercept

$\beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6$  = coefficients,  $\epsilon$  = error term

X1 = comparability

X2 = investment decisions

X3 = timeliness

X4 = measurement and recognition

X5= transparency

X6= Financial statement disclosure.

### **3.6 Data Validity and Reliability.**

The participants were briefed early in advance by the researcher on the need and importance of the study and permission sought for their participation in order to have their full support. There was guidance on how to answer the questionnaire from the researcher. This ensured high completion rate and accuracy of the information provided. Audited financial statements for different firms listed at NSE were used to collect secondary data.

## CHAPTER FOUR

### DATA ANALYSIS, RESULTS AND DISCUSSION.

#### 4.0 Introduction

To investigate the effect of adopting IFRS on the quality of financial reporting of companies listed at Nairobi securities exchange. This was in the light of the relevance of IFRS adoption in developing and emerging economies and the quality of financial reporting on the financial statements of companies operating in such economies.

The data collected was analysed using statistical package for social science (SPSS) and variances analysed using a regression model.

Data collected from questionnaire from 33 respondents that is 3 from each category of 11 sample companies listed at NSE. The results on the age of company listed at NSE are as following; Table 1

#### Number of years listed at Nairobi securities exchange

No of years	No of respondents
Less than 1 year	3
3-5	3
5-7	3
7-10	12
10 and above	12
Totals	33

#### **4.1 International Financial Reporting Standards**

Majority of companies used GAAP as a standard while a few didn't apply any standard before the introduction of IFRS. 80% of the respondents prefer the IFRS than 20% previous standards. 90% says that the previous standards were time consuming and 10% says IFRS is time consuming. 85% prefers the IFRS and 15% prefer previous standards.

#### **4.2 Effect of Adopting IFRS on the Published Financial Statements.**

The first objective of this study was to evaluate the effect of adopting IFRS on the published financial statements of listed companies at NSE. To achieve this objective, the staff and directors of sample firms listed at NSE were asked to react to several statements as well as rank some possible effects of IFRS adoption where the market structures and managerial behaviours are distinct from developed world where most of the studies are based.

All companies review there audited financial statements annually and unaudited reports quarterly.

The results of quality of financial reporting are summarized in Table 2.

Table 2

Qualities of Financial Reporting

<b>Quality of financial reporting</b>	<b>No extend</b>	<b>Small extent</b>	<b>Moderate extend</b>	<b>Great extend</b>	<b>Very great extend</b>	<b>Totals</b>
Transparency	-	2	7	15	9	33
Preparation cost	1	3	5	16	8	33
Investment decision	-	2	7	10	14	33
Timelines	1	2	6	18	7	33
Measurement and recognition	-	3	5	8	17	33
Financial statements disclosure	1	1	6	9	16	33

The data was analyzed using a regression model to determine the quality of the financial reporting



### 4.3 Comparing The Extend of Financial Reporting And Value Relevance of Companies Listed at Nairobi Securities Exchange.

The second objective of the study was to compare the extend of the financial reporting quality and the value relevance of companies listed at NSE. To achieve this objective the staff and directors of companies listed at NSE were asked to indicate to what extent has the qualities of international financial reporting standards helps them as a user or preparer make decision and has the decision have any quality of financial reporting and value relevance. Their results are summarized in Table 3.

Table 3

#### Qualities Of Financial Reporting Standards And Extend On Decision Making

<b>Quality of financial reporting standard</b>	<b>No extend</b>	<b>Small extend</b>	<b>Moderate extend</b>	<b>Great extend</b>	<b>Very great extend</b>	<b>Totals</b>
Relevance	-	2	9	15	7	33
Understand ability	1	1	7	9	15	33
Comparability	1	2	6	8	16	33
Reliability	-	3	6	8	16	33

#### 4.4 Regression Analysis

The study sought to determine the extent to which IFRS adoption impacts on the quality of financial reporting by companies listed at Nairobi securities exchange. To achieve this objective, the study used a regression model to determine the relationship between the variables.

##### 4.4.1 Model Summary

The model summary provides information about the regression line's ability to account for the total variation in the dependent variable. The dependent variable's total variation can be measured by its variance. If the regression line is not completely horizontal (i.e. if the b coefficient is different from 0), then some of the total variance is accounted for by the regression line.

Table 4; Model Summary

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.892 <sup>a</sup>	.796	.578	2.241

a. Predictors: (Constant),

comparability, investment decisions, timeliness, measurement and recognition, transparency, Financial statement disclosure

The findings reveal that 80% of the variation in quality of financial reporting was explained by the variables in the model. This implies that regression model adopted for this study was a satisfactory predictor.

#### 4.4.2 Analysis of Variance

Analysis of variance (ANOVA) was used to determine the impact of independent variables have on the dependent variable in a regression analysis. Below are the results of the findings:

Table 5; Analysis of Variance

ANOVA a

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	29.474	6	4.9123	11.101	.002 <sup>b</sup>
	Residual	10.178	23	.4425		
	Total	39.652	29			

a. Dependent Variable: Quality of financial reporting b. Predictors: (Constant), comparability, investment decisions timeliness, measurement and recognition, transparency, Financial statement disclosure

From the findings in table 4.2 above, the p-value=0.002 which is less than 5%. This means that the model was statically significant in predicting the relationship between IFRS adoption on the quality of financial reporting by companies listed at Nairobi securities exchange at 5% level of significance.

### 4.4.3 Tests of Coefficients

The study determined the level of statistical significance between IFRS adoption impacts on the quality of financial reporting by companies listed at Nairobi securities exchange. Below are the results of the statistical tests carried out by determining whether the mean difference is significant at 5% level.

Table 6; Coefficients

Coefficients a

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	2.301	3.212		3.319	1.458
comparability	.219	.121	.154	.241	.057
investment decisions	.315	.244	.278	.287	.048
Timeliness	.478	.213	.422	.102	.050
measurement and recognition	2.117	.743	.414	1.213	.031
transparency	.367	1.131	.267	.407	.027
Financial statement disclosure.	.135	.732	.158	.542	.050

a. Dependent Variable: Quality of financial reporting

Below is the regression model that was obtained from the results of the analysis below:

$$QFR = 2.301 + .219X_1 + .315X_2 + .478X_3 + 2.117X_4 + .367X_5 + .135X_6$$

From the findings, the p-values obtained were as follows: p=.057, p=.048, p=.050, p=.031, p=.027 and p=.050. Since the p-values were less than 5%, this means that the

relationship between the variables was statistically significant since the p-values of all the independent variables from the table were less than 5%.

The regression analysis found that there was a direct relationship between the variables. This means that holding all other factors constant a unit increase in one of the independent variables resulted into a corresponding increase in the dependent variable (Quality of financial reporting).

## **CHAPTER FIVE**

### **SUMMARY, CONCLUSION AND RECOMMENDATION.**

#### **5.0 Introduction**

This chapter describes the summary, conclusion and recommendation of the study

#### **5.1 Discussion**

The objectives of this study was to evaluate the effect of adopting IFRS on the published financial statements of listed companies at NSE and to compare the extend of the financial reporting quality and the value relevance of companies listed at NSE. Data analysis and interpretation revealed the following major findings under this objective. It revealed that that there was a direct relationship between the variables (comparability, investment decisions timeliness, measurement and recognition, transparency, financial statement disclosure). This means that holding all other factors constant a unit increase in one of the independent variables resulted into a corresponding increase in the dependent variable (Quality of financial reporting).

#### **5.2 Conclusion**

This study investigated effect of adopting IFRS on the quality of financial reporting of companies listed at Nairobi securities exchange. The study specifically sought to investigate the effect of adopting IFRS on the published financial statements of listed companies at NSE and to compare the extend of the financial reporting quality and the value relevance of companies listed at NSE. The study established that there was a direct relationship between the variables (comparability, investment decisions timeliness, measurement and recognition, transparency, financial statement disclosure and the independent variable (quality of financial reporting). In view of these findings

the study concludes that the adoption of IFRS by companies listed at NSE have a better quality financial reporting.

### **5.3 Recommendation**

The researcher has argued in this report that companies should adopt the IFRS for quality reporting. The quality of financial reporting enhances comparability, easy under stability, reliability and reliable financial information. It is against this background that the recommendations below are made. Despite its limitations, this study made its stated objectives. Basing generalisations on the findings of this study, the researcher recommends that all companies should adopt the IFRS for quality financial reporting.

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## Appendix 2

### IFRS and IAS (2011 / 2012)

IFRSs:

- [IFRS 1](#) *First-time Adoption of International Financial Reporting Standards*
- [IFRS 2](#) *Share-based Payment*
- [IFRS 3](#) *Business Combinations*
- [IFRS 4](#) *Insurance Contracts*
- [IFRS 5](#) *Non-current Assets Held for Sale and Discontinued Operations*
- [IFRS 6](#) *Exploration for and evaluation of Mineral Resources*
- [IFRS 7](#) *Financial Instruments: Disclosures*
- [IFRS 8](#) *Operating Segments*

IASs:

- [IAS 1](#) *Presentation of Financial Statements*
- [IAS 2](#) *Inventories*
- [IAS 7](#) *Statement of Cash Flows*
- [IAS 8](#) *Accounting Policies, Changes in Accounting Estimates and Errors*
- [IAS 10](#) *Events After the Balance Sheet Date*
- [IAS 11](#) *Construction Contracts*
- [IAS 12](#) *Income Taxes*

- [IAS 16](#) *Property, Plant and Equipment*
- [IAS 17](#) *Leases*
- [IAS 18](#) *Revenue*
- [IAS 19](#) *Employee Benefits*
- [IAS 20](#) *Accounting for Government Grants and Disclosure of Government*

*Assistance*

- [IAS 21](#) *The Effects of Changes in Foreign Exchange Rates*
- [IAS 23](#) *Borrowing Costs*
- [IAS 24](#) *Related Party Disclosures*
- [IAS 26](#) *Accounting and Reporting by Retirement Benefit Plans*
- [IAS 27](#) *Consolidated and Separate Financial Statements*
- [IAS 28](#) *Investments in Associates*
- [IAS 29](#) *Financial Reporting in Hyperinflationary Economies*
- [IAS 31](#) *Interests in Joint Ventures*
- [IAS 32](#) *Financial Instruments: Presentation*
- [IAS 33](#) *Earnings per Share*
- [IAS 34](#) *Interim Financial Reporting*
- [IAS 36](#) *Impairment of Assets*
- [IAS 37](#) *Provisions, Contingent Liabilities and Contingent Assets*



- [IAS 38](#) *Intangible Assets*
- [IAS 39](#) *Financial Instruments: Recognition and Measurement*
- [IAS 40](#) *Investment Property*
- [IAS 41](#) *Agriculture*