INSTITUTIONAL INVESTORS' PERCEPTIONS ON QUALITY OF FINANCIAL REPORTING IN KENYA

BY

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Declaration

This research project is my original work and has never been presented for a degree award in any other university.

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This project was submitted for examination with my approval as the University Supervisor.

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Dedication

I wish to dedicate this work to my parents Samuel Kariuki and Beatrice Njoki, my husband Samson Muriuki, and my sons Newton and Elvis.

Acknowledgement

First. I thank my Almighty God for seeing me through this project. I wish to acknowledge and thank my supervisor for the guidance and support he accorded me. Special thanks go to my colleagues who in one way or another contributed to the success of this work. Finally. I wish to thank my family for the all round support they have shown throughout the entire project.

Abstract

Financial reports are formal records of a business' financial activities. They provide an overview of a business' profitability and financial condition in both short and long term. There are four basic financial statements namely the Balance sheet. which is also referred to as statement of financial condition. reports on a company's assets. liabilities and net equity as of a given point in time. income statement. Cash flow statement and Statement of changes in shareholders equity which explains the changes in a company's shareholders equity over the reporting period. In addition. financial reports contain elaborate disclosure which aims at enhancing the understanding of the financial statements.

The key objectives of the study were to determine the type of information in the financial reports that is regarded as very useful by the institutional investors in Kenya. to determine institutional investors' perception on information reported in the financial reports with respect to usefulness in decision making and to identify the challenges facing investors as they use financial reports of the companies in Kenya.

The design of the study was the descriptive survey design. The target population consisted of all the institutional investors' participating at the NSE. The researcher will sample two respondents from each of the 24 institutions in trading NSE. The overall sample size of 48 respondents will be selected from the target population. Data was collected using semi-structured questionnaires and was analyzed using descriptive statistics.

The researcher found out that the type of information in the financial reports that was regarded as very useful by the institutional investors in Kenya was total assets. non-current liabilities. retained earnings. cash flows from investing activities. and dividends per share. The institutional investors' also perceived the financial report in terms of completeness. comparability. and consistency as good. while in terms of undersandability. relevance. faithful representation. neutrality. predictive ability and timeliness it was regarded as fair. It was also found that the biggest challenge that faces the users of financial reports in Kenya is the technical nature of language of presentation.

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List of Acronyms

I.F.R.Ss	International Financial Reporting Standards
I.A.S.C	International Accounting Standards Committee
F.M.S	Financial management system
Q.F.R	Quality financial reporting
I.A.N	International Audit Networks
C.B.A	Collective Bargaining Agreements
F.S	financial statements

CHAPTER ONE: INTRODUCTION

1.0. Background of the Study

Financial reports are formal records of a business' financial activities. They provide an overview of a business' profitability and financial condition in both short and long term. There are four basic financial statements: Balance sheet which is also referred to as statement of financial condition. reports on a company's assets. liabilities and net equity as of a given point in time. income statement (also referred to as Profit or loss statement which is a report on a company's results of operations over a period of time). Cash flow statement (reports on a company's cash flow activities. particularly its operating. investing and financing activities) and Statement of changes in shareholders equity which explains the changes in a company's shareholders equity over the reporting period.

In addition. these contain disclosures which enhance the understanding of the financial statements. For large corporations. these statements are often complex and may include an extensive set of notes to the financial statements (F.S) and management discussion and analysis. Notes to financial statements are considered an integral part of the financial statements. The financial information provided by managers of a company is used by interested parties to make decisions that. in turn. affect a company's financial condition and the economic well-being of its managers.

According to Smith (1995) accounting provide quantitative information. primarily financial in nature. about economic entity that is intended to be useful in making economic decisions. that is. in making reasonable choices among alternative courses of action. The role of financial accounting and reporting in the economy is to facilitate the making of commercial and economic decisions. These decisions include investment decision such as decision on whether to buy. hold or sell investments and credit decision like whether to lend or not to as well as terms of lending. Both investors and creditors do a thorough analysis of the financial statements before investment to be sure of returns or profit.

The second use of financial statements is to assist in accessing the stewardship role of an organization. The financial statements show the accountability of the management in respect of the resources entrusted to them by the investors. Financial reports and statements represent the mechanism by which those entrusted with resources are held to account for the custody of those resources. The purpose of the annual reports is to convey information, which is useful to those who have an active interest in the organizations, mainly shareholders (Zairi and Letza, 1994). The users of financial reports must understand the context in the financial statements and reports in order to use them effectively. Thomas (2003) argued that companies must first recognize investors and others who use financial reports as customers. He asserts that to a customer a high-quality financial report is the one that helps them make better decisions more effectively. He emphasized that the financial statements must be current, comprehensive, easy to understand and accurate. Financial reporting should include explanations and interpretations to help users understand the financial information provided. Objectivity, accuracy and fairness lead to credible information. He noted that disclosure and transparency are important elements of high-quality reporting (Naswa, 2003).

For corporate information to be useful, it should be presented in an understandable manner. This reality was emphasised by Buzby (1974), who demonstrated that the annual report could be adequate and readable if the information contained in it is presented in an understandable manner and grouped and organised appropriately. Similarly, Wolk et al. (1992) contended that even if users of annual reports are assumed to be knowledgeable, the information itself could have different degrees of comprehensibility. Hence, the quality of understandability is a characteristic influenced by both users and preparers of annual reports. Thus, the notion of understandability is of great concern to users of annual financial statements.

Another important characteristic of useful corporate information is credibility. Credibility is viewed as an important characteristic of corporate information sources. To ensure that the corporate message is communicated to effectively, the company makes every effort to ensure a correct selection of information (Neimark, 1992). Generally speaking, information contained in the annual report can be divided into two main parts. The first part comprises the chairman's and directors' reports. The second part contains the main financial statements, which include the balance sheet, income statement, cash flow statement, auditor's report, and notes to the financial statements.

The profit and loss and the balance sheet are generally viewed as the most important sections of the corporate annual report. They are also the most commonly used by investors in the investment decision-making process (Epstein and Anderson. 1994; Berry and Waring. 1995). At present. the importance of the cash flow statement is increasing. while the income statement is being regarded as less significant (Epstein and Pava. 1993). This information is mainly non-quantitative. and normally includes a review of the year's operations. important projects. news of recent developments. and progress of the company within the prevalent economic. social and political environments (Lee and Tweedie. 1981). This information. contained in the two main parts of the annual report. is important to investors in their investment decisions.

The usefulness of information disclosed by a company is measured. among other things. by its relevance. Relevance of accounting information has three perspectives:- predictive value. timeliness and feedback value. Outdated information is irrelevant and could lead to incorrect decisions. For the corporate information to be relevant. it must be available to decision-makers before it loses its capacity to influence their decisions. Barton (1982) and Solomons (1989) indicated that timeliness of information is one of the main aspects of relevance. In this respect. Davies and Whittered (1980) concluded that timeliness is a necessary condition to be satisfied. if financial statements are to be useful.

Financial Reporting Practices in Kenya

Financial reporting practices are perceived to have improved significantly since ICPAK's decision to implement international standards in accounting and auditing. Discussions with some institutional investors. regulators. company directors. and academics in Kenya reveal that the financial reporting regime has experienced significant changes over the past 12 months. Bank failures and reports about manipulation of asset valuation in the financial statements of some large enterprises in the late 1990s provide examples of the unsatisfactory quality of financial reporting (Schipper and Vincent. 2003). ICPAK's decision to introduce IASs and ISAs and the ensuing (largely voluntary) efforts have brought about improvements that represent a significant step forward. However. the investment community perceives that considerable further improvements are required.

1.1.1 Quality Financial Reporting Concept

Quality financial reports. allows financial analysts to conduct a financial analysis and interpretation. It is a process of examining relationships among financial elements and making comparisons with relevant information. It is a valuable tool used by investors and creditors. financial analysis and others in their decision making processes related to stocks. bonds and other financial investments. The goal in analyzing financial statements is to access past performance and the current financial position and to make predictions about the future performance of a company (Business and finance Encyclopedia. 2001).

The primary qualities that make accounting information useful for decision making are relevance and reliability. Accounting information is relevant if it is capable of making a difference in a decision. For information to be relevant. it should have: predictive or feedback value. and it must be presented on a timely basis. Accounting information is reliable to the extent that it is verifiable. is a faithful representation and is reasonably free of error and bias. To be reliable. accounting information must include: verifiability. representational faithfulness. and neutrality.

The secondary qualities identified are comparability and consistency. Accounting information that has been measured and reported in a similar manner for different enterprises is considered comparable. Accounting information is consistent when an entity applies the same accounting treatment to similar events from period to period.

The relevance of information is affected by its predictive value. confirmatory value. materiality and timeliness. The fundamental principal of any financial report lies on its understandability. relevance. reliability and comparability. Quality in financial reporting is the hierarchy of accounting qualities with relevance and reliability considered primary. In order for information to be reliable. the information should be faithfully represented. verifiable. prudent and complete. The management of the organizations should balance constraints on relevant and relevance information. including timeliness. benefit. cost and qualitative characteristics. As Naswa (2003) puts is. a high quality accounting standard produce financial statements that report events in the period in which they occur –not before and not later. He argues that quality is represented by the usefulness of financial information in making investment decisions. As such quality is related to both the ability to predict and the relevance of the information. International Financial Reporting Standards (IFRSs) (2006) attributes quality financial reporting "as having high degrees of excellence in terms of information disclosed and the standards of usefulness in the context of the needs of users. Although the International Accounting Standards Board (IASB) recognizes that the information need of all users cannot be met by financial statements. but it takes the view that some needs are common to all users. In particular the users have interest in the financial position. and financial performance.

The main users of financial reports are the creditors and investors (both current and Prospective ones) Prospective investors make use of financial statements to assess the viability of investing in a business. Current Investors who are the providers of risk capital and their advisors are concerned within the risk of inherent in and return provided by their investments. They need information to determine whether they should buy. hold or sell. Shareholders are also interested in information which enables them to assess the ability of the enterprise to pay dividends.

Creditors include the financial institutions (banks and other lending companies). These use the financial reports to decide whether to grant a company with fresh working capital or extend debt securities (such as a long-term bank loan or debentures) to finance expansion and other significant expenditures. Government and their agencies are interested in allocation of resources and therefore. the activities of enterprises. They also require information in order to regulate the activities of enterprises. determine taxation policies and as the basis for nation income and similar statistics.

Suppliers and other creditors are interested in information that enables them to determine whether amount owned to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuous of the enterprise as a major customer. Customers have an interest in information about the continuous of an enterprise especially when they have a long-term involvement with or are dependent on the enterprise.

1.2 Statement of the Problem

The goal of investors in a private, profit seeking enterprise is to maximize their wealth which means maximizing the present value of the future cash flows. For more wealth maximizing investors, investment decision requires information that would enable them predict the future cash flow from the investments and the associated risks volatility. Investors receive the information they need to evaluate an investment's future cash flows and risks from many source including: the Balance sheet, Cash flow statement, income statement among others. Many users thus rely on financial statements as their major source of financial information and such financial statements should therefore be prepared and presented with their needs in view (IFRS, 2006). Most annual, financial statement and their annexed notes have formed the most critical basis for information on investments. This has been the case not withstanding the fact that they are essentially historical measures of performance. It is argued that in the absence of drastic happenings either to the company or industry, future performance and risks returns (earnings) mimic the past hence justifying the use of financial statements despite their historical perspective.

Accountants are aware of the limitations of the information contained in the financial report and have attempted to address this shortcoming by enhancing the scope of the generally accepted accounting principles and financial reporting standards. Every year new reporting standards are released by such standard bodies as Financial Accounting Standards Board (FASB) in the US and International Accounting Standards Board (IASB) or existing standards are revised to reflect the changes in either the reporting environment or business complexities. In brief, the goal is to improve the quality of financial reports. Obviously quality financial information should be reflected in the security prices.

The investing public remains cautious on the information contained in the financial reports. This has been worsened by reported cases of misrepresentation and outright fraud in financial statements. The infamous Enron and WorldCom financial reporting scandal are still fresh in our minds. The investors have reacted strongly against such scandals whenever they have been unveiled and pressure their leaders to legislate laws that would protect them (plus pressing for prosecution of alleged management practices culprits) for example the Enron and world scandal, the US congress legislated a law (famously known as the Sarbaves-Oxley act 2002) which among others created a public company accountant oversight board which regulates the work of public accountants and corporate reporting. This is on the top of FASB also created through a piece of legislation.

Since 1999, Kenya (ICPAK), has adopted the IFRS which if well implemented would greatly enhance the quality of financial reports. Therefore this study aims at establishing how investors perceive the quality of financial reports by Kenya companies. The study will focus on the institutional investors licensed by the Capital Market Authority (CMA).

1.3 Objective of the Study

The broad objective of the study was to establish the investors' perception on quality of financial reporting in Kenya as practiced by publicly listed companies.. The study focused on the following Specific objectives:

1. To determine the type of information in corporate financial reports that is regarded as very useful by the institutional investors in Kenya.
2. To determine institutional investors' perception on information reported in the financial reports with respect to usefulness in decision making.
3. To identify the challenges facing investors as they use financial reports of the companies in Kenya.

1.4 Significance of the Study

The results from this study will be of benefit to the management of organizations in improving their existing financial reporting to capture the needs of the target users and make them user-friendly. The findings of this study will assist accounting and finance fraternity in designing financial reports that are easy to use and are able to meet users' needs more effectively. The findings of this study will also form the basis for further studies by other scholars and researchers who might be interested to carry this subject further on.

CHAPTER TWO: LITERATURE REVIEW

2.0. Introduction

This chapter details a review of the related literature on the subject under study by various researchers, scholars, analysts and authors. The research drew materials from several sources which are closely related to the theme and the objectives of the study.

2.1 Development of Financial Reporting Systems

Accounting professionals agree that modern accounting date back in the fourteen century when double entry system began. However, the origins of accounts are generally attributed to the work of Luca Paciol; a famous Italian Renaissance Mathematician. He described a system to ensure that financial information was recorded efficiently and accurately. With the event of industrial age in the nineteenth century and later emergency of large corporations, a separation of the owners from managers of business took place. As a result, the need to report the status of the business enterprises continued to become of significant importance to ensure that managers acted in accordance with owners' wishes. In addition, transaction between businesses became more complex. This led to the emergence of financial reports.

Currently financial statements are the primary means through which financial information is communicated to those outside the enterprise. A set of financial statement consists of four related accounting reports. They include; a balance sheet, an income statement, statement of cash flow, owners' equity statement. A balance sheet shows the financial position of the company at a specific date by indicating the resources that it owns, the debts it owes and the amount of owners' equity in the business while an income statement indicates the profit of the business over the proceeding year or other time period. A cash flow statement summarizes the cash receipts and cash income statement while owners' equity statement explains certain changes in the amount of the owners' equity in the business.

To ensure that all the financial reporting are done accurately and in a standard manner, international bodies such as European Union (EU), Financial Accounting Standard Board (FASB) in the USA and other various bodies around the world prepared standards called

International Financial Reporting Standards (IFRS). This provides general guidelines on how financial reports should be presented. The aim of the standard is to regulate as well as enhance quality financial reporting.

2.2 Financial Management Systems

Financial management system (FMS) can be defined as the process of managing an organization's financial resources so that it can meet its objectives. Financial management encompasses accounting and financial reporting, forecasting and budgeting. It encompasses the two core processes of finance operations and resource management operations including management decisions. FMS determines the nature of the financial report that goes to the users.

All firms require finances to do their routine (administrative), business transactions and investment purposes. It should include internal control measures that ensure resources use is consistent with the policies; resources are safeguarded against waste, loss and misuse; and reliable data are obtained, maintained, and disclosed in reports. Appropriate internal controls shall be applied to all system inputs, processing, and outputs. Financial information generated should be timely and relevant to support management decision, support budget formulation and execution functions and monitor the system to ensure integrity of financial data. Budgets are important for planning and control purposes. Managers are supposed to adhere to the financial plan and its one tool used for evaluation of business performance in terms achieving set objectives while keeping within the financial plan.

2.3 Objectives of Financial Reporting

The objective of financial reporting is to provide useful information to various user groups, all of whom have different information needs. Zairi and Letza (1994) asserted that the fundamental objective of financial reports is to communicate economic measurements of any information about the resources and performance of the reporting entity, useful to those having reasonable rights to such information. The intention of financial reporting is to show what is actually happening to an entity, expressing the salient facts as far as practicable in financial terms. Financial statements provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial reporting aid in economic decision-making. the balance sheet provides the user with information on an enterprise's financial position. the income statement provides the user with information about the enterprise's financial performance and the cash flow statement provides the user with information about the cash flows of the enterprise (Flynn. 1987). Financial statements also show the result of management's accountability for the resources entrusted to it.

2.4 Quality Financial Reporting

Quality financial reporting (QFR) should posses high degree of excellence in terms of information disclosed and the standard of usefulness in the context of the need of users. For financial reporting to be effective all relevant information should be represented in unbiased understandable and timely manner.

Accountants should go beyond the timely reporting and the interpretation of past events. There is need to aid in the creation of useful forecasts of future operation. The users of accounting information must understand the content of the financial statements and reports in order to use it effectively. The quality of financial reporting is judged on how well it aids the investor to determine how the future earnings will be different from current earnings. Quality financial reporting identifies sustainable earnings.

Magrath and Weld (2002) noted that fraudulent accounting leads to staggering losses. They observed that Earning Management practices can be designed either to assist managers in fulfilling their obligations to stakeholders or to deceive investors. Managers smooth earnings to create a lower risk alternative that is highly sought after by investors (Davin. 2004).

For depth and better understanding of the information content in the annual reports there is need for financial analysis. Analysis of financial statements is an indispensable part of lending. investing and other financial decisions. The analytical process underlying the inferences of financial statements. users make use of the vast array of information including economic industrial social and political data but the most important quantitative data are financial accounting data. Kieso (1992) noted that analyzing financial statements involves evaluating three characteristics of a company: its liquidity, profitability and its solvency. Chenhall and Juchau, (1977) however noted that skillful use of account data for financial analysis requires a thorough understanding of the accounting framework underlying their composition including the practices governing measurements of assets liabilities equities and operating results for a company.

In order to improve the quality of corporate financial reporting the audit quality needs to be enhanced and enforcement mechanisms strengthened since the banks as the primary users of financial statements consider audited report as very reliable and of high quality. In the commercial/industries sector users generally considered the financial statements prepared by joint stock companies (audited) as more reliable than those prepared by limited liability companies (un-audited). The quality of financial reporting would improve when there is a strong regulatory regime combined with effective enforcement mechanisms to ensure compliance with accounting and auditing standards and with the auditors' professional ethics. (Word Bank, 2004).

The standards for financial reporting in the United States are known as GAAP and are established by the Financial Accounting Standards Board (FASB). Financial reporting is driven by the general purpose of meeting the needs of external users that lack the ability to prescribe the information they need and, therefore, must rely on information that companies provide. In addition, general purpose financial reporting is directed toward the common interests of various potential users of that reporting for making investment and credit decisions.

QFR involves companies getting in touch first with the users to better understand their needs and serve them more quickly, thoroughly and conveniently. QFR calls for voluntarily expanding the scope and quality of reported information to ensure users are more fully informed. In response to financial reporting scandals of public companies, Congress passed, and the President signed, the Sarbanes-Oxley Act of 2002, which imposed new requirements for public companies and their auditors. Among those requirements included: increased responsibility for boards of directors and audit committees, certification by CFOs and CEOs of the accuracy of financial statements: and additional disclosures in the Management Discussion and Analysis section of reports filed with the Securities and Exchange Commission (SEC). The Act also formalized the SEC's reliance on FASB as the accounting standard-setter for public companies, and it provides for FASB's funding via fees assessed on public companies based on market capitalization. Both the SEC and FASB primarily focus on general purpose financial reporting that provides information to external users of that information. Additionally, both the SEC and FASB identified the following as priorities of standard setting: More timely guidance, Movement towards convergence to a high quality set of standards used both domestically and internationally, Movement towards more principle-based (or objective-based) standards and standards that are anchored in an asset/liability approach rather than a revenue/expense approach, Movement towards fair value measurements where it is determined that such measurements provide for relevant financial information. FASB also is given explicit (via the AICPA's code of conduct) and implicit (via general acceptance) authority to set standards for private companies.

2.5 Empirical Findings on Financial Reporting

Although financial reports contain information useful for decision-making process users of financial reports perceive them differently. According to a study done by Chang and Most (1985) some individual investors did not consider the annual report particularly useful in decision-making, while others were of the view that the financial reports do not meet their information needs. However, these studies found out that these annual reports are read more thoroughly than any other source of information.

Sources of financial information influenced the users' perception of financial reporting. In a study done by Epstein and Pava (1993) in London, found out that the annual report as a source of information had increased in importance. Furthermore, the study found out that the importance of the balance sheet had increased, over the same period of time but the perceived usefulness of the income statement had declined. Another study done in South Africa by Stainbank and Peebles (2006) sought to investigate the sources of financial information used for investment decisions-making regarding buying of holding and selling of ordinary shares by retail investors.

Studies done in Australia by Chenhall and Juchau (1977) and Winfield (1978), found the annual report to be the most important source of information for investor decision-making, while studies done by Anderson (1979) and Courtis (1982) ranked stockbrokers as the most important source of information for investor decision-making. Studies by Anderson (1979) and Courtis (1982) also found out that the balance sheet and the income statement were regarded as the two most important statements in the annual report for decision-making. However a study done by Chang and Most (1985) in USA found that out that newspapers and magazines were the preferred source of information for investments decision- making than annual financial reports while income statement was regarded as the most important statement in the annual report with regard for investments decision making.

Joshi and Abdulla ((1994) emphasized that information requirements of users of annual reports should be recognized by companies. When researching on the issue of users' needs in annual reports. Stanga and Benjamin, (1977) found many deficiencies in the published annual reports of large industrial firms. The study found out that the differences in size of companies did not appear to be related in explaining the differences in annual report disclosure among large industrial firms. Cook and Sutton (1995) stresses on the fact that companies should focus on the information requirements of shareholders so that the annual report satisfies their needs. Preparing summary annual reports rather than engaging into information overload by providing a detailed annual report can satisfy their needs. Hence, companies should disclose the many pieces of information in a clear and understandable format in a summary annual report that will increase the relevance and value of shareholder communication.

2.6 Earnings Quality and Accounting's Conceptual Framework

There is a relationship between earnings quality and accounting's conceptual framework. First, the framework interprets earnings as a measure of the value a firm creates. According to Statement of Financial Accounting Concepts (SFAC) (FASB), "the primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and it components" Secondly, the framework focuses on accrual earnings, not cash flow. According to SFAC, "the investors and creditors interest in an enterprise's future cash flows leads primarily to an interest in information about its earnings rather than information directly about its cash flows". Thirdly, the conceptual framework suggests that earnings quality should be measured in terms of its decision-usefulness to financial statement readers. According to SFAC, readers of financial statements use reported earnings in various ways. Four specific examples are provided. Readers use earnings "to help them (a) evaluate management's performance, (b) estimate "earnings power" or other amounts they perceive as "representative" of long-term earning ability of an enterprise, (c) predict future earnings, or (d) assess the risk of investing in or lending to an enterprise" these three points are used to define "earnings quality." While the conceptual framework addresses the issue of how investors use reported earnings. Repeated statements by academics indicate that there is no consensus in the academic or professional literature on how to define earnings quality.

McNichols et al (2003) related earnings quality to the persistence of earnings, the level of accruals, and earnings that reflect the underlying economic transactions. Of these, the first two seem to be connected to empirical measures, while the last seems to be a theoretical definition. Schipper and Vincent (2003) looked explicitly at empirical measures of earnings quality and relate these measures to decision usefulness and an economic-based definition of earnings. They conclude that, in addition to the well-known estimation issues connected with most earnings' quality measures, choice and measurement of the accounting constructs also may affect the earnings' quality measures. In summary, high quality earnings result from accounting policy choices that generate reported earnings that enable financial statement readers to make better decisions.

Over the last three years, SEC investigations have uncovered earnings management practices that have pushed the boundaries of GAAP (reporting standards), even to the point of out-right fraud. In some instances, independent auditors were blamed for not catching or correcting accounting irregularities. In others, it is clear that management intended to deceive outside auditors and audit committees. Regardless of fault, when earnings management and fraudulent accounting schemes are uncovered, the monetary losses can be staggering. In addition, the accounting profession has taken steps to educate accountants about earnings management practices and their effects and consequences (Magrath and Weld, 2002).

2.7 Financial Reporting and Disclosure in Kenya

Ahmed (1994) suggested that the disclosure levels in the balance sheet, income statement and notes for accounting policies were of relatively high level, mainly because of the enforcement of the Securities and Exchange Rules and also due to the adoption of selected international accounting standards affecting those statements and notes. The Kenya companies Act (CAP 486) sets the general framework for financial accounting and reporting by all registered companies in Kenya and stipulates the basic minimum requirements with regard to financial reporting. In particular the sixth schedule of the Act sets out the disclosure requirement in respect of the balance sheet and the profit and loss account. On July 1, 1977 the accounting Act chapter 531 laws of Kenya established three bodies namely Institute of certified Public Accountant of Kenya (ICPAK), Registration of Accountants Board (RAB) and Kenya Accountants and Secretaries National Examinations Board (KASNEB).

ICPAK is responsible for the development and implementation of accounting and auditing standards (KASs) since the early 1980s. In 1998 the ICPAK decided to adopt International Finance Reporting Standards (IFRSs) without any modification and as a result from 1999 financial statements for all companies in Kenya have been required to comply fully with IFRSs. Later ICPAK introduced auditor independent to enhance the credibility of financial statements (Center for Corporate Governance, CCG, 2004).

To further encourage quality reporting, the financial reporting (Fire) award was launched in 2001 to enhance the credibility of financial statements and ensure they were prepared in accordance with all the provision of IFRSs provision of the company's Act best practice in governance and corporate citizenship as well as other requirements that are specific to a particular reporting entity. By rewarding those whose statements demonstrate excellence in financial reporting, the Fire Award seeks to institutionalized integrity and transparency of those who rely on such information. On the other hand, through the Fire Award, challenges facing organizations in implementing financial report standards are identified and appropriate strategies are initiated to aid participants in overcoming these challenges (Fire award Report, 2005).

CHAPTER THREE: RESEARCH METHODOLOGY

3.0. Introduction

This chapter details the research methodology to be used in this study. This includes the population, the sample, type of data collected, method of data collection, and also the data analysis procedures employed.

3.1. Research Design

In assessing the investors' perception on quality of financial reporting in Kenya, descriptive research was used. Descriptive research determines and reports the ways things are (Gay, 1981). This approach was appropriate because the study involved fact finding and enquiries to establish the investors' perception on financial reporting in Kenya at the moment.

3.2. Target Population

Mugenda and Mugenda (2003) defined the target population as that population to which a researcher wishes to generalize result of a study. The target population for this study were all the institutional investors' participating at the NSE. An institutional investor is an investor, such as an insurance company, retirement fund, hedge fund, or mutual fund that is financially sophisticated and makes large investments, often held in very large portfolios of investments. The study targeted institutional investors because they were the main users of financial reports. However the main focus of this study was the institutional investors associated with NSE because most of the individual investors rely greatly on the information given to them by the investments advisors (like the stock brokers) and also they are easily accessible as compared to individual investors. Therefore institutional investors acted as representative of all the users of financial reports.

3.3. Sample Design

Purposive sampling method was applied to select the sample for the study. According to Mugenda and Mugenda (2003) purposive sampling is a sampling technique that allows a researcher to get cases that have the required information with respect to the objectives of the study. The researcher sampled two respondents from 24 institutions. Samples were drawn from as shown in the sampling matrix in table 3.1. The overall sample size of 48 respondents was selected from the target population.

Table 3.1: The sampling matrix

Investors	Total Number of institutions	No. of Respondents sampled per institution	Sample size
Institutional investors	24	2	48

Source: Researcher (2006)

3.4. Data collection

Relevant data was collected through the use of questionnaires. The questionnaire consisted of both open-ended and closed questions covering issues on investors' perception on financial reports. The field study involved questionnaire administration to the target respondents. Questionnaires were used because they are easy to administer to respondents scattered over a large area and convenient for collecting more information within a short period of time. Open-ended questions permitted free responses from the respondents. without providing or suggesting any structure for the replies. The closed questions enabled responses of the respondents to be limited to stated alternatives.

3.5. Data analysis

After the fieldwork, all the questionnaires were adequately checked for accuracy and completeness before analysis. The data was coded and entered into a spreadsheet and analyzed using SPSS (Statistical Package for Social Sciences). Exploratory analysis was performed first to ensure that the output is free from outliers and the effects of missing responses are at minimum. Descriptive statistics and cross-tabulations techniques were the principal data analysis techniques. The data was presented using bar graphs, percentages, frequency tables among others

CHAPTER FOUR: DATA ANALYSIS AND INTERPRETATION

4.1 Introduction

This chapter presents analysis and findings of the research. From the study population targets of 48 respondents. 33 respondents responded and returned the questionnaire, constituting 68.8% response rate.

4.2 General Information

Table 4.2: Gender

	Frequency	Percent
Male	17	51.5
Female	16	48.5
Total	33	100.0

The findings from the above table revealed that the majority of the respondents were male as shown by 51.5%, while females were shown by 48.5% of the respondents. This information was also shown in the figure below.

Table 4.3: Age of the respondent

	Frequency	Percent
26-35 Years	12	36.4
Above 35 Years	11	33.3
Below 25 Years	10	30.3
Total	33	100.0

On the age of the respondents, the researcher found out that the majority of the respondents were aged 26-35 years as indicated by 36.4% of the respondents, followed by 33.3% of the respondents who were above 35 years, while 30.3% of the respondents were below 25 years old. This information was also shown in the figure below.

Table 4.4: Investment institution that the respondent works with

	Frequency	Percent
Others	12	36.4
Mutual Funds	6	18.2
Insurance firms	5	15.2
Fund Managers	4	12.1
Unit Trusts	3	9.1
Pension Fund	3	9.1
Total	33	100.0

The study also sought to investigate on the investment institution that the respondent worked with. From the findings in the above table, the majority of the respondents as shown by 36.4% reported that they were working with other investment institutions which were investment advisor/stock agency and stock brokers, 18.2% said that they were working with mutual funds, 15.2% reported that they were working with insurance schemes, 12.1% said that they were working with fund managers, while the respondents who said that they were working with unit trusts and pension funds were shown by 9.1% each. This information was very important to the researcher as it helped her to know whether the respondents were in the relevant institutions and whether they were versed with the quality of financial reporting in Kenya. This information was also shown in the figure below.

Table 4.5: Department that the respondent works in

	Frequency	Percent
Administration and Personnel	16	48.5
Others	12	36.4
Finance and Control	5	15.2
Total	33	100.0

The respondents were also asked to indicate the department that they worked in. From the findings in the above table, the study revealed that the majority of the respondents were in the finance and control department as indicated by 48.5% of the respondents, 36.4% said that they were working with other departments such as research department, customer service department, stock broking and fund services department, while 15.2% of the respondents said that they were working with administration and personnel department. This information was also shown in the figure below.

Table 4.6: Duration of working in the organization

	Frequency	Percent
2 years	13	39.4
4 years	5	15.2
1 year	4	12.1
10 years	3	9.1
5 years	3	9.1
6 years	3	9.1
3 years	2	6.1
Total	33	100.0

The duration of working in the organization was also investigated in the study. The findings from the above table revealed that the majority of the respondents had been working in the organization for 2 years as shown by 39.4%. 15.2% had been working in the organization for 4 years. 12.1% had been in the organization for 1 year. the respondents who had been in the organization for 5 years. 6 years and 10 years were shown by 9.1% each. while 6.1% of the respondents reported that they had bee working in the organization for 3 years. This information was also very important to the researcher as it helped her to know how well versed the respondent was with the quality of financial reporting in Kenya which depended on the number of years the respondents had been in the organization.

Table 4.7: Highest level education

	Frequency	Percent
University Postgraduate	14	42.4
University Graduate	10	30.3
Tertiary College	9	27.3
Total	33	100.0

On the highest level of education. the researcher found out that the majority of the respondents were university postgraduates as shown by 42.4%. 30.3% were university graduates. while 27.3% of the respondents reported that they were from tertiary college. From this information. the researcher was able to have confidence in the data collected since all the respondents were able to read and understand the questionnaire and hence give the most relevant responses. This information was also shown in the figure below.

4.3 Investors' Perception on Quality of Financial Reporting In Kenya

Table 4.8: Specific training specification

	Frequency	Percent
Finance	13	39.4
Accounting/Audit	9	27.3
Management	6	18.2
Others	5	15.2
Total	33	100.0

The study also sought to investigate on the specific training specification of the respondents. From the findings, the study revealed that the majority of the respondents had trained in finance as shown by 39.4%, 27.3% had trained in accounting/audit, 18.2% had trained in management, while 15.2% of the respondents had trained in other specifications such as business administration. This information was also shown in the figure below.

Table 4.9: Sources of Information Considered Being the Main Sources of Information When Making Investment financial Decisions

	Yes
Company Announcements/Annual Reports	78.8
Financial Analyst Advice	69.7
Newspapers, Magazines and Journals	63.6
Technical Analysis	48.5
Communication with Management	30.3
Internet	24.2
Stockbroker Advice	0
Family/Friends Advice	0

The above table shows the findings on the sources of information considered as the main sources of information when making investment decisions. From the above table the majority of the respondents said that these sources were company announcements/annual reports as shown by 78.8%, financial analyst advice shown by 69.7%, and newspapers, magazines and journals as shown by 63.6% of the respondents in order of preference.

Table 4.10: Usefulness of the Information Contained in the Financial Reports With Respect To Investment Decision Making In Terms Of Quality Attributes

	Very Useful	Useful	Not Useful At All
Relevance	%	%	%
Predictive Value	39.4	54.5	6.1
Feedback Value	24.2	60.6	15.2
Timeliness	36.4	15.2	48.5
Reliability			
Representativeness	63.6	21.2	15.2
Neutral	9.1	75.8	15.2
Faithfulness	15.2	27.3	57.6
Verifiability	57.6	18.2	24.2
Objectivity	39.4	36.4	24.2
Comparability			
Over the Years	57.6	42.4	0
Disclosure Notes	57.6	30.3	12.1
Consistency	66.7	33.3	0

In the above table, the researcher sought to find out the usefulness of financial reports with respect to investment decision making in terms of quality attributes listed in the above table. On relevance the most useful information was on predictive value as shown by 39.4% of the respondents followed by feedback value as shown by 24.2% and lastly was timeliness as shown by 36.4% of the respondents.

On reliability, the researcher found out the most useful information was on representativeness and neutral as shown by 63.6% and 9.1% respectively, and verifiability and objectivity as shown by 57.6% and 39.4% respectively. On comparability, the most useful information was over the years and consistency as shown by all the respondents and disclosure notes as shown by 87.9% of the respondents.

Table 4.11: Kind of Financial Report Perceived To Contain the Most Important Information for a Company/Organization

	Yes	No
Annual Report	51.5	48.5
Interim Report	24.2	75.8
Audit Report	48.5	51.5
Quarterly/Half Year Report	30.3	69.7

Preliminary Announcement	24.2	75.8
Prospectus	39.4	60.6
Published Statements by Company Officials	24.2	75.8
Company Website (Excluding Annual Report)	0	100

The findings in the above table shows the kind of financial report perceived to contain the most important information for a company/organization. From the findings, the financial report perceived to contain the most important information for a company/organization by the majority of the respondents was the annual report as shown by 51.5% of the respondents. This information was also shown in the figure below.

Table 4.12: Information Regarded As Most Useful In the Financial Reports

	Most Useful	Useful	Not Useful	Weighted Scores
Balance Sheets				
Non-Current Liabilities	30.3	45.5	24.2	1.9
Current Liabilities	33.3	60.6	6.1	1.7
Non-Current Assets	36.4	63.6	0	1.6
Total Liabilities	42.4	51.5	6.1	1.6
Current Assets	45.5	54.5	0	1.5
Total Assets	78.8	6.1	15.2	1.4
Contributed Capital	69.7	24.2	6.1	1.4
Statement Of Change In Equity				
Total Equity	54.5	30.3	15.2	1.6
Changes In Capital During The Year	66.7	18.2	15.2	1.5
Retained Earnings	48.5	51.5	0	1.5
Cash Flow Statement				
Profit/Loss Before Tax	57.6	27.3	15.2	1.6
Cash Flows From Investing Activities	48.5	51.5	0	1.5
Cash Flows From Financing Activities	57.6	33.3	9.1	1.5
Change In The Working Capital	57.6	42.4	0	1.4
Change In Net Cash Flow	66.7	27.3	6.1	1.4
Cash Flows From Operating Activities	75.8	24.2	0	1.2
Income Statement				
Dividends Per Share	54.5	9.1	36.4	1.8
Earnings Per Share	63.6	36.4	0	1.7
Turnover/Income/Relevance	60.6	24.2	15.2	1.5

Earnings After Tax	78.8	6.1	15.2	1.4
Others				
Accountant Policies	75.8	9.1	15.2	1.4
Attached Noted	42.4	42.4	15.2	1.7
Chairman's Report	15.2	75.8	9.1	1.9
Auditor's Report	66.7	18.2	15.2	1.5
Management Forecasting	54.5	30.3	15.2	1.6

In the above table, the researcher sought to investigate the information regarded as the most useful in the financial reports in the above table. The researcher then presented the findings using the mean scores for easier interpretation.

From the findings in the above table, it is evident that all the information non-current liabilities, total equity, turnover/income, dividends per share, and earnings per share were regarded as useful in the financial reports. This was because all these information had a mean score raging from 1-2 to 1.9 which in the response scale of 1-3 this means that this information was regarded as useful in the financial reports.

Table 4.13: Rating Quality of Kenya Companies Financial Reporting

	Very Good	Good	Fair	Bad	Worst	Mean
Understandability	9.1	30.3	39.4	21.2	0	2.7
Relevance	24.2	21.2	30.3	18.2	6.1	2.6
Reliability	9.1	36.4	48.5	6.1	0	2.5
Faithful Representation	15.2	21.2	18.2	45.5	0	2.9
Neutrality	9.1	90.9	0	0	0	2.9
Completeness	33.3	36.4	24.2	6.1	0	2
Comparability	33.3	30.3	15.2	15.2	6.1	2.3
Predictive Ability	9.1	15.2	75.8	0	0	2.7
Consistency	24.2	27.3	33.3	15.2	0	2.4
Timeless	30.3	12.1	6.1	42.4	9.1	2.9

The respondents were also requested to rate the quality of Kenya companies financial reporting in terms of the attributes in the above table. The findings were also presented using mean scores for easier interpretations.

From the findings, the quality of Kenya companies in terms of completeness, comparability, and consistency was regarded as fair by the majority of the respondents as it had a mean score of raging from 2-2.4, where in the response scale of 1-5, this means that the majority of the respondents regarded it as good. The quality of Kenya companies in terms of undersandability, relevance, faithful representation, neutrality, predictive ability and timeliness was regarded as fair as they had a mean score raging from 2.5-2.9.

Table 4.14: Level of Agreement with the Quality of Financial Reporting

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	W Sc
Investment decision-making is affected when a company does not comply with the set regulation of financial reporting	9.1	0	0	24	66.7	4.4
The usefulness of the financial reports are impaired by their length	0	0	27.3	18	54.5	4.
Market-driven financial reporting would provide more useful information	0	0	18.2	30	51.5	4.
The financial reports are difficult to understand and that the information contained should be summarized	0	9.1	0	61	30.3	4.
More information in the financial report should be subject to audit	0	0	33.3	33	33.3	4

From the findings in the above table, the majority of the respondents were in agreement that the financial reports are difficult to understand and that the information contained should be summarized, more information in the financial report should be subject to audit, the usefulness of the financial reports are impaired by their length. Investment decision-making is affected when a company does not comply with the set regulation of financial reporting and market-driven financial reporting would provide more useful information as all these statements had a mean score raging from 4-4.4 which was clear that the majority of the respondents agreed.

4.4 Challenges Facing Users of Financial Reports in Kenya

Table 4.15: Challenges that face the users of financial reports in Kenya

	Frequency	Percent
The technical nature of language of presentation	19	57.6
The format of presentation	14	42.4
Total	33	100.0

The findings in the above table show the challenges that face the users of financial reports in Kenya. From the findings, the biggest challenge was found out to be the technical nature of language of presentation as shown by 57.6% of the respondents, while 42.4% of the respondents said that the challenge faced by the users of financial reports in Kenya was the format of presentation.

CHAPTER FIVE: DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Discussions

From the analysis and data collected the following discussions. conclusions and recommendations were made. The analysis was based on the objectives of the study. From the findings. the sources of information considered being the main sources of information when making investment decisions by the majority of the respondents were company announcements/annual reports. financial analyst advisory. and newspapers. magazines and journals.

On the usefulness of the information contained in the financial reports with respect to investment decision making in terms of quality attributes the researcher found out that on the most useful information was on predictive value followed by feedback value and lastly was timeliness. On reliability. the researcher found out the most useful information was on representativeness. neutral. verifiability and objectivity while on comparability. the most useful information was over the years and consistency followed by disclosure notes.

The study also revealed that the financial report perceived to contain the most important information for a company/organization was the annual report (financial statements). On the information regarded as useful in the financial reports. the researcher found out that non-current liabilities. total equity. turnover/income. dividends per share. and earnings per share.

The quality of Kenya companies' financial report in terms of completeness. comparability. and consistency was regarded as good. while in terms of undersandability. relevance. faithful representation. neutrality. predictive ability and timeliness it was regarded as fair. From the findings. the majority of the respondents said that the financial reports in their current form are difficult to understand and that the information contained should be summarized. More information in the financial report should be subject to audit e.g chairman's report. the usefulness of the financial reports are impaired by their length. investment decision-making is affected when a company does not comply with the set regulation of financial reporting and market-driven financial reporting would provide more useful information.

The study also revealed that the technical nature of language of presentation was regarded as the biggest challenge that faces the users of financial reports in Kenya.

5.2 Conclusions

From the findings, the researcher concluded that the type of information in the financial reports that is regarded as very useful by the institutional investors in Kenya was total assets, current assets, non-current assets, total liabilities, current liabilities, non-current liabilities, contributed capital, total equity, changes in capital during the year, retained earnings, profit before tax, change in the working capital, cash flows from operating activities, cash flows from investing activities, cash flows from financing activities, change in net cash flow, turnover/income, dividends per share, earnings per share, earnings after tax, accountant policies, attached noted, chairman's report, auditor's report and management forecasting.

The researcher also concluded that the institutional investors' perceived the financial report in terms of completeness, comparability, and consistency was regarded as good, while in terms of undersandability, relevance, faithful representation, neutrality, predictive ability and timeliness it was regarded as fair. It was also concluded that biggest challenge that faces the users of financial reports in Kenya is the technical nature of language of presentation was regarded as important.

5.3 Recommendations

From the findings and the conclusions, the researcher recommended that the accounting and finance fraternity should develop a way of designing financial reports that are easy to use and are able to meet users' needs more effectively. It was also recommended that management of organizations should try and improve their existing financial reporting to capture the needs of the target users and make them user-friendly.

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Appendix 1: Questionnaire for Institutional Investors

The questionnaire is meant to collect information on the investors' perception on quality of financial reporting in Kenya. Kindly answer the questions by writing a brief statement or ticking in the boxes provided as will be applicable.

SECTION A: GENERAL INFORMATION

1. What is your Gender?

   Male ☐

   Female ☐

2. What is your age

   Below 25 years ☐

   26-35 years ☐

   Above 35 years ☐

3. Which investment institution do you work with?

   Mutual funds ☐

   Unit trusts ☐

   Pension fund ☐

   Insurance schemes ☐

   Fund managers. ☐

   Others (specify)..

4. Which department are you currently working in?

   1) Finance and Control ☐
   2) Operations ☐
   3) Quality Assurance and Standards ☐
   4) Administration and Personnel ☐
   5) Information Communication Technology ☐
   6) Planning and Marketing ☐
   7) Audit Department ☐
   8) Public Relations ☐

   ☐

9) Legal department

10) Others (please specify)...

5. How long have you been working in this organization? ______________ years
6. What is your highest level of education
    1) Secondary ☐
    2) Tertiary College ☐
    3) University Graduate ☐
    4) University Postgraduate ☐
    5) Other (please specify) ______________________________

SECTION B: INVESTORS' PERCEPTION ON QUALITY OF FINANCIAL REPORTING IN KENYA

7. What is your specific training specification?
    1) Accounting /Audit ☐
    2) Finance ☐
    3) Management ☐
    4) Operations ☐
    5) Public Relations ☐
    6) Information Communication Technology ☐
    7) Legal matters ☐
    8) Planning and Marketing ☐
    9) Other (please specify) .... ☐
8. As a user of financial reports, which sources of information do you consider to be the main sources of information when making investment decisions (such as buy, hold or sell)?
    1) Stockbroker advice ☐
    2) Financial analysts advice ☐
    3) Family/friends' advice ☐
    4) Company announcements/annual reports ☐
    5) Communication with management ☐

6) Newspapers. magazines and journals

7) Technical analysis

8) Internet

9) Others (specify)..

9. As an investor. how would you rank the usefulness of the information contained in the financial reports with respect to investment decision making in terms of the quality attributes listed in the table below? Rank the following attribute in shown: **(1= very useful, 2=useful, 3=not useful at all)**

Statements	**1**	**2**	**3**
a) Relevance			
i) Predictive value			
ii) Feedback value			
iii) Timeliness			
B)Reliability			
i) Representativeness			
ii) neutral			
iii) faithfulness			
iv) verifiability			
v) Objectivity			
c) Comparability			
i) Over the years			
ii) Disclosure notes			
iii) Consistency			

10. What kind of financial report do you perceive to contain the most important information for a company/organization?

1) Annual report

2) Interim report

3) Audit report

4) Quarterly/half year report

5) Preliminary announcement

6) Prospectus

7) Published statements by company officials

8) Company web-site (excluding annual report)

9) Others (specify)..

11. What kind of information would you regard as most useful in the following financial reports? Tick the ranks them in order of importance (1^{st} . 2^{nd} or 3^{rd})

A)	**Balance sheets**	Ranks		
		1	2	3
i	Total assets			
ii	Currents assets			
iii	Non-current assets			
iv	Total liabilities			
v	Current liabilities			
vi	Non-Current liabilities			
v	Contributed capital			
B	**Statement of change in Equity**	1	2	3
i	Total equity			
ii	Changes in capital during the year			
iii	Retained Earnings			
c)	**Cash flow**	1	2	3
i	Profit/loss before tax			
ii	Change in the working capital			
iii	Cash flows from Operating Activities			

iv	Cash flows from investing Activities			
v	Cash flows from financing Activities			
vi	Change in net cash flow			
d)	**Income Statement**	1	2	3
i	Turnover/income			
ii	Dividends Per Share			
iii	Earnings Per Share			
iv	Earnings After Tax			
e	**Others**	1	2	3
i	Accountant policies			
ii	Attached noted			
iii	Chairman's reports			
iii	Auditors' report			
iv	Management forecasting			

12. How would you rate quality of Kenya companies financial report in terms of the following attributes.(**1= very good, 2=good, 3=fair, 4=bad. 5=worst)**

Statements	**1**	**2**	**3**	**4**	**5**
a) Understandability					
b) Relevance					
c) Reliability					
d) Faithful representation					
e) Neutrality					
f)Completeness					
g) Comparability					

h) Predictive ability					
I)Consistency					
j) Timeliness					

13. To what extent would you agree/disagree with the following statement as regards to the quality of financial reporting (Tick appropriately)

(Where; 5=Strongly Agree,4=Agree, 3=Neutral, 2=Disagree, 1=Strongly Disagree]

Statements	1	2	3	4	5
a) The financial reports are difficult to understand and that the information contained should be summarized					
b) More information in the financial report should be subject to Audit.					
c) The usefulness of the financial reports are impaired by their length.					
d) Investment decision-making is affected when a company does not comply with the set regulation of financial reporting.					
e) Market-driven financial reporting would provide more useful information.					

SECTION C: CHALLENGES FACING USERS OF FINANCIAL REPORTS IN KENYA

14. In your own opinion, what challenges face the users of financial reports in Kenya? Please tick as applies.

The technical nature of language of presentation ( )

The length of the financial statements ( )

The format of presentation ( )

Other (specify) ( )

....

....

15. What recommendation would you make as pertains to users' perception on the quality financial reporting in Kenya?

____

____

____

____

THANK YOU FOR YOUR CO-OPERATION