EFFECTS OF FINANCIAL REPORTING QUALITY ON SUBSEQUENT FREE CASHFLOWS OF FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE

BY:

NJOROGE MERCY NJOKI

REG: D63/74946/2014

A RESEARCH PROJECT SUBMITTED IN PARTIAL FULIFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF SCIENCE IN FINANCE, SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

NOVEMBER, 2016

DECLARATION

I hereby declare that this research project is my own work and effort and it has not been presented in any other university anywhere for an academic award.

NJOROGE MERCY NJOKI

D63/74946/2014

SIGN ………………………………………………..

This research projecc has been submitted for examination with my approval as the candidate's University supervisor.

NAME: MR. JAMES KARANJA

SIGN………………………………………………….

DATE…………………………………………………

NAME: MS. HELEN KINYUA

SIGN………………………………………………….

DATE…………………………………………………

ACKNOWLEDGEMENTS

I acknowledge the contribution of all those who have made this research work a reality. Special regards to my supervisors Ms. Helen Kinyua and Mr. James Karanja for their guidance throughout the research process.

I recognize appreciate the tireless support and contributions of classmates and from my colleagues which made every step a success.

I appreciate the patience and support of my family members who have massively given the moral support throughout the project. To them I forever remain indebted.

DEDICATION

I dedicate this research work to the Njoroge's for their great understanding, support and encouraging words throughout the period, which has made this achievement a reality.

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LIST OF ABBREVIATIONS

CMA	Capital Markets Authority
CBK	Central Bank of Kenya
CSR	Corporate Social Responsibility
D/E	Debt to Equity ratio
DDM	Dividend Discount Model
EVA	Economic Value Added
FCF	Free Cash Flow
FRQ	Financial Reporting Quality
GAAP	Generally Accepted Accounting Principles
IASB	International Accounting Standards Board
ICPAK	Institute of Certified Public Accountants
IFRS	International Financial Reporting Standards
IR	Information Ratio
NFP	Non Financial Performance
NSE	Nairobi Securities Exchange
RIM	Residual Income Model
ROA	Return on Assets
ROI	Return on Investment
SPSS	Software Package of Social Sciences

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ABSTRACT

Financial reporting is a formal way, in which a firm represents its activities for information and evaluation of its financial position and performance by its stakeholders, through preparation of the profit and loss acccount, changes in equity statement, balance sheet and the cashflows statement. Upon preparation of these statements, an evaluation is conducted to determine the financial performance of the firm using such measures as Return on Assets (ROA), Return on Investment (ROI), Debt to Equity (D/E) ratio and other liquidity ratios.

The objective of the study was to establish the impact of financial reporting quality on the subsequent cashflows of firms by exploring the effects of relevance, reliability, understandability and comparability as the indictors of financial reporting quality. Further, exploring creative accounting and earnings management which tend to portray the firm's performance in a positive way in order to attract investors and protect the management from actions of debt holders due to contravening debt covenant conditions.

The research considered financial statements from firms listed at the Nairobi Securities Exchange (NSE) for the period between 2011 and 2015. This involved gathering information on the reporting trends of firms against a content analysis checklist that covered relevance and reliability which are the fundamental characteristics relating to content, and understandability and comparability; the enhancing characteristics relating to presentationas stipulated by International Financial Reporting Standards (IFRS).Descriptive study design was adopted to obtain factual, accurate and systematic data and the Software Package of Social Sciences (SPSS) was used to analyse the data and establish the relation between the variables.

In conclusion, it was established that financial reporting quality affects subsequent cashflows to a low degree of 23.1% while 76.9% of the influence is caused by other variables. Similarly, it was established that relevance and reliability have a significant relationship with cashflows while understandability and comparability were found to be insignificant.

CHAPTER ONE: INTRODUCTION

Over the years, financial performance of firms, both unlisted and those listed in the domestic and foreign securities exchange has been used as a benchmark in identifying firms worth investing in. Investors globally use such measurement tools as Return on Assets (ROA), Debt to Equity (D/E) and Return on Investment (ROI) ratios to determine the financial performance of firms before investing in them. These ratios have been categorized as traditional financial performance measures, (Elaine and Thomas 2013). Some investors will determine the value of the firm over and above the financial ratios by using such valuation methods as the Residual Income Method (RIM), Dividend Discount Model (DDM), Free Cash Flow to Firm (FCFF) model and the Price Multiples, (Kaplan, 2014).

In order to measure the financial performance and value these firms, preparation of financial statements is paramount and subsequently report the same in accordance with the International Financial Reporting Standards (IFRS). These standards are guidelines that ensure that financial statements adhere to the qualities of relevance, reliability, uniformity and understandability,(IASB, 2010).

In the recent past, following increased cases of manipulation of accounting figures and creative accounting techniques being adopted by senior management in various firms in order to portray an overly positive position of a firm in a bid to attract investors in an ever increasing competitive market, there have been calls for adopting cashflow analysis and non-financial performance (NFP) techniques, in addition to the financial measures to have both a qualitative and quantitative analysis of the performance of the firm. These measures embrace corporate

governance as a way to enhance accountability and responsibility of the management of firms to all the stakeholders of the firm with a bid to ensure that all their interests are met in equal measures. Meanwhile, the performance of the firm is determined by among other things its management. This is determined by the Information Ratio (IR) which is key in determining the capability of the management in creating value for the investors. It is a product of the managers' skill and ability, and the frequency of available opportunities from which the manager can invest in, (Kaplan, 2014).

1.1.1 Financial Reporting Quality

Financial reporting is the manner in which firms show their performance to various stakeholders, (IASB, 2010), through preparation of financial statements.These include shareholders, financiers, creditors, customers and the governmet. The purpose of financial reporting is provision of useful information for decision making by various stakeholders through giving information about the reporting entity. Theses decisions could include provision of resources to the firm. This could be through buying and selling of short term amd long term securities. Elaine and Thomas (2013), identify the statement of financial position, statement of income, statement of cashflow and the statement of changes in equity as key financial statements for any firm.

According to Kaplan (2014), financial reporting quality refers to the characteristics of a firm's financial statements. The criterion for judging this is the adherence to generally accepted accounting principles (GAAP) in the jurisdiction in which the firm operates. However, given that GAAP provide choices of methods, estimates and specific treatment of main items, compliance with GAAP by itself does not necessarily result in financial reporting of the highest quality, (Barth et al, 2001). High quality financial reporting has the characteristics of relevance; ability

to influence the decisions of users, reliability; represents faithfully the transactions and events it purports to represent, understandability; information provided is readily understandable by users and comparability; ability of users to compare financials performance and position of the firm with others in the same industry, within the firm over time and establish trends, (IASB, 2010).

1.1.2 Free Cashflow

The balance sheet and the income statement provide an overview of the firm's financial position and performance respectively, (Elain and Thomas, 2013). However, the cashflow statement is vital in analysing a company's long term success. Stakeholders are able to evaluate the liquidity, financial flexibility and solvency of a firm through the disclosures on how funds were obtained and utilized. The ability of a firm to react and adapt to financial opportunities and adversities is refered to as financial flexibility, (Black et al, 2006). Cashflow is a metric of the amount of money that flow in and out of a company's bank account, (Lipe, 1990), while free cashflow is the cash that remains once the firm has paid all its expenses. A positive free cashflow indicates the company is generating adequate cash to meet its needs, to reinvest and grow the business. On the other other hand, free negative cashflow implies that a firm is not generating enough cashflows.

Good corporate governance impacts ona firm's value since it helps improve the amount of cashflows expected to be distributed to investors through reduction of information asymmetry and expropriation by insiders. To evaluate performance effectively and efficiently, financial performance indicators chosen need to be measurable, relevant and important to the firm under consideration. In making investment decisions, there is need users of financial statement to analyse the operating cashflow against the net income which is a key performance measure.

Earnings are more subject to aggressive accounting and earnings management techniques, (Barth et al, 2001).

1.1.3 Relationship between FRQ and Subsequent Free Cashflow

According to Jonas and Blanchet, (2000), information asymmetries occurs when information is known to only a few people and especially insiders. Subsequently, release of financial information by a firm reduces these asymmetries between management, cretidors, shareholders, investors and other third parties who may have an interest in the firm.This, therefore, results into concerns on the financial reporting quality and its implication on the cfree cashflows to the firm and the general financial performance. In other words, what is the perception of the market to the financial reporting quality by firms.

Growth and corporate performanceare determinants of financial information quality reported by firms, (Lee et al.,2006).McDemmott (2011) conducted a study on how financial results were affected by FRQ and established that since FRQ higher quality reduces moral hazard issues, investments' in CSR efficiency was greatly improved by financial statements. As a result, the future performance of a firm is improved since the CSR benefits all investors across board.Future economicperformance is influenced by accounting and financial information (Bushman and Smith, 2001), and therefore high FRQ results to an improved efficiency in the diverse investments of a firm.

1.1.4 Nairobi Securities Exchange

This is the principal bourse in Kenya which provides an automated platform for the listing and trading of multiple securities. It was constituted in 1954 as Nairobi Stock Exchange. It changed its name in July 2011 Nairobi Securities Exchange Limited. It is regulated by the Capital

Markets Authority (CMA) and has the mandate of overseeing its member firms. Currently, the NSE has 65 listed firms in 14 different sectors.

According to the NSE listing rules, (2014), a listed firm's securities maybe suspended or delisted for failure to adhere to the rules and procedures as laid down. Under these regulations, firms are required to adhere to the continuous listeing obligations among them disclosure of periodic financial information and miscellaneous provisions. Failure to adhere to these obligations, besides other rules has seen firms both listed and unlisted at the NSE put under statutory management.

The health of a firm is a key consideration for its continued listing in the NSE and thus evaluation of the free cashflow of these listed firms is important to ensure that investors do not lose their money by investing in profitable firms yet the firms have liquidity problems. FRQ characteristics of disclosure, timeliness in release of financial information and key announcements by firms and consistency in application of accounting standards are some of the key emphasis by NSE as an oversight body. When profitable firms are put under receivership, questions arise over their FRQ and NSE is on the spot over its oversight role.

1.2 Research problem

Financial reporting is a requirement for firms by the IFRS and many regulatory agencies across the globe and a prerequisite in evaluating a firm's performance by various stakeholders, (IFRS, 2006). Profits are very important for a company, however, through accrual accounting, earnings management and adoption of aggressive accounting methods, if companies generate little cash from the profits they may face financial risks despite being profitable, (Lee et al, 2002). Cashflow from operations is the lifeblood of a company and the key metric that investors have to

measure the health of a firm. Cashflows are hard to manipulate and thus a better measure of the firm's health compared to profits, despite the fact that many investors lean towards net income. Additionally, a company that does not generate cashflows in the long run could face going concern challenges, (Leuz et al, 2003). FRQ endeavours to ensure that financial information is relevant, reliable, understandable and comparable, and aggressive accounting techniques which could portray the information as otherwise are eliminated or reduced, (Jonas and Blanchet, 2000).

In the recent past, there have been concerns over perceived profitable firms, for example Uchumi Supermarket and Chase Bank going under, being put under receivership or statutory management despite the bottom line number being positive and impressive to investors. This implied there were underlying issues with the quality of reporting by the firms which among others could have included creative accounting and earnings management, (Sarbaves-Oxley Act 2002). Subsequently, investors will be required to look beyond the profitability of a firm and analyze its reports holistically to establish the effect of the reports in the present and future. Conclusively, it may be said that profitability is not a guanttee that a firm is doing excellently well, and the more profitable a firm is, the more the need to evaluate the cash position to determine its going concern.

In a research on consequences of FRQ on corporate performance as measured by market to book value using explanatory research design, (McDermott, 2014), examined three proxies of financial reporting quality; earnings quality, conservatism and accruals quality. In conclusion, it was established that the relationship between the proxies and performance was influenced by extent of perception of corruption, systems of accounting, cycle of the economy and application of IFRS by the firm in the country it is domiciled. Shehu and Ahmad, (2013), on a research on

firms characteristics and financial quality in Nigeria, considered firm size, leverage, independent directors, profitability, liquidity and growth as factors that affected the financial reporting quality and subsequently the performance. They concluded that the aforementioned factors were the constraining factors that motivated managers to act opportunistically in preparing financial statements leading to manipulation of financial statements.

Kariuki and Jagongo (2013), in a research on investors' perception on FRQ in Kenya, sought to establish the nature of information in financial statements that is deemed paramount by the institutional investors in Kenya. The researchers studied all the institutional investors in the Nairobi Securities Exchange. The study adopted the descriptive survey design They concluded that institutional investors regarded information on total assets, liabilities, non-current assets, total equity, current and non-current liabilities, operating profits and activities as the most useful.

In conclusion, it was evident that the profitability of a firm was not a guarantee of its financial health especially in the wake of stiff competition among firms to attract investors leading to increased aggressive accounting techniques and earnings management to enhance profits. FRQ can be used to enhance reporting on the performance (profitability) of firms, what would be the effect of FRQ on subsequent free cash flow of the firm, as a measure of the firm's health?

1.3 Objective of the study

The study was aimed at establishing the effect of financial reporting quality on subsequent operating cashflows of firms listed in the NSE.

1.4 Value of study

Various researches have been conducted on the impact of various firm decisions on investors and stakeholders. Some of these decisions include dividend payment on non-payment

announcements, share split, bonus and rights issue, profitability, merger, receivership and liquidation announcements. Each of these has a direct relation with the financial performance of the firm.

However, the NFP also contributes heavily on the firm's overall performance and much of it may not be reflected in the firm's financial statement. Disclosure of the NFP would greatly influence the decision making of investors and other stakeholders. The focus on such concepts such as economic value added (EVA) other than the traditional ROA or ROI would assist in establishing the overall value a firm has added to investors' wealth since profitability is not a guarantee that a firm is adding value to shareholders' wealth, (Michael, 2012).

This study will help stakeholders and investorsin analyzing the financial performance of a firm holistically both financial ,non-financial performance and the cash position. It will also help the Government and other regulatory agencies in regulating the industry and developing new regulations as the economy grows and as investors' needs increase. This will build investor confidence which is key for growth and development of any economy globally.Further, it will help firms in upholding good corporate governance while exercising transparency, accountability and responsibility in their financial reporting.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter reviewed theories on financial reporting and empirical studies on financial performance of firms. It also discussed determinants of financial performance of firms.

2.2 Theoretical Review

This section reviewed the entity theory, entreprise theoryand proprietary theories of preparation of consolidated financial statements.

2.2.1 Entity Theory

According to Francis et al, (2004), under the entity theory, owners' equity is acknowledged to be a liability or an obligation of the entreprise to the owners, albeit elastic residual rather than fixed and contractual. The accountability and performance of equity holders is a key concern since they account for minority interest in onsolidation of financial statements, (Belkaoui, 2004).

The shareholders and the firm are viewed as two different legal entities, whether they are from the subsidiary or the parent company, (Willingham, 1964). Upon consolidation of the entity, controlling and non-controlling shareholders are considered as two distinct groups, with each sharing a proportion of the consolidated equity, (Zeitun and Tian, 2007). In preparation of the consolidated balance sheet, subsidiary balance sheet items including goodwill are included at their full values as at the date of combination. No consideration is given to the acquisition percent. On the other hand, the consolidated statement of income shows a combination of allocations between the non controlling and controlling groups,(Stephano, 2002).

2.2.2 Enterprise / Social Theory

This theory views the firm as an institution with social responsibilities. The focus is not on te traditional financial reporting using the balance sheet, profit and loss account and the cashflow statements. On the contrary, Firms' actionsresults into a direct impact on its stakeolders who among them include financiers, creditors, employees, investors and the government.According to Suojanen (1954), this theory stemmed from the separation of ownership of firms from their management resulting into increased efficiency in operations. Subsequently, this has led to increased performance of firms and thusfirms are able to generate adequate income, thereby reducing reliance on external financing.

Soujanen, (1958), under this theory, reporting focuses more on the impact of the firm on the society and the value that the firm adds to the society. Value addition is the key goal of the firm and thus a value ddition report is prepared alongside the traditional financial reports. However, the income statement and balance sheet are secondary to the value added reports.

All stakeholders in a firm have different rights which are their claims against the firm. However under this theory, the rights of the shareholders are superceded by the firm and its survival, (Suojanen, 1954).

2.2.3 Proprietary Theory

According to William, (1962), the proprietary theory views the firm and its owners as a single legal entity, this means that the resources of the firm are considered the resources of the owners and vice versa. These includes the assets and liabilities. Similarly, income earned by the firm is considered an income to the owners of the firm, which aims at increasing the wealth of the shareholders. On the other hand, expenses by the firm are viewed as expenses of the owner and

vice versa. This has the effect of decreasing wealth of the shareholders.Proportionate consolidation (pro rata) is adopted in preparation of consolidated financial reports under this theory. In contrast to the entity theory, the parent firm reports its proportionate percent of a acquisition in the subsidiary' s assets and liabilities.

Due to the relationship between the firm and its owners, the shareholders are viewed as the principal while the firm becomes the agent. The firm manages investment on behalf of the owners.

2.3 Determinants of Financial Performance

This section discusses the macro-economic factors, the factors specific to the firm and the NFP measures that affect financial performance.

2.3.1 Macro-economic Factors

Gul et al, (2011), discovered that besides firm specific characteristics, other macro-economic factors affect the performance of these firms. These are factors that affect the entire economy in general and include inflation, interest rates, political stability, exchange rates and gross domestic product. During boom sessions, the gross domestic product increases leads to increased investment and growth opportunities leading to an increase in employment oppotunities. Subsequently, all other factors remaining constant, firms' performance increase and vice versa.

In addition to the macro-economic factors, Saleemi (2007), identifies industry factors as another key determinant of financial performance. These are factors that affect firms in a particular industry among them legal and regulatory issues which may include taxation.

2.3.2 Firm Specific Factors

These are factors that affect that particular firm only and are so specific to the firm. According to Watts and Zimmerman (1986), the leverage level of a firm has a direct impact on the firm's reporting. High leverage indicates that debt holders would exercise control over the firm's management and reporting and thus managers of highly levered firms would follow practices to present higher income through manipulation of financial reports in order not to break debt covenants with debt holders.

According to Farber (2005), corporate monitoring by institutional investors constrains' management behavior to manage earnings. This is because institutional investors have the ability, resources and opportunity to monitor and take action against non-performing managers or those involved in earnings management in order to please investors by portraying a positive performance of the firm contrary to the actual performance.

Liquidity is another firm specific factor that affects the performance of a firm. It refers to the availability of cash to meet immediate needs of the firmwhile considering the financial obligations corresponding to that period (IFRS 2006). It is the ability of the firm to meet its current obligations. Profitability of firms is positively related to adequate levels of liquidity, (Dang, 2011).However, very large firms could have a negative effect of size due to increased red tapes among other reasons, (Yuqi, 2007). Subsequently, the effect of liquidity on the firm's financial performance appears ambiguous, (Jovanovic, 1982). According to Kaplan (2014), the firm's size has a positive correlation with its financial performance which is attributed to the high level of supervision and likely regulatory requirementsthat come along with large firms especially public firms.

2.3.3 Non Financial Performance Measures

These are regarded as the modern performance measures which are qualitative in nature and reflect the long-term viability and health of the firm. They help improve the firm’s success in such areas which include company profile, quality of products and services, human resources and brand awareness.

In evaluating performance, the key steps of performance measurement, attribution and appraisal are followed, (Magrath and Weld, 2002). However, if only financial performance indicators are used, performance attribution may not be well achieved. Therefore, inclusion of NFP indicators helps in holistically evaluating the performance of a firm.

2.3.4 Earnings Management

According to Schipper and Vincent (2003), earnings management is the intentional involvement of the management in the process of determining earningsin order to achieve personal selfish goals that may not be aimed at maximizing the wealth of the shareholders. Most commonly, it often involves window dressing the accounts, moreso the profits, which are used by most investors as a metric in measuring the financial performance of a firm.Cosmetic earnings management occurs when managers manipulate accounts without actual cashflow implications, for example, pre or post recognition of earnings Real earnings management occurs when managers take actions with cashflow implications for purposes of managing earnings, for example, manipulation of earnings which leads to increase or decrease in the amount of tax paid, Davin (2004). Strategies adopted in earnings management include increasing income, big bath, income smoothing and classifactory earnings management.

2.4 Characteristics of Financial Reporting

The four key characteristics of financial reporting according to IASB, (2010), are relevance, reliability, understandability and comparability of financial reports. Relevance; information is relevant when it has the ability of influencing the decisions of users. If information available is used to make a decision, that information is considered relevant. This information has the capacity to provide predictive value, feedback value and is also timely. If information available has no impact on the decision making process, it is irrelevant and therefore disregarded.

Reliability; information is reliable when it presents faithfully what it ought to represent, that is,free from biasness and material error and therefore its users can wholly rely on it in making decisions, (IASB, 2010). Reliability is affected by such other factors as: substance over form neutrality, prudence, completeness.

Understandability; this implies that financial statement users can easily understand information contained in the reports. This is facilitated by presentation of the financial reports in an orderly manner and in a language that the users would understand. Presumably, users of financial statements have the basic understanding of the accounting language and are willing to study the information diligently, (IASB, 2010). Subsequently, preparers of financial statements will include all relevant information in the reports despite their complexity notwithstanding the fact that some users may not comprehend the reports.

According to IASB, (2010), comparability implies that users of financial reports should be in a position to carry out a comparative analysis of financial statements of a firm across various periods to establish trends and the changes in financial performance and position of the firm over time. Similarly, users should be in a position to carry out a comparative analysis of different

firms in the same industry to evaluate their performance and financial position. This calls for consistency in the adoption of accounting policies across periods within a firm and across firms in the same industry.

2.5 Empirical Literature Review

McDermott (2014), in a research on how corporate performance was affected by financial reporting quality examined three variables of financial reporting quality; earnings quality, conservatism and accruals quality. The aim of the research was to establish the effects of quality reporting on financial performance using the ratio of market value to book value using explanatory research design. In conclusion, it was established that the link between the performance and variables was moderated by influence of the economic cycle, the accounting system in use in that country, application of IFRS and magnitude of perception of corruption.

Shehu and Ahmad, (2013), on a research on firms characteristics and financial quality in Nigeria, considered firm size, leverage, independent directors, profitability, liquidity and growth as factors that affected the FRQ and subsequently the performance. The study pooled balanced panel data of 24 firms, adopted a correlational study design and used multiple regression as a tool of analysis. In sum, firm characteristics of listed manufacturing firms in Nigeria had impacted significantly on their financial reporting quality. They concluded that the aforementioned factors were the constraining factors that motivated managers to act opportunistically in preparing financial statements leading to manipulation of financial statements.

Shawn et al (1999), used explanatory research designin a study on the relationship between financial performance and quality stakeholder management models in the United States of

America, to determine the impact of strategic shareholder management, intrinsic stakeholder management and resource allocation on the firms'financial performance. They concluded that all the three variables had a positive effect on the firms'financial performance.

Kariuki and Jagongo (2013), in a research on investors' perception on quality of financial reporting in Kenya, sought to establish the nature of information in the financial reports that is perceived as most important by the institutional investors in Kenya. The researchers studied all the institutional investors in the Nairobi Securities Exchange. The study adopted the descriptive survey design They concluded that institutional investors regarded information on total assets, liabilities, non-current assets, total equity, current and non-current liabilities, operating profits and activities as the most useful.

Maleya and Willy (2013), conducted a research on the factors affecting the financial performance of listed firms at the NSE in Kenya. The researchers considered leverage, firm size and age as the only factors influencing performance of firms. The study usedexplanatory research design on firmswhich had consistently traded at the NSE during the period 2006-2012,other than insurance companies and banks.This study was necessitated by trade off and the agency theories and a purposive sampling technique was adopted. The researchers concluded that the selected variables had a positive correlation to the financial performance of firms.

This research will seek to establish the effect of financial reporting quality using the proxies of relevance, reliability, faithful representation, timeliness, understandability and comparability and their effect on the firms' financial performance.

Vincent and Gemechu (2013), used generalised least square on panel data and a linear multiple regression to study the factors that determined commercial banks in Kenya financial

performance. In conlusion, the researchers established that except for liquidity, this performance was significantly affected by other factors specific to the banks. They concluded that board and management decisions were the key drivers of performance of commercial banks in Kenya, and that micro economic factors had no significance.

2.6 Conceptual Framework

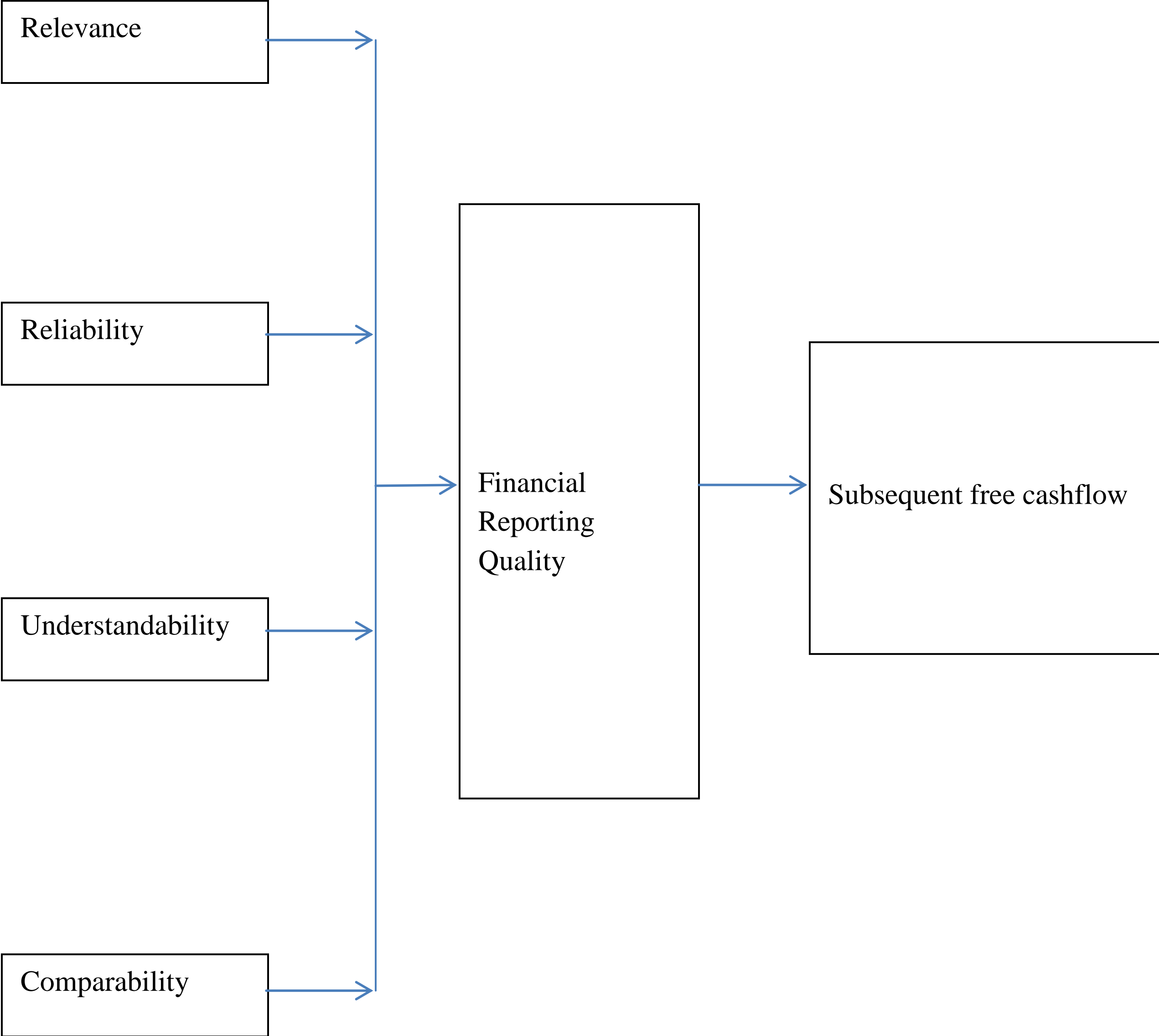

Figure: 1

2.7 Summary of Literature Review

Several researches have been conducted on the financial performance of firms and factors that affect this performance among them the financial reporting. McDermott (2014) used explanatory research to determine the consequences of financial reporting quality, earnings quality, conservatism and accruals quality on corporate performance. In conclusion, the researcher established that the level of corruption was a key moderator on the aforementioned proxies.

Shehu and Ahmad (2013) conducted a correlational research in Nigeria on the impact of firm size, leverage, profitability and liquidity on FRQ and subsequently on the financial performance of firms. The researchers concluded that motivated the management to manipulate the financial statements to portray a different picture for the actual representation of facts.

Kariuki and Jagongo (2013), conducted a descriptive study on investors' perception on FRQ in Kenya. They sought to establish the information in financial reports that investors consider as key in decision making and concluded that this information includes information on total assets, non current assets, liabilities, equity and operating profits.

Descriptive and explanatory research designs have been used majorly in the researches while variables used have varied from one research to another. These variables include among others financial reporting quality, earnings quality, conservatism, accruals quality, firm size, independence of directors, strategic shareholder management, liquidity and age of the firm.This research adopted a descriptive research design to build upon these researchesand used the variables of relevance, reliability, comparability and understandability as the keyfactors that affect financial reporting quality which collectively affect the subsequent cash flows of firms listed in the NSE.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the methodology that the researcher used to implement the research. It discusses the research design, the type and source of data, the data collection and analysis technique used.

3.2 Research Design

This is an arrangement of conditions for collection and analysi of data in a way that seeks to combine objective of the research with relevance, (Dul and Hak, 2008). This research used descriptive study design. This is a design in which data and features about the phenomenon orpopulation under study are described as they are. The researcher has no control over the variables and reports on the findings as they are. The researcher chose this design because data description obtained through this design was factual, accurate and systematic.

3.3 Population

Kothari, (2004) describes it as a group of objects, events or individuals with a common observable characteristic. The population of this research wasall the 64 firms listed at the NSE between 2011 to 2015 .

3.4 Data Collection

Gary, (1994), defines this as the process of systematically measuring information on variables of interest in order to test hypothesis, answer research questions and evaluate outcomes. To achieve the objective of this study secondary data was required. Secondary financial statements data wereobtained from the Capital Markets Authority (CMA). A content analysis checklist was used to collect data for each variable as indicated in appendix 1.

3.5 Data Analysis

Mosby (2009), describes this as the performance of qualitative and quantitative analysis in respect to a research design relevant to the data through the process classification, coding and tabulation of information. Data collected wasscored and an analysis done using the Software Package of Social Sciences (SPSS) V.24. This tool enables data to be analyzed by inputting all the data from the checklistas scored.

3.5.1 Analytical Model

$$Y = \alpha + \beta_1x_1 + \beta_2x_2 + \beta_3x_3 + \beta_4x_4 + \varepsilon$$

The above analytical model was used where;

Y –represented cash flow measured by free cash flow to total assets, which wasfree cash flow divided by total assets. It evaluated the company's ability to generate cash flow in respect to its total assets.

α – the intercept

β_1 β_2 β_3 $\beta_4\beta_5$ - Coefficients as was determined by the model

x_1 - relevance measured by the predictive value, feedback value, confirmative value and timeliness of the financial statement reports.

x_2-reliabilitymeasured by the extent to which the financial statements' informationwas verifiable, free from bias, faithfully represented and free from error material or immaterial. It is measured the ability of the firm to meet its current obligations.

x_3 - understandability measured by the extent to which the financial statements were presented in an orderly manner, disclosures made and explanatory notes easily understandable.

x_4- measured by the extent to which performance of a firm was compared across several periods and with other firms in the same industry .

ε – Error term

3.5.2 Test of significance

The analysis on regression results were interpreted on the usingR^2, F-statistics and the beta significance values from the coefficient of the x variables. Significance was tested at 5% level.

CHAPTER FOUR: DATA ANALYSIS, INTERPRETATION AND DISCUSSIONS

4.1 Introduction

This chapter presents findings on the objective of the study which was aimed at establishing the effect of financial reporting quality on subsequent cashflows of firms listed at the Nairobi Securities Exchange. Secondary data on financial statements was analyzed for the listed firms for the period between 2011 and 2015.

4.2 Response rate

A content analysis checklist was done for 173 financial statements of the listed firms out of a possible 260 financial statements. This represented about 53% of the entire population of study.

4.3 Descriptive statistics

This section presents the descriptive statistics on relevance, reliability, understandability and comparability.

4.3.1 Descriptive statistics on Relevance

Table 4.1: Relevance descriptive statistics

		1	2	3	4	5	Total %	Mean	Std. Dev.
1.	To what extent do the financial statements provide predictive value	21.7	53.6	17.4	4.3	2.9	100	2.13	0.903
2.	Financial statements are prepared on a fair value basis	0	97.1	2.9	0	0	100	2.03	0.168
3.	To what extent do the financial statements provide feedback value	1.4	0	97.8	0.7	0	100	2.98	0.255

4.	Financial statements disclose risks and opportunities the firm is exposed to	1.4	86.2	0.7	11.6	0	100	2.22	0.662
5.	To what extent does the information contained in financial statements provide confirmative value	97.2	1.4	1.4	0	0	100	1.04	0.267

Source: Author (2016)

The audited financial statements disclosed that 21.7% of the annual reports do not provide a predictive value, 53.6% reports focused on the current period, 17.4% forecasted for the next period while only 4.3% and 2.9% provided a medium term (1-5 years) forecast and long term (5-10 years) forecast respectively. On preparation of financial statements 97.1% were based on a historical basis with specific items reported at fair value while only 2.9% balanced between historical and fair value. 1.4% of the annual accounts provided no feedback, 97.8% provided feedback on the current period while only 0.7% provided feedback with explanations on events and transactions of the period being reported on. On disclosure of risks and opportunities, 1.4% provided no disclosure, 86.2% disclosed only the risks the firm was facing, and 0.7% disclosed opportunities only while only 11.6% balanced between opportunities and risks facing the firm. On confirmative value, 97.2% provided no confirmative value while confirmative value in relation to general performance and current period were 1.4% for each.

4.3.2 Descriptive statistics on Reliability

Table 4.2: Reliability descriptive statistics

		1	2	3	4	5	Total %	Mean	Std. Dev.
1.	Financial statements are free from error, material or immaterial.	0	0	0	2.9	97.1	100	4.97	0.168
2.	Financial statements are free from bias.	31.2	18.1	29.7	21.0	0	100	2.41	1.138
3.	The financial reports include an auditor's report	0	0	0	8.7	91.3	100	4.9	0.348
4.	Financial statements are prepared under the going concern assumption	1.4	71.0	0.7	6.5	20.3	100	2.73	1.259
5.	Disclosure on corporate governance issues	5.8	22.5	62.3	6.5	2.9	100	2.78	0.771

Source: Author (2016)

Most annual reports represented by 97.1% were free from error with only 2.9% requiring restatement of previous period's figures. There was no annual report that was free from bias; 31.2% had more than 6 items requiring the critical judgment and estimate by the management, 18.1% had 5-6 items, 29.7% had 3-4 items while only 21% had 1-2 items. All reports had an unqualified auditor's report. However, 8.7% included an emphasis of matter paragraph and 91.3% had no emphasis of matter. On the going concern assumption, 1.4% did not mention the basis of preparation, 71% mentioned the assumption in the director's report, 0.7% mentioned it in the notes to the accounts, 65% mentioned it in both the director's report and noted to the accounts. Only 20.3% supported their use of the going concern assumption. On disclosure of corporate governance issues, 5.8% did not have a corporate governance statement, 22.5% had 1-

4 components, 62.3% had 5-10 components, 6.5% had 11-15 components while only 2.9% had 16 and above components.

4.3.3 Descriptive statistics on Understandability

Table 4.3: Understandability descriptive statistics

		1	2	3	4	5	Total %	Mean	Std. Dev.
1.	Financial statements are presented in an orderly manner.	0	0	0	0	100	100	5	0
2.	Explanatory notes/notes to the financial statements are easily understandable.	0	0	99.3	0.7	0	100	3.01	0.085
3.	Use of tables and graphs to explain trends across financial periods.	48.6	4.3	21.0	17.4	8.7	100	2.33	1.441
4.	Definition of technical terms to enhance user understanding	94.2	5.8	0	0	0	100	1.06	0.235
5.	To what extent do you deem the financial statements complete	0	0.7	1.4	94.9	2.9	100	4	0.27

Source: Author (2016)

All financial reports were presented by an orderly manner, with 99.3% of explanatory notes explaining what happens with only 0.7% explaining the key terms used. On graphical presentation of trends, 48.6% had neither graphs nor tables, 4.3% had 1-2 graphs/tables, 21% had 3-5 tables/graphs, and 17.4% had 6-10 graphs/tables while only 8.7% had more than 10 tables/graphs. 94.2% annual reports had no glossary while 5.8% defined technical terms within

the text. All annual reports the four financial statements, 0.7% had only the financial reports, 1.4% had the reports plus note to the accounts only, and 94.9% included additional operational accounts while only 2.9% included a summary of key ratios.

4.3.4 Descriptive statistics on Comparability

Table 4.4: Comparability descriptive statistics

		1	2	3	4	5	Total %	**Mean**	**Std. Dev.**
1.	To what extent are accounting standards applied consistently in preparation of financial statements	0	0	2.2	39.1	58.7	100	4.57	0.54
2.	To what extent are accounting policies in use disclosed	0	0	0	0	100	100	5	0
3.	Ease in comparison of financial statements across periods	2.2	75.4	22.5	0	0	100	2.2	0.455
4.	Ease in comparison of financial statements with other firms by use of such measures as ratios	69.6	25.4	1.4	2.9	0.7	100	1.4	0.73

Source: Author (2016)

Annual reports disclosed consistency in the application of accounting standards with 2.2% of revision having an impact on the financial statements, 39.1% had no impact to the accounts while 58.7% there were no revisions to the accounting standards. Accounting policies in use were fully disclosed. There was no comparison of annual reports beyond a five year period. 2.2% presented only the current period performance, 75.4% provided the previous year's comparative figures and 22.5% provided the previous year's comparative value plus a five year summary. On

ratio analysis; 69.6% had0-2 ratios, 25.4% had 3-5 ratios, 1.4% had 6-7 ratios, 2.9% had 8-9 ratios and 0.7% had above 10 ratios.

4.4 Regression Analysis

This section presents the summary of the regression model used, analysis of variance (ANOVA) and coefficients analysis.

4.4.1 Regression Model

Table 4.5: Regression model

Model	R	R^2	Adjusted R^2	Std. Error	Change statistics				
					R	F	df1	df2	Sig. F
1	.481[a]	.231	.208	1.611886	.231	9.988	4	133	.000

Source: Author (2016)

Table 4.5 indicates that there is a 48.1% positive relationship between the cashflows of a firm and the qualitative characteristics of relevance, reliability, understandability and comparability as measured by the correlation coefficient (R). Further, the model shows a 0.231 coefficient of determination as measured by R^2. This means that 23.1% of the subsequent cashflows of a firm are determined by FRQ characteristics of relevance, reliability, understandability and comparability. Subsequently, 76.9% of the cashflows of a firm are determined by other factors not studied.

4.4.2 Analysis of Variance (ANOVA)

Table 4.6: ANOVA Analysis

Model	Sum of squares	df	Mean square	F	Sig.
Regression	103.97	4	25.949	9.988	.000
Residual	345.557	133	2.598		
Total	449.355	137			

Source: Author (2016)

Analysis of variance (ANOVA) is shown on the table above. At 95% confidence level, the F statistics value is 9.988 with a P value of .000, meaning that the model is significant (P value of .000 is < .005) which shows the significance of a model at 95% confidence level.

4.4.3 Coefficients Analysis

Table 4.7: Coefficients Analysis

Model	Unstandardized coefficients		Standardized coefficients	t	Sig.
	B	Std. error	beta		
(constant)	9.024	2.281		3.956	.000
Relevance	1.437	.498	.254	2.885	.005
Reliability	-1.051	.300	-.277	-.3.504	.001
Understandability	1.737	.510	-.291	3.403	.261
comparability	-.500	.535	-.075	-.934	.352

Source: Author (2016)

Table 4.7 describes the regression analysis beta coefficients. The higher the standardized beta coefficient the stronger the effect of the independent variable on the dependent variable. It indicates a standardized beta coefficient of 0.254, which means a significant strong effect of

relevance on cashflows as compared to reliability, and comparability which have a beta of -0.277, -0.291 and -0.075 respectively.

4.5 Correlation Analysis

Table 4.8: Correlation Analysis

	cashflows	relevance	reliability	understandability	comparability
cashflows	1.000	.284	-.201	.365	.044
relevance	.284	1.000	.269	.422	.243
reliability	-.201	.269	1.000	.048	.0.074
understandability	.365	.422	.048	1.000	.264
comparability	.044	.243	.074	.264	1.000

Source: Author (2016)

Table 4.8 shows a weak positive correlation between cashflows and relevance, understandability and comparability of 0.284, 0.365 and 0.044 respectively. It also shows a weak negative correlation of -0.201 between cashflows and reliability. Similarly, it shows weak positive correlations among the independent variables ranging between 0.048 and 0.422.

4.6 Interpretation of Findings and Discussions

The study established an overall weak and positive correlation of 48.1% between cashflows and qualitative characteristics of relevance, reliability, understandability and comparability. It further established that only 23.1% of the cashflows are determined by the qualitative characteristics while 76.9% of cashflows are determined by other factors under study. This is in line with a study by (Healy and Palepu, 2001), which concluded that there was no much evidence that firms which adopted high level of financial reporting quality enjoyed low costs of debt, that is the cost of debt for a firm was determined by much more factors thanFRQ.

The study established a significant relationship between cashflows, relevance and reliability. This could be explained by the fact that both relevance and reliability are the fundamental characteristics relating to content of financial statements for which many stakeholders would analyze critically. This concurs with the findings of (Leuz and Verrenchia, 2000), which concluded that relevance and reliability are characteristics aimed at reducing asymmetry between firms and external suppliers of capital, and that constrained firms would be more attractive to financiers through quality reporting.

Meanwhile, the study established a no significance between cashflows, understandability and comparability. Equally, this could be explained by the fact that the two are enhancing characteristics which relate to the presentation of financial statements and are largely guided by GAAP, IFRS' and national standards governing presentation of financial statements. This finding supports (McDermott, 2014) research findings that the relationship between financial reporting quality, earnings quality, conservatism were moderated by adoption of IFRS, the accounting system in the country and the influence of the economic cycle.

The study further established that there is weak but positive correlation among the four qualitative characteristics ranging between 0.048 (correlation between reliability and understandability) and 0.422 (correlation between relevance and understandability). This results into the overall weak correlation between the dependent and independent variables.

CHAPTER FIVE: SUMMARY OF FINDINGS

5.1 Introduction

This chapter presents the summary of findings, conclusions, limitations of the study, policy recommendations and recommendations for further research.

5.2 Summary of findings

The objective of the study was to establish the effect of financial reporting quality on subsequent cashflows of a firm. The study established there is a 48.1% positive relationship between cashflows and financial reporting qualities of relevance, reliability, understandability and comparability as determined by the correlation coefficient (R), while the cashflows are influenced to a level of 23.1% by the said characteristics as measured by (R^2).

Further, the study established that there is a significant relationship between cashflows, reliability and relevance while there was insignificant relationship between cashflows, understandability and comparability.

The coefficients analysis establish a weak positive correlation among the fundamental and enhancing characteristics of relevance and reliability on one hand and understandability and comparability on the other. This ranged between 0.048 and 0.422. Meanwhile, there was a negative correlation of -0.201 between cashflows and reliability.

5.3 Conclusions

The objective of the study was to establish the effect of financial reporting quality on subsequent cashflows of a firm. The study established, FRQ affects cashflows to the extent of 23.1% only while 76.9% is as a result of other factors not considered in the study. It also established that there is a significant relationship between cashflows and relevance and reliability. Meanwhile, it

established insignificant relationship between cashflows and understandability and comparability. Further, it established a weak positive relationship between cashflows, relevance, understandability and comparability, while there was a weak negative relationship between cashflows and reliability.

In conclusion, FRQ in isolation may not be the best measure of factors affecting cashflows since it has a low coefficient of determination (0.231) as measured by R^2.

5.4 Limitations of the Study

This study focused on the effect of financial reporting quality on subsequent cashflows of the firm in isolation from other factors that influence cashflows. Subsequently, the results indicated that financial reporting quality influence on cashflows is only 23.1% while the remainder of 76.9% is influenced by other factors not considered in this study.

Similarly, this study was conducted on firms listed at the NSE only leaving out unlisted firms in which investors too and other stakeholders have put in their money with aim of wealth creation. The results of these findings may be worse off for the unlisted since listed firms are guided by more stringent rules and regulations than are unlisted firms.

Finally, the study considered all listed firms without special attention to the specific cash needs and industrial regulations of firms the different sectors. For example, the Central Bank of Kenya (CBK) requires all banks to maintain a reserve requirement of one billion shillings and a certain minimum requirement at the close of business each day. This regulation is not applicable to other sector firms listed in the NSE.

5.5 Recommendations

This section gives recommendations on policy formulation and further research.

5.5.1 Policy Recommendations

Cashflows are a better measure of the health of a firm as compared to profits (Leuz et al, 2003), since they are hard to manipulate. Due to the stringent regulations governing listed firms on financial disclosures and presentation, the enhancing financial reporting characteristics may have had no significance on the cashflows as they are regulated. Therefore, there is need to formulate policies that would ensure that enhancing characteristics of understandability and comparability add value to the financial reports to enable users of these reports make informed decisions.

5.5.2 Recommendations for Further Research

This study focused on effect of financial reporting quality in isolation from other variables and thus there is need to carry out further study on factors such as size of the firm, age of the firm, liquidity, quality of management among others on the firm's cashflows.

Similarly, the study focused on listed firms only which is small percentage of total firms in the economy and thus the replicability of the findings may be a challenge due to the different operational dynamics of the different firms. There, there is need for a study to be conducted on the unlisted firms which the large proportion of total firms in the economy including parastatals and other government entities.

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APPENDICES

APPENDIX I: CONTENT ANALYSIS CHECKLIST

This checklist is intended to answer questions in respect to relevance, reliability, understandability and comparability as the key indicators of financial reporting quality.

The scale range is between 1-5, with 1 being the least value and 5 the highest value. A move towards 5 indicates high Financial Reporting Quality while a move towards 1 indicates declining Financial Reporting Quality.

	INDICATOR	**OPERATIONALISATION**	**SCORES**				
	RELEVANCE		**1**	**2**	**3**	**4**	**5**
1.	To what extent do the financial statements provide predictive value	1. No prediction 2. Focus on current period 3. Next period forecast only 4. Medium term forecast (1-5 years) 5. Long term forecast (5 years and above)					
2.	Financial statements are prepared on a fair value basis	1. Based on historical cost only 2. Most historical cost 3. Balance between historical cost and fair value 4. Most fair value 5. Fair value only					
3.	To what extent do the financial statements provide feedback value	1. No feedback 2. Little feedback on the past 3. Feedback is present 4. Feedback explains events and transactions 5. Comprehensive feedback					
4.	Financial statements disclose risks and opportunities the firm is exposed to	1. No disclosure 2. Risk disclosure only 3. Opportunities disclosure only 4. Balance both risk and opportunities 5. Comprehensive disclosure on both and courses of action					

5.	To what extent does the information contained in financial statements provide confirmative value	1. None 2. Relating to general performance 3. Relating to current period 4. Relating to medium term forecasts 5. Relating to long term forecasts					
TOTAL SCORE							
RELIABILITY							
6.	Financial statements are free from error, material or immaterial.	1. > 10 errors requiring restatement of figures 2. 7-9 errors 3. 4-6 errors 4. 1–3 errors 5. No errors					
7.	Financial statements are free from bias.	Based on the number of items requiring critical judgment and estimation by the management 1. 6 and above 2. 5-6 3. 3-4 4. 1-2 5. None					
8.	The financial reports include an auditor's report	1. Adverse opinion 2. Disclaimer of opinion 3. Qualified opinion 4. Unqualified opinion with emphasis of matter 5. Unqualified opinion					
9.	Financial statements are prepared under the going concern assumption	1. None 2. Mentioned in the directors, report only 3. Mentioned in the notes only 4. Mentioned in both 5. Comprehensive support for use of the going concern assumption					

10.	Disclosure on corporate governance issues	Based on the number of corporate governance component disclosures made: 1. None 2. 1-4 components 3. 5-10 components 4. 11-15 components 5. 16 and above					
TOTAL SCORE							
UNDERSTANDABILITY							
11.	Financial statements are presented in an orderly manner.	1. Complete table of contents 2. Headings 3. Order of components 4. Inclusion of summaries 5. Accurate referencing of notes to the accounts					
12.	Explanatory notes/notes to the financial statements are easily understandable.	1. No explanations 2. Very short descriptions 3. Explanation describe what happens 4. Explanation of key terms 5. Comprehensive explanations					
13.	Use of tables and graphs to explain trends across financial periods.	1. No graphs 2. 1-2 graphs 3. 3-5 graphs 4. 6-10 graphs 5. 10 and above graphs					
14.	Definition of technical terms to enhance user understanding	1. No glossary 2. Terms are defined in-text 3. 1 page glossary 4. 2-3 pages 5. 3 and above pages					
15.	To what extent do you deem the financial	1. Less than 4 financial statements 2. 4 financial statements 3. 4 financial statements + notes to					

	statements complete?	the accounts 4. Financial reports + other operation reports 5. Comprehensive audited reports + a summary of key ratios					
TOTAL SCORE							
COMPARABILITY							
16.	To what extent is there consistency in application of accounting standards in preparation of financial statements	Based on changes and revision of accounting standards: 1. No consistency 2. Revision without notes 3. Revision with impact 4. Revision with no impact to the accounting figures 5. No revision					
17.	To what extent are accounting policies in use disclosed	1. No disclosure 2. Disclosure of 2-4 policies 3. Disclosure of 5-7 policies 4. Disclosure of 8-10 policies 5. Full disclosure					
18.	Ease in comparison of financial statements across periods	1. No comparison 2. Comparison with previous year only 3. Comparison with previous year + a summary of previous years 4. 5 years comparison 5. 10 years comparison					
19.	Ease in comparison of financial statements with other firms by use of such measures as ratios	1. 0-2 ratio 2. 3-5 ratios 3. 6-7 ratios 4. 8-9 ratios 5. 10 and above ratios					
TOTAL SCORE							

APPENDIX II: LIST OF FIRMS LISTED AT THE NSE

1. ATHI-RIVER MINING LTD
2. ATLAS DEVELOPMENT SERVICES
3. BAMBURI CEMENT LTD
4. BARCLAYS BANK OF KENYA LTD
5. BAUMANN & COMPANY LIMITED
6. BOC KENYA
7. BRITAM HOLDINGS LTD
8. BRITISH AMERICAN TOBACCO LTD
9. CAR & GENERAL COMPANY LTD
10. CARBACID INVESTMENT LTD
11. CENTUM INVESTMENT CONPANY LTD
12. CFC STANBIC HOLDINGS LTD
13. CIC INSURANCE GROUP LTD
14. CO-OPERATIVE BANK OF KENYA
15. CROWN PAINTS KENYA LTD
16. DEACONS KENYA LTD
17. DIAMOND TRUST BANK
18. EAAGADS LIMITED
19. EAST AFRICAN BREWERIES
20. EAST AFRICAN CABLES LTD
21. EAST AFRICAPORTLANDS CEMENT COMPANY
22. EQUITY BANK

23. EVEREADY EAST AFRICA

24. EXPRESS KENYA LTD

25. FLAME TREE GROUP HOLDINGS LTD

26. HOME AFRICA

27. HOUSING FINANCE GROUP LTD

28. I&M HOLDINGS KENYA COMMERCIAL BANK

29. JUBILEE HOLDINGS

30. KAKUZI LIMITED

31. KAPCHORUA TEA LTD

32. KENGEN

33. KENOLKOBIL LTD

34. KENYA AIRWAYS

35. KENYA ORCHARDS LTD

36. KENYA RE

37. KPLC COMPANY LTD

38. KURWITU VENTURE LTD

39. LIBERTY KENYA HOLDINGS LTD

40. LIMURU TEA LTD

41. LONGHORN PUBLISHERS LTD

42. MARSHALLS (E.A) LTD

43. MUMIAS SUGAR COMPANY

44. NAIROBI BUSINESS VENTURES LTD

45. NAIROBI SECURITIES EXCHANGE

46. NATION MEDIA GROUP LTD

47. NATIONAL BANK OF KENYA

48. NIC BANK

49. OLYMPIA CAPITAL HOLDINGS LTD

50. SAFARICOM LTD

51. SAMEER AFRICA LTD

52. SANLAM

53. SASINI TEA LTD

54. STANDARD CHARTERED BANK KENYA LTD

55. STANDARD GROUP LTD

56. STANLIB FAHARI INCOME REIT

57. TOTAL KENYA

58. TPS EASTERN AFRICA

59. TRANCENTURY LTD

60. UCHUMI SUPERMARKETS LTD

61. UMEME

62. UNGA GROUP LTD

63. WILLIAMSON TEA LTD

64. WPP SCANGROUP LTD