THE ADEQUACY OF THE PREFFERED PRESENTATION FORMAT OF THE INCOME STATEMENT IN PROVIDING INFORMATION TO INVESTORS

MWANGI LUCY WAMUGO

REG: NO. D61/9102/2005

SUPERVISOR: MR ABDULATIF ESSAJEE

A PROJECT REPORT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION

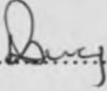**UNIVERSITY OF NAIROBI**

SCHOOL OF BUSINESS

NOVEMBER 2009

DECLARATION

This research project report is my original work and has not been presented for any degree award in any university.

Name: **MWANGI LUCY WAMUGO**

Admission Number: **D61/9102/2005**

Signature:..

Date: ....6th - NOVEMBER - 2009......

This research project report has been submitted for examination with my approval as the university supervisor.

Name: **ABDULATIF ESSAJEE**

Signature: ....

Date: ....5TH NOVEMBER 2009........

DEDICATION

This research project report is dedicated to my husband for his great assistance and support throughout my study. To my Dad who planted a seed in me, to always reach the greatest heights.

ACKNOWLEDGEMENT

I express my gratitude to my supervisor Mr Abdulatif Essajee of University of Nairobi, department of finance and accounting for his guidance and support throughout this project work. I am also grateful to my colleagues at KCA University who continuously encouraged me throughout my studies. May God bless you all.

ABSTRACT

The study aimed at examining the adequacy of the preferred presentation format of the income statement in providing information to investors. To achieve this, the study set out to identify the information that investors look for in the income statement and the most preferred income statement presentation format by investors.

The study used 44 University of Nairobi MBA students as surrogate investors. The study adopted a descriptive research design. Primary data was used to accomplish the stated objectives. The primary data was collected using questionnaires which were administered by direct interaction with the respondents. Attached to the questionnaire were the 'by nature' and 'by function' presentation formats of income statements of a dummy company developed according to the provisions of IAS 1. The respondents were required to indicate their preferred presentation format of the income statement. The questionnaire sought the investors' opinion on the two alternative presentation formats of the income statement, in meeting the qualitative characteristics of accounting information of relevance, understandability, comparability and reliability. The study also sought to identify the information investors look for in the income statement and its relative importance. The two alternative formats were then analyzed to find out which of the two displays the information considered to be important to the investors.

The 'by nature' presentation format of the income statement was found to be the most preferred by investors and was the most adequate in providing information to investors. The study also showed that the income statement has several limitations.

TABLE OF CONTENT

LIST OF TABLES

LIST OF FIGURES

ABBREVIATIONS

FASB   -   Financial Accounting Standards Board

(In this project the abbreviations refer to the US Financial Accounting Standards Board).

GAAP   -   Generally Accepted Accounting Principles

IAS   -   International Accounting Standards

IASB   -   International Accounting Standard Board

IASC   -   International Accounting Standards Committee

IFRS   -   International Financial Reporting Standards

MBA   -   Masters of Business Administration

NYSE   -   New York Stock Exchange

OCI   -   Other comprehensive income

US   -   United States

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

At the end of each accounting period, firms prepare a set of financial statements which include a statement of financial position formerly referred to as the balance sheet, a statement of comprehensive income, which is an expansion of the income statement, a statement of cash flows and a statement of changes in equity. The financial statements are used by a variety of users who include investors, prospective lenders, owners, employees, customers and governments and their agencies to help them make economic decisions. (IASB 2009)

For the financial statements to be useful to the users, the information must have the qualitative characteristics of relevance, reliability, understandability and comparability. Information is relevant if it has the capability of influencing decisions. Relevance is affected by the nature as well as materiality of information. Information is said to be material if its omission or mis-statement could influence the decision of the users. For information to be reliable it must be free from any material error and can be depended upon by users to present faithfully that which it purports to represent or is expected to reasonably represent (IASC- Framework, 2009).

The income statement, one of the financial statements, is at the heart of financial reporting. It is the primary focus for companies in announcing their results. It is also the centerpiece of analysts' interpretation of those results and the basis for earnings forecasts. In turn, these

forecasts are central to the determination of share prices. The income statement presents the entity's performance during the current accounting period and is structured to present the various components of net profit in order to communicate a range of relevant information (Abarbanell and Lehavy, 2003). The income statement should be informative and should reflect the facts in accordance with the accepted accounting practice .It must meet the needs and requirements of the 'non-insider', (Tilly, 1948).

Historically, the format of financial statements has varied from one country to another. Due to the attractiveness of their capital markets, the strength of their accounting professions and the influence of their institutional investors, Anglo-American countries have seen a steady increase in the impact of their accounting practices on other nations, even influencing the actual format of financial statements (Ding, Jeanjean and stolowy, 2008). There are two types of presentation formats of the income statement used by companies based on the way expenses are classified and arranged in the income statement. First, there is the format where the expenses in the income statement are presented 'by nature'. Secondly, there is a format where the expenses in the income statement are classified 'by function'. The format that will give the fairest presentation of the entity's performance should be chosen. Where a functional analysis is followed, however, the entity must also disclose information on the nature of expenses, including depreciation, amortization, and staff costs (IAS 1). The disclosure is normally done in the notes to the accounts.

Presentation 'by nature' facilitates the comparison between enterprises, which cannot be readily done with a functional presentation because the basis of allocation of costs to functions

is not standardized. Display 'by nature' better articulates the changes in the statement of financial position and provides a more direct link to the activities noted in the statement of cash flows. (IASB, 2009)

The different presentation formats have the ability of influencing the user's judgment of past and future performance of the company. For example, given two different companies with one excluding depreciation from the cost of sales figure to derive gross profit and showing the depreciation as a separate line item, while the other includes depreciation of production plant in the cost of sales figure, it would seem that the former company generates more gross profit. This may therefore imply that the income statement presentation format will have an impact on the relevance of the information contained therein.

Previous studies' results have shown that different presentation formats can be used to create different impressions about the companies' performance even where the bottom line profits are the same. For information to achieve maximum usefulness, the method of presentation must be such as to facilitate correct interpretation. Users' expectations must also be considered by the preparers of the financial statements. For communication to be effective there has to be a match between the expectations of the users and the format selected by the company to present the financial statement (Thacker, 1962). This study focuses on examining which format, 'by nature' or 'by function' format of presentation of the income statement is most preferred by investors in Kenya and the adequacy of the same in providing investors with the information they need.

It is quite clear from finance theory that share prices take account of a wide range of information, and not just the figures in the income statement, and certainly not just the "bottom line" or "earnings". If this is the case, it is important to display performance in total, that is every change in the shareholders' funds (except transactions with shareholders), and not disguise the matter by artificial distinctions such as those employed in the traditional approach. The information contained in the income statement is vital for the investor to make a sound decision on whether to invest or disinvest from a company (Epstein et al, 1993). Whether the presentation format of the income statement influences the investor's decision making in Kenya is however not clear.

Kenya appears to be the pace setter in the East Africa region in many areas including the accountancy profession. It follows the international financial reporting standards which are developed by IASB. IASB is dominated by member countries from the developed world. There is therefore the risk of the standards being skewed towards the needs of the developed countries. This study is therefore important as it will identify any reporting gap by listed companies in Kenya.

Ding et al (2008) did a study to identify the preferred presentation format of the financial statements by listed non financial companies in France. The results showed that the 'by nature' format was the most preferred presentation format. These results cannot be generalized to include Kenya since France is a developed country while Kenya is a developing country. The environmental setting for the two countries Kenya and France are also different.

4

1.2 Statement of the problem

The income statement is important to investors because it is the basic measuring stick for profitability. The income statement provides the investor with much insight on how the company spends much of its income and the investor can compare that with similar companies. The information contained in the income statement is vital to make sound decisions on whether to invest or disinvest in a company (Epstein, 1993). Whether the presentation format of expenses in the income statement influences the investor's decision making is however not clear. Other studies have looked into the impact of information presentation on human judgment. For example, Maines and McDaniel (2000) used a psychological based framework to study the effects of comprehensive-income format on non professional investor judgment.

Investors will use the information in the income statement to make predictions about the future performance of the company. According to IASC (2009) the ability to make predictions from financial statements is enhanced by the manner in which information on past transactions and events is displayed.

It is commonly assumed that investors' value financial information presentation in their investment decision making (Basu and Markov,2004), but the extent to which they value this factor in income statements in Kenya, across decision contexts requires examining, particularly since studies conducted locally have not attempted to address this issue. Knowing the propensity of investors' use of financial statements as a source of information and whether the format of presentation of expenses in the income statement affects decision making will contribute to a better understanding of investment decision-making.

Ding et al (2008) did a study to determine why French listed companies had a preference for 'by nature' format of income statement presentation. The results of the study confirmed that the choice of presentation is influenced by among other factors internationalization. This study did not address the adequacy of the preferred format in providing information to investors. Baker et al (2005) conducted a study to determine why firms in the airline industry in the US have a preference for 'by nature' format as opposed to the usual presentation of income statement in that region that is 'by function' format. They found that the preference for 'by nature' reflects the requirement of government agencies that require such information as presented in the format of presentation. Both of these studies were conducted in developed countries yet Kenya is a developing country. The results of preferred formats cannot be therefore generalized to Kenya. It is from this background that the study was conceived seeking to investigate the adequacy of the preferred presentation format of the income statement, that is, 'by nature' and 'by function', in providing information to investors.

1.3 Objectives of the Study

The study was guided by the following objectives:

1.3.1 Broad Objective

The main objective of the study was to investigate the adequacy of the preferred presentation format of the income statement in providing information to investors.

1.3.2 Specific Objectives

i) To determine the most preferred presentation format of the income statement by Kenyan investors.

ii) To determine the adequacy of the preferred presentation format of the income statement in providing information to investors.

1.4 Significance of the Study

The proposed study will be of great importance to various stakeholders.

a) Future Scholars

The study will add to the existing body of knowledge on presentation of income statements and the adequacy of the preferred format in providing information to investors for decision making purposes. This will be useful for future scholars on the subject.

b) Investors

The study findings will also be of importance to investors in the country. The study will pinpoint the information that investors look for in the income statement. This will enable them make better decisions.

c) Listed Companies' Management

The listed companies' management may use the study findings to adjust their income statement presentation format to bridge the gap between the expectations of the investors in presentation

of the income statement and their preferred format. This may make it easy for them to raise capital through the stock market.

d) Accounting Regulatory Bodies

In Kenya, the accounting regulatory bodies include the Institute of Certified Public Accountants, capital market authorities, Central bank, commissioner of insurance and others that are specific to given industries. The authorities will benefit from the study as the findings of the study will include perception and the attitudes of the investors at the Nairobi Stock Exchange. These findings and the suggestions from the study will enable these bodies come up with relevant policies concerning presentation of income statement to enable investors make sound judgments based on the information contained therein.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter looked at an overview of the accounting conceptual framework specifically narrowing down to the qualitative characteristics of financial information and users of financial information. It also looked at the user's information needs and the provisions of IAS 1 with regard to presentation of the income statement (statement of comprehensive income). The chapter also reviews other related researches, which include income statement presentation format and the value of the income statement in investment decisions.

2.2 Qualitative characteristics of accounting information.

> *"The role of the accounting conceptual framework is to provide a structure for thinking about what is 'better' accounting and financial reporting. It is a theoretical endeavor with practical aim of clarifying the objectives of financial reporting, and how alternative practices are likely to help achieve those objectives....one cannot make a rational choice of accounting procedures without some framework of principles"* (Macve 1970).

FASB (1976) has defined the accounting conceptual framework as a constitution, coherent system of interrelated variables and fundamentals that can lead to consistent standards and that prescribes the nature, functions and limits of financial statements. The conceptual framework provides the qualitative characteristics of financial information that makes it useful to readers who use it to make various economic decisions.

9

IAS 1, Presentation of financial statements, prescribes the basis for presentation of general purpose financial statements to ensure comparability both with the entity's statements of previous periods and with financial statements of other entities. The standard also sets out the framework and the overall responsibilities for the presentation of financial statements, guidelines for their structure and minimum requirements for the content of financial statements (IASB 2009).

According to the IASC - Framework (2009) qualitative characteristics are the attributes that make information provided in the financial statements useful to users. There are four primary qualitative characteristics, namely relevance, comparability, reliability and understandability.

Relevance of financial information

To be useful, information must be relevant to the decision making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate the past, present, or future events or confirming, or correcting, their past performances. The ability to make predictions from financial statements is enhanced by the manner in which information on past transactions and events is displayed. For example, the predictive value is enhanced if unusual abnormal and infrequent items of income or expenses are separately disclosed. The relevance of information is affected by its nature and materiality. Information is said to be material if its omission or misstatement could influence the decision of the users (IASC-Framework, 2009).

Comparability of financial information

Financial statements should be prepared to enable users to identify trends of financial position and performance over time and compare financial statements of enterprises. Comparability implies that users must be informed of the accounting policies used and any changes in policies. For comparability to be possible there has to be consistency in treatment of similar items from year to year. There should also be uniformity; implying firms should prepare financial statements as per the accounting standards (IASC-Framework, 2009). Presentation 'by nature' facilitates the comparison between enterprises, which can not be readily done with a functional presentation because the basis of allocation is not standardized.

Reliability of financial information

Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could be reasonably be expected to represent. To be reliable, information must be faithfully presented. The transactions should also be accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The preparers of financial statements should also apply prudence and provide complete information within the bounds of materiality and cost (IASC-Framework, 2009).

Understandability of financial information

Information should be readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business, economic activities and accounting and are willing to study the information with reasonable diligence. However information about complex

11

matters that should be included in the financial statements because of its relevance to the decision making needs of users should not be excluded merely on the grounds that it may be too difficult for some users to understand (IASC-Framework, 2009).

Having looked at the qualitative characteristics of financial information, it should be appreciated that there are various limitations of meeting the characteristics in the provision of financial information. For example, complex information should not be excluded on the basis that it will be difficult for users to understand it as this may compromise on the reliability and relevancy of the financial statements. An inclination towards one characteristic compromises another hence tradeoffs have to be made between the qualitative characteristics.

2.3 Income statement presentation format

According to IASB and FASB discussion paper (2006), presentation of the income statement should meet the following objectives; portray a cohesive financial picture of the entity's performance, disaggregate information so that it is useful in predicting an entity's future cash flows and help users assess the liquidity of and financial flexibility of an enterprise. The question is whether the financial statements presented by the listed firms in Kenya do meet these objectives.

According to IAS 1 (2009) an entity is allowed to present an analysis of expenses recognized in the profit or loss using a classification based on either nature or their function within the entity, whichever provides information that is reliable and more relevant. Expenses are sub classified to highlight components of financial performance that may differ in terms of

frequency potential for gain or loss and predictability. The choice between the function of expenses method and the nature of expenses depends on historical and industry factors and the nature of the entity. Because each method of presentation has merits for different types of entities, the standard requires management to select the presentation that is reliable and more relevant (IAS 1). According to Beaver, Mc Nichols and Rhie (2005) increased discretion impairs the quality of financial statement data.

According to Money Instructor (2009) the income statement is a direct result of the information that is recorded in the journals and ledgers, and then transformed into concise, compiled revenue and expense figures. It is usually prepared directly from the monthly 'closing of the books' and provides an accurate picture of the revenue and expense of the business for a specified period of time; usually a month, quarter or year. The income statement is not only used by management within the company, but also by investors and creditors outside the company to evaluate profitability, performance and aid in the assessment of risk for the investor or creditor.

The income statement is divided into three parts, that is, total revenues, total expenses, and net income. The first section listed on the income statement is the total revenues reported for the particular period of time. Other than revenues generated from the normal operations of business, there are other sources of revenue such as rent and interest incomes that must also be included in the 'total revenue' area. The next section is known as 'total expenses'. This section includes all expenses incurred in the direct operation of the business. The most common forms of expenses include wages, salaries, rents, utilities, insurance and supplies and

other miscellaneous expenses. Finally, the entry known as 'net income' is a result of the subtraction of the total expenses from total revenues. The net income reported on the income statement is then transferred to the statement of owner's equity, and incorporated further into the information that is made available through the financial statements (Money instructor, 2009).

2.4 Empirical studies

Riedl and Srinivasan (2008) did a study to investigate whether presentation of special items within the financial statements reflects the firm's underlying economic performance or opportunism. They examined the presentation of recognized special items either as a separate line item on the income statement or aggregated within another line item with disclosure only in the footnotes. Their study was motivated by standard-setting interest in performance reporting and financial statement presentation, as well as prior research investigating managers' presentation choices in other contexts. Using different constructs of persistence to capture the economics of reported special items, they found evidence consistent across a range of specifications that special items highlighted on the income statement are more transitory than those revealed only in the footnotes.

In an experiment Maines and McDaniel (2000) examined whether and how alternative presentation formats affect nonprofessional investors' processing of comprehensive-income. Ninety five evening MBA students were used as surrogate investors. The respondents were asked to analyze an insurance company's financial statements which presented unrealized gains on investment either on the statement of comprehensive income or the statement of

14

changes in equity. The results of the experiment showed that the financial-statement format for presenting comprehensive income did not significantly affect nonprofessional investors' acquisition and evaluation of that information, but generally did significantly influence their information weighting and resulting performance judgment to noncore activities. The experiment found that nonprofessional investors will tend to rely on the financial statements to signal the importance of information, suggesting that the weight they attach to both core and noncore information will depend on presentation format. Nonprofessional investors' judgments will be influenced by information related to noncore activities only when presented in a statement of comprehensive income.

Hirst and Hopkins (1998) who did a similar study assert that different financial statement presentation format can influence whether investors read comprehensive income information. Their study revealed that half of the analysts receiving the statement of stockholders' equity did not even recall seeing the term 'comprehensive-income. This implies that showing components of the income statement in other locations other than on the face of the income statements may have an implication on whether the users will actually read them. According to IAS 1, an entity classifying expenses 'by function' is again required to disclose additional information on the nature of expenses. That being the case, questions arise on whether really there is a difference between the 'by nature' format and 'by function' format in terms of provision of information. The conclusions drawn by Hirst and Hopkins (1998), Maines and McDaniel (2000) and others scholars may indicate that a difference may really exist from the readers' perspective.

Financial statements provide information that is used by various interested parties to assess the performance of managers and make economic decisions (Gowthorpe and Amat, 2005). It is sometimes argued that managers can strategically select accounting methods to misrepresent the firm's performance in attempts to maximize their own expected utility (Suh, 1990).

·Historically the format of the financial statements has varied from one country to another. Recently due to their capital market attractiveness, the strength of their accounting professions and the influence of their institutional investors, Anglo-American countries have seen a steady increase in the impact of their accounting practices on other nations, even influencing the actual format of financial statements. French accounting regulations allow a certain degree of choice in consolidated balance sheet and income statement format, that is, 'by nature' or 'by function' (Ding et al, 2008).

YU (2000) did a study to investigate whether a company's choice of income statement format is associated with the industry-specific and company specific accounting characteristics. Using 8353 US companies' data the study supported their hypothesis that a company's choice of income statement presentation format is associated with the companies' standard industrial classification code (SIC) and several other characteristics ascribed to financial ratios. The study suggested that the flexibility in selecting the financial statement presentation formats allows companies to better disclose their industry-wide characteristics and thus facilitates better disclosure. Yu's study differs from this research because while he focused on examining the factors associated with the choice of presentation format by firms, this research focuses on establishing the adequacy of the preferred format in providing information to investors.

According to Fairfield et al (1996) flexibility of the presentation format of income statement is negatively associated with the quality of disclosure. McVy (2006) examined the classification of items within the income statement as an earning management tool. McVy (2006) reported that managers opportunistically shift expenses between categories to overstate core earnings while keeping the bottom-line earnings unchanged.

2.4.1 Studies on other presentation formats

Besides the presentation format addressed by this study there are other studies on other possible income statement presentation formats, such as the matrix format, numeric versus non numeric format, tabular versus graphical presentation, single-step versus multi-step format and others. These presentation formats are not the focus of this study but they however serve to indicate whether or not the presentation format of the income statement does matter to investors in their decision making processes.

2.4.1.1 Matrix format

Tarca et al (2007) conducted an experiment to investigate the potential benefits of an alternative format for the income statement, the matrix format. Matrix format presents a three column statement comprising a total column that includes all items of income and expense for the period (that is, a single statement of comprehensive income) and two further columns that provide a line byline desegregations of the items into "re-measurements" and "before re-measurements" (Barker, 2004).Sophisticated financial statement users (financial analysts and professional accountants) and less sophisticated financial statement users (MBA students) were required to extract information from income statement either in the IAS 1 format or in the

matrix format. They found that the matrix format improves the accuracy with which users extract financial information. This result is driven by greater accuracy, for all user groups, on 'below the line' items. Furthermore, despite lack of familiarity with the matrix format, its use did not appear to affect the time taken, the ease of extracting financial information, or users' task completion confidence. Tarca et al (2007), in their study used MBA students as surrogate users of financial statements. This study also used MBA students as surrogate investors.

2.4.1.2 Numeric versus non numeric forms of presentation

According to Bell (1984), information for management decisions is typically presented in both numeric and non-numeric forms. He undertook a research to test whether the choice of presentation form affects the use of such information by decision makers in evaluating corporate performance. The experiment considered two information forms: numeric and non-numeric information in evaluating a company. Selected information from corporate annual reports together with extracts from the presidents' letter was provided to a group of practicing financial analysts. They were asked to evaluate two companies. The results of the experiment suggested that when the link between organizational actions and future performance is not well established and understood, financial analysts give more weight to non-numeric information. This study has important implications because it shows that in certain situations managers can influence financial analysts' use of information by varying presentation form.

2.4.1.3 Tabular versus graphical format

Hard and Vanecek (1991) did an experiment to investigate the association between presentation format and task when subjects used financial statements. The experiment required

subjects who participated to complete one of four tasks which were ranging from low task level to high task level. To complete the task the subjects were required to use either graphical or a tabular presentation format. The results of this experiment suggested that presentation format, with respect to the task being performed, does have a relationship to the decision-making process of financial decision makers.

The optimum format (tabular or graphical) for presenting information may depend upon several factors which include the type and amount of information included in the report and the process the reader uses. The information set and the method chosen to process the information have an interactive effect on the quality of decisions. Therefore, an information system should provide reports that contain the pertinent information set (format) for the process (task) at hand. Reports should enhance the decision-making task, thus enabling the reader to understand and use annual reports accurately. Otherwise, the reader may make wrong decisions or be unable to make timely decisions. The study was significant because accountants and researchers select report formats which should consider both the nature of information being presented and the task being performed. The report formats they select affect allocation and appropriate use of resources as well as the decision-making ability of the readers of the reports. Accountants and researchers may use the results of the study to determine the appropriate report format which they should use when presenting financial information (Libby 1981).

So and Smith (2003) did a study to determine the difference in decision making quality when presenting multivariate data with tables , profiles and schematic faces. The study also sought to examine the relationship between decision making quality and various data presentation

methods and individual characteristics (personality, cognitive style, cognitive ability and demographic variables) of the user. 86 third year accounting undergraduates and 51 part- time students of masters or doctoral programs in business were used as respondents. They were asked to perform decision making tasks using different test instruments conveying the same information. The study concluded that schematic faces and bar graphs produce superior performance to both financial ratios and trend diagrams in both decision accuracy and processing time. The study also suggested that more attention need to be devoted to in the decision making process to matching of data presentation media with attributes of the decision maker. These conclusions concur with an earlier study by Smith and Taffler (2002) that did an experiment to determine how communication on financial performance can be improved through cartoon graphics. These studies indicate that in presenting information in the financial statements it is very important to consider the user's ability to synthesize the information contained therein.

The information investors look for in an income statement has in many cases been addressed in terms of how the investors use the information in the income statement. According to Epstein (1993) the information contained in an income statement is vital to make sound decisions on whether to invest or disinvest in a company. IASB (2009), states that the objective of the financial statements is to provide information about the financial position, performance and changes in the financial position of an entity that is useful to a wide range of users in making economic decisions, and to provide the current financial status of the entity to its shareholders and public in general.

According to Beaver, McNichols and Rhie (2005) the financial statements which include the income statement should facilitate prediction of bankruptcy. The income statement used in conjunction with other financial statement should help users predict the amount and timing of cash flows.

2.5 Preferred presentation format of the income statement components

Firms in the airline industry have a preference for the 'by nature' format rather than 'by function' format of income statement. Preference for 'by nature' may reflect the requirement of government agencies that need such information to prepare national income accounts. 'By nature' format allows calculation of value added by an enterprise to the overall economy. Preference for 'by function' presentation reflects an emphasis of the needs of the capital markets. The 'by function' format is the preferred format in North America and is used by most firms on the New York stock exchange (Baker, Ding, and Stolowy, 2005).

Ding et al (2008) examined a sample of 199 French listed companies in an attempt to understand why some firms preferred not to use the French traditional 'by nature' format and instead preferred the 'by function' presentation format of the income statement. The results of the study confirmed that the choice of the format of presentation is related to internationalization which is influenced by factors such as size, international auditor, accounting standards, foreign listing and international sales. Out of a sample of 199 listed non financial companies 131firms used by nature, 36 adopted by function while 32 used a hybrid of the two formats. The conclusions about the preferred format cannot be generalized to Kenya as

France is a developed country while Kenya is a developing country. The capital market in France is also more developed than the Kenyan capital market.

IASB (2009) has indicated that presentation of income statement 'by function' provides more relevant information to users than classification by nature. IASB however also points out that allocating costs to functions may require arbitrary allocation and involve considerable judgment. Since each format has its own advantages and disadvantages managers are given the discretion to select the presentation that is reliable and more relevant. McNichols and Rhie (2005) assert that increased discretion impairs the quality of financial statements data.

Pandit and Phillips (2004) did a study to investigate the reporting preference of comprehensive income by listed companies in the (NYSE) New York stock exchange. The study showed that out of a sample of 100 annual reports of NYSE-listed companies 89 chose the format in which other operating income were included in the statement of changes in equity, 9 chose the format in which they presented a separate statement of comprehensive income, 2 chose the format in which comprehensive income was presented as a component of their income statement. This study sheds more light into the fact that managers can choose a given presentation format to distort reality.

According to Pandit and Phillips (2004)

> *'the use of the 3rd format of reporting comprehensive income would enable managers obscure any undesirable impact of negative OCI components by hiding it in the statement of changes in equity'.*

The 3rd format involves showing the OCI in a statement of changes in equity.

Campbell et al (1999) studied 73 US companies and found that majority chose to report comprehensive income in the statement of stockholders equity. The research also found that the firms that chose to report comprehensive income in the stockholders equity had a materially negative amount of OCI. This study concurs with Bhamornsiri and Wiggins (2001) who did a similar study and found out that a significant number of firms reported comprehensive income in the statement of stockholders equity. However the firms chose the format regardless of whether the OCI was positive or negative.

Campbell's study has a similarity with this proposed study as it was concerned with identifying the firms' choice of presentation format in respect to components of income. The study is also concerned with presentation of income statement components, that is, expenses.

2.6 Conclusion

Various studies have been conducted addressing the presentation format of the information contained in the financial statements which includes the income statement. Little attention has been focused on the arrangement and classification of expenses in the income statement. The formats of the income statement presentation addressed are somewhat different from 'by nature' and 'by function'. This clearly indicates that there is a research gap requiring to be addressed by researchers.

The studies that have been done on presentation formats of the income statement have all indicated that the presentation format of the elements of income statement does have an impact on the users' decision making processes. The literature review indicates that it is important for

preparers of financial statements to consider the requirements of the users in selecting the presentation format. The researcher is not aware of any study done in Kenya to address the issue of the income statement presentation in terms of the arrangement of the expenses on the face of the income statement. IASB (2009) has addressed the issue of the income statement presentation, that is, 'by nature' and 'by function'. IAS 1 gives the preparers of the financial statements the discretion to choose between the two alternative formats. It will therefore add a lot of value to determine the adequacy of the preferred presentation format of the income statement by Kenyan firms in providing information to investors.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter describes the methodology that was adopted to achieve the research objectives. It consists of the research design, target population and sampling design, data collection methods, and data analysis procedures and methods that were used.

3.2 Research Design

The study adopted a descriptive research design. Descriptive research study is a study concerned with finding out who, what, where, when, or how much in the problem situation at hand. Cooper and Schindler (2003) describe such a research design to be descriptive. Descriptive research design helped in finding out the preferred presentation format of income statements and its adequacy in providing information to investors.

3.3 Population and Sampling Design

3.3.1 Population

"A population is an entire group of individuals, events or objects having common characteristics that conform to a given specification." (Mugenda and Mugenda, 2003). According to Cooper and Schindler (2003), a population element is the subject such as a person in an organization, customer database, or the amount of quantitative data on which the measurement is being taken. The population of the study consisted of all University of Nairobi

25

MBA students who were undertaking financial accounting course in Nairobi at the time of the study as surrogate investors.

The list of MBA students was obtained from the records office. The MBA students who were undertaking financial accounting course at the time of the study were 434. The MBA students were used as surrogate investors since as prospective or actual investors they are more likely to make intelligent investment decisions based on relevant information and by studying financial statements. They also meet the stock exchanges definition of financial literates (McDaniel, Martin and Maines, 2002). Other studies have successfully used MBA students as surrogate investors, for example Tarca et al (2007) and Bell (1984).

3.3.2 Sampling Frame

The process of constructing or designing a sample is called sampling, which begins by defining the sampling frame. Sampling frame is a complete or partial listing of items comprising the population. Sampling frame provides a list of elements from which the sample is actually drawn. Ideally, it is a complete and correct list of population members only. For this research study, the sampling frame came from the list of MBA students as surrogate investors. Therefore, the sampling frame was used as a checklist for drawing samples of elements (MBA students) for sampling purposes.

3.3.3 Sampling Technique

Simple random sampling was used to sample the MBA students who were undertaking financial accounting course at the time of the study. An already compiled list of the students was obtained from the records office; using random numbers from the tables a sample of forty four students was selected. The sample size of ten percent of the population was determined before the selection of the sample units. According to Kothari (2004) random sampling ensures that the law of statistical regularity which states that if on average the sample chosen is a random one, the sample had the same composition and characteristics as the universe.

3.3.4 Sample Size

According to Ramenyi et al (2003), a number of factors need to be taken into consideration in determining sample size. The factors include variability in relation to time, costs, accuracy, estimates required, the confidence with which generalization to the population are made and the homogeneity or heterogeneity of the population. Sommer and Sommer (1997) recommend that a sample size of any study should be based on what a researcher considers to be statistically logical and practicable.

This study took a sample size of forty four units of the population, representing ten percent of 434 of MBA students. The factors considered in deciding on this sample size are time and resources and the fact the questionnaire was administered on a one to one basis to control for reliability of the research instrument.

3.4 Data Collection Methods

The study used primary data obtained through administering questionnaire. According to Chandran (2003), a questionnaire is a series of written questions on a topic about which the respondents' opinions are sought. Questionnaires provide a high degree of data standardization and adoption of generalized information amongst any population. The study adopted the questionnaire as a data collection instrument. The questionnaire contained both closed and open questions.

Closed questions sought to gather demographic information and other statistical data while open questions sought to establish opinion from the respondents and gather more of the qualitative data. The questionnaire was administered by the researcher through direct interaction with the respondents to explain the aim of the study. Attached to the questionnaire was a copy of an income statement of a fictitious company presented using the two alternative presentation formats. The income statement has been developed based on IAS 1. The aim of the questionnaire was to identify the information investors look for in income statements and to determine the preferred presentation format of income statement by investors.

3.4.1 Reliability and validity of the data collection instrument.

According to Mugenda and Mugenda (2003) reliability is a measure of the degree to which the research instrument yields consistent results after repeated trials. Validity is the degree to which results obtained from the analysis actually represents the phenomenon under study. The reliability of the primary data was obtained through pre testing the questionnaire. The

28

questionnaire was administered on ten of the respondents on a pilot basis. The questionnaire was administered through direct interaction with the respondents which facilitated probing by the respondents where a question may not be clear to him. Validity was achieved through reference to the accounting standards and the accounting conceptual framework.

3.5 Data analysis procedures

The data from the questionnaire was analyzed with the help of statistical package for social sciences (SPSS). Confirmatory factor analysis was used. According to Obure (2002), confirmatory factor analysis attempts to test specific research hypothesis about the factors structure for a set of variables in one or several samples. The researcher also used graphical analytic technique which involved dividing the data set (observed characteristics) into categories in order to compare the patterns of data between the resulting subsets. The research findings were presented in frequency tables, pie and bar charts for ease of reference.

CHAPTER FOUR

DATA ANALYSIS, PRESENTATION AND INTERPRETATION

4.1 Introduction

In this chapter, the data collected has been analyzed to get a clear picture of the results and to compare them with the expectations. The chapter captures the background information of the study population and the responses to the questionnaire. This chapter consists of quantitative and qualitative analysis.

4.2 Quantitative and qualitative analysis

The data collected from the research was analyzed to filter and interpret findings that came up. This is due to the fact that data obtained was raw and required processing for it to be of value to the users of the research findings. Analysis was done to compare the findings from the different sources and to come up with results; which could lead to the recommendations and conclusions. Through analysis, the data findings were easy to follow and draw conclusions and recommendations from these data that is refined and straightforward. The researcher was able to administer forty (40) questionnaires on a one to one basis. The researcher was unable to administer four (4) questionnaires as the respondents claimed to have a busy schedule.

4.2.1 Response Analysis.

Table 4.1 Response rate.

Category	Respondents	Percentage (%)
Response	40	91
Non Response	4	9
Total	44	100

Figure 4.1 Distribution of Response rate.
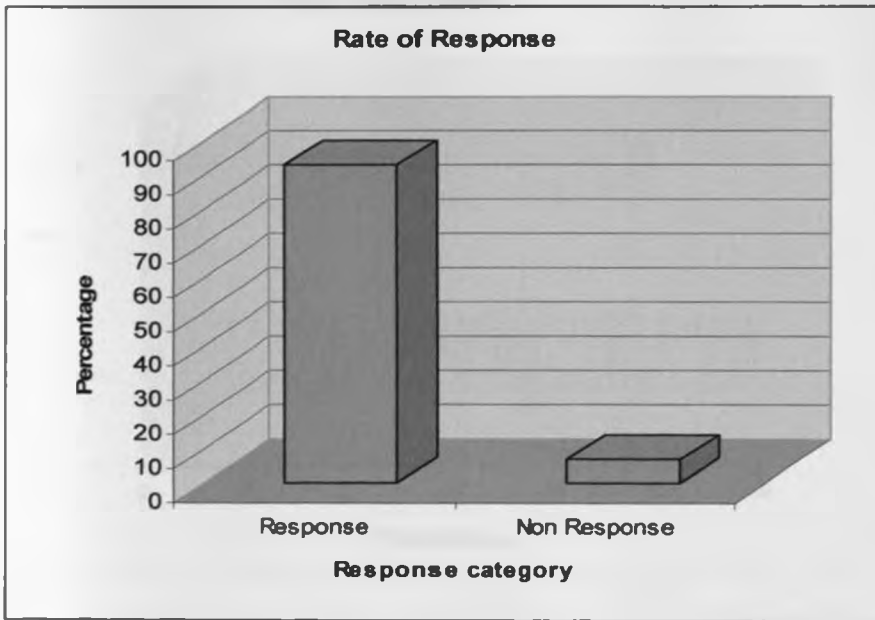
Source: Research data

The response rate was expected to be higher than the above figure. Four out of the forty four respondents were unwilling to participate due to what they said was their busy schedule.

4.2.2 Information regarding Respondent's Gender

Table 4.2 Respondents Gender.

Gender Category	Frequency	Percentage (%)
Male	22	55
Female	18	45
Total	**40**	**100 %**

Figure 4.2 Respondents Gender.
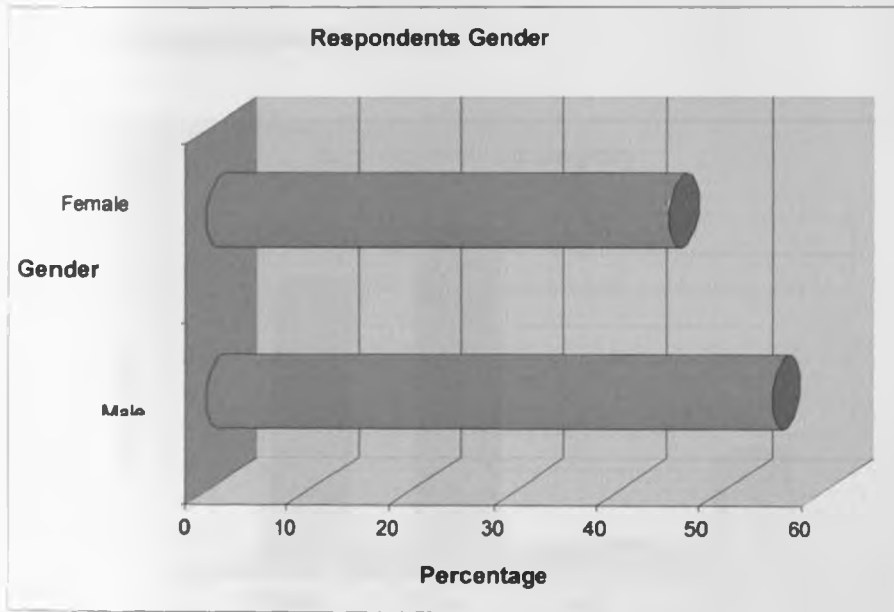
Source: Research data

The findings revealed that 55% of the respondents were male, while 45% were female.

4.2.3 Information regarding Employment Category.

Table 4.3 Employment Category.

Employment sector	Frequency	Percentage (%)
Private	15	38
Public	18	45
Self Employed	1	2
Other	6	15
Total	**40**	**100**

Figure 4.3 Employment Category.
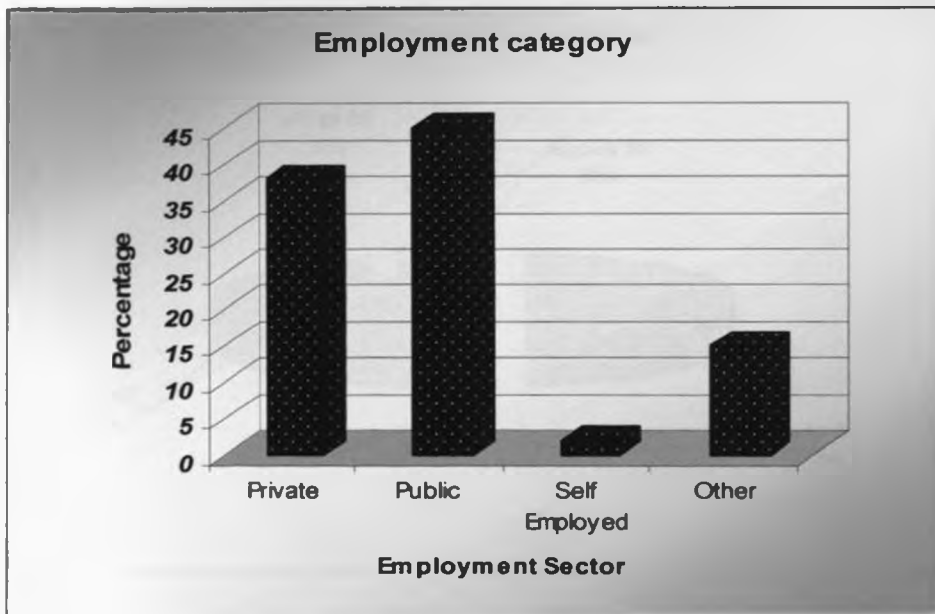
Response from the questionnaire regarding employment category indicated that 45% of the respondents work in the public sector, which form the majority. 38% of the respondents were employees from the private sector. 2% of the respondents were self employed. While the remaining 15% of the respondents work in other areas other than those mentioned.

4.2.4 Information regarding Respondents Age.

Table 4.4 Respondents Age.

Age Category	Frequency	Percentage (%)
21 to 30	20	50
31 to 40	18	45
41 to 50	2	5
Above 50	0	0
Total	**40**	**100**

Figure 4.4 Respondents Age.
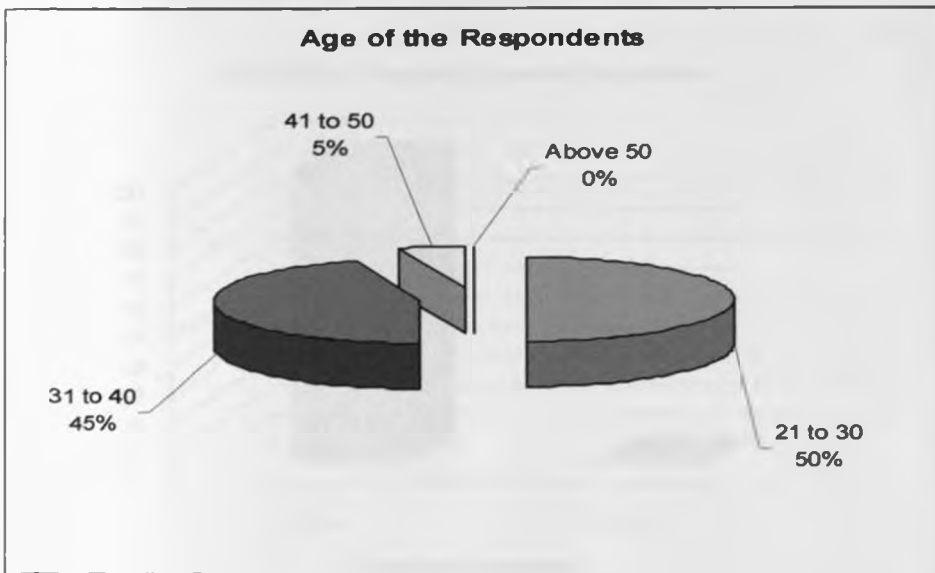
Source: Research data

The study findings revealed that 50% of the respondents fall within the age bracket of between 21-30 years, while 45% of the respondents fall within the age bracket of and 31-40 and 5% of the respondents fall within 41-50 years.

4.2.5 Consideration of Information contained in the income statement for decision making purpose.

Table 4.5 Importance of Income Statement Information.

Response Category	Frequency	Percentage (%)
Yes	40	100
No	0	0
Total	40	100

Figure 4.5 Importance of Income Statement Information.

Importance of Income Statement Information
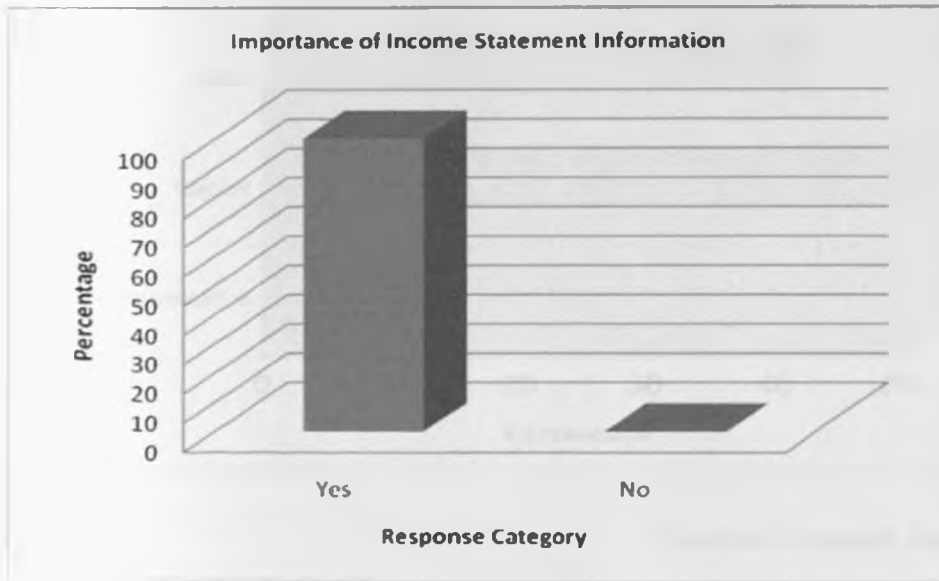
Source: Research data

From the above table and bar chart it is evident that all prospective investors highly regard information from income statements as this is their main decision making tool. This was supported by 100% of the respondents.

4.2.6 Information regarding the type of investments.

Table 4.6 Type of Investment.

Investment Type	Frequency	Percentage (%)
Speculative	4	10
Capital	20	50
Both	16	40
Total	40	100

Figure 4.6 Type of Investment.

<div align="right">

Source: Research data

</div>
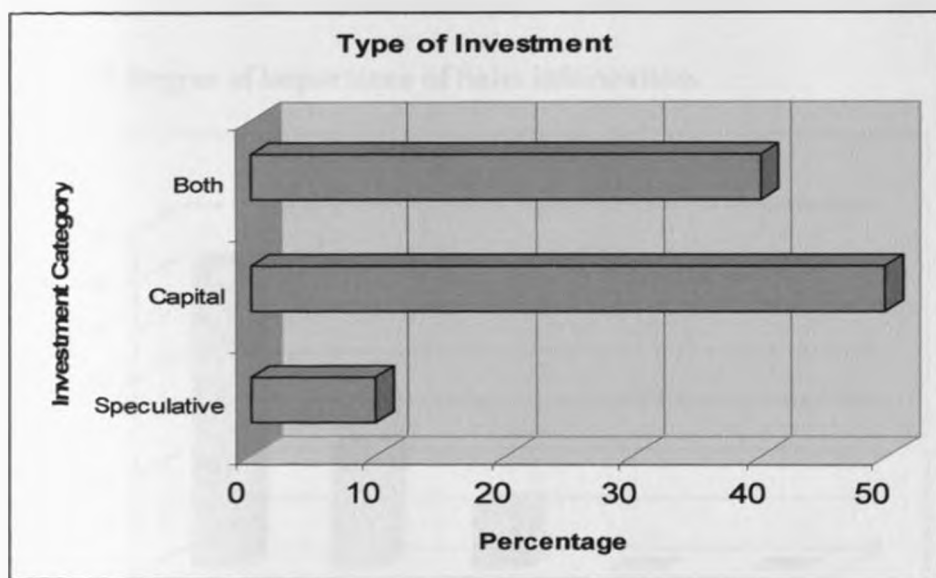
From the above table, 50% of the respondents prefer capital investments, while 40% of the respondents prefer both capital and speculative types of investments. Only 10% of the respondents prefer speculative type of investment.

4.2.7 Information looked for in an income statement (Sales).

Table 4.7 Degree of importance on Sales information.

Response Category	Frequency	Percentage (%)
Critically Important	25	62
Very Important	10	25
Important	5	13
A little important	0	0
Not Important at all	0	0
Total	40	100

Figure 4.7 Degree of importance of Sales information.
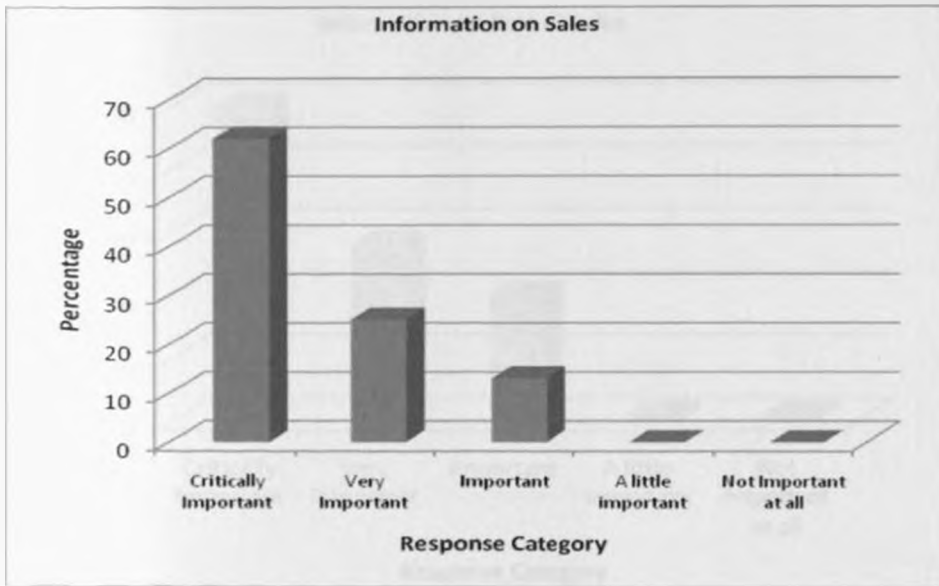
<div align="right">**Source: Research data**</div>

62% of the respondents felt that a report on sales is critically important in making investment decisions. 25% of the respondents felt that sales information is very important, while 13 % of the respondents felt that it is important.

4.2.8 Information looked for in an income statement (Cost of Sales).

Table 4.8 Degree of importance of Cost of Sales information.

Response Category	Frequency	Percentage (%)
Critically Important	20	50
Very Important	10	28
Important	8	20
A little important	1	1
Not Important at all	1	1
Total	**40**	**100**

Figure 4.8 Degree of importance of Cost of Sales information.
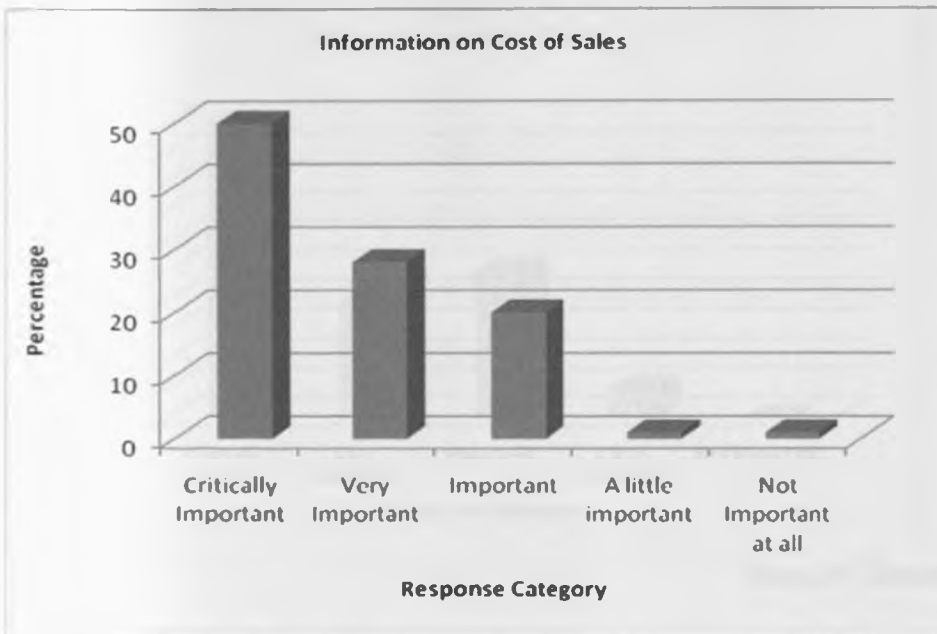
Source Research data

From the above table and bar chart, it is observed that information on cost of sales was critically important to 50% of the respondents.28% of the respondents indicated it is very important, and 20% of the respondents claimed that it is an important factor in making investment decision. Only 2% of the respondents indicated that information on cost of sales is of little importance if not important at all.

4.2.9 Information looked for in an income statement (Gross Profit).

Table 4.9 Degree of importance of Gross Profit information.

Response Category	Frequency	Percentage (%)
Critically Important	20	50
Very Important	8	20
Important	10	25
A little important	2	5
Not Important at all	0	**0**
Total	**40**	**100**

Figure 4.9 Degree of importance of Gross Profit information.
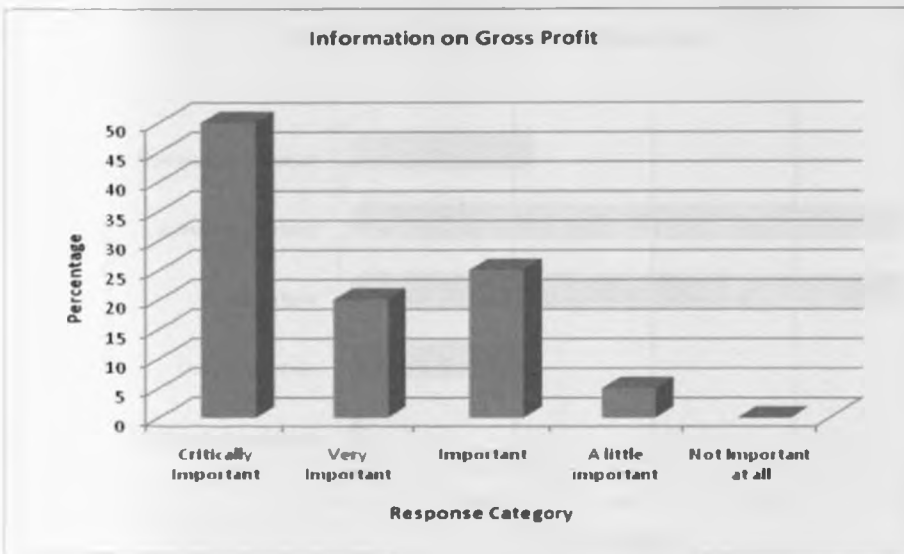
Source: Research data

From the table and bar chart above it is clear that information on gross profit is critically important for investment decision making and is supported by 50% of the respondents, 25% of the respondents felt that it is important while 20% of the respondents felt that it is very important and should be considered in making decisions. Only 5% of the respondents said it is a little important

4.2.10 Information looked for in an income statement (Depreciation Expense).

Table 4.10 Degree of importance of Depreciation Expense information.

Response Category	Frequency	Percentage (%)
Critically Important	0	0
Very Important	5	12
Important	15	38
A little important	15	38
Not Important at all	5	12
Total	40	100

Figure 4.10 Degree of importance of Depreciation Expense information.
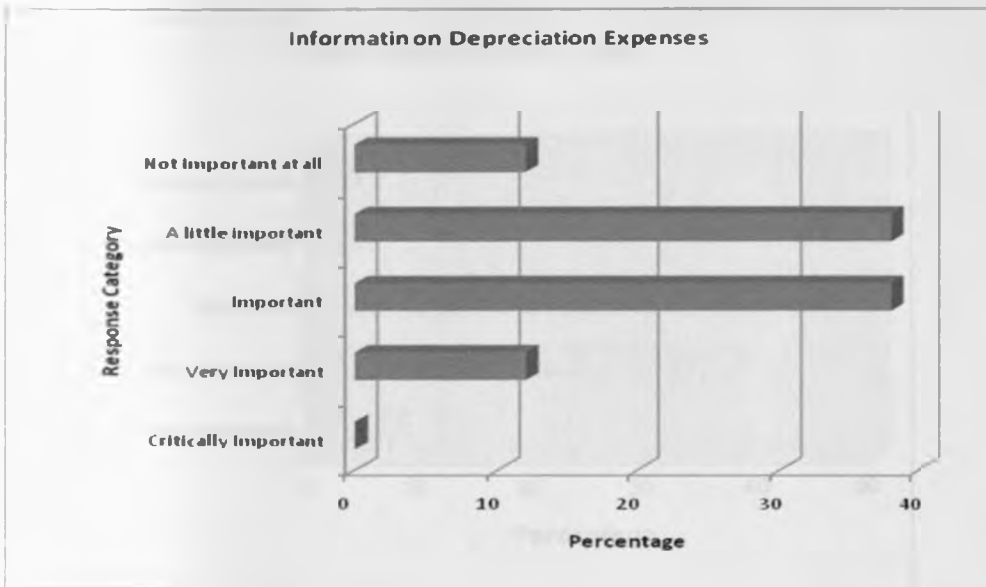
Source: Research data

None of the respondents considered information on depreciation expense to be of critical importance in making investment decisions. Only 12% of the respondents considered information on depreciation expense as being very important. 38% of the respondents indicated that information on depreciation expense is important, another 38% of the respondents indicated that information on depreciation expense is a little important, while 12% of the respondents claimed that information on depreciation expense is not important at all.

40

4.2.11 Information looked for in an income statement (staff cost).

Table 4.11 Degree of importance of Staff Cost information.

Response Category	Frequency	Percentage (%)
Critically Important	3	8
Very Important	15	38
Important	18	45
A little important	2	4
Not Important at all	2	4
Total	**40**	**100**

Figure 4.11 Degree of Importance of Staff Cost information.
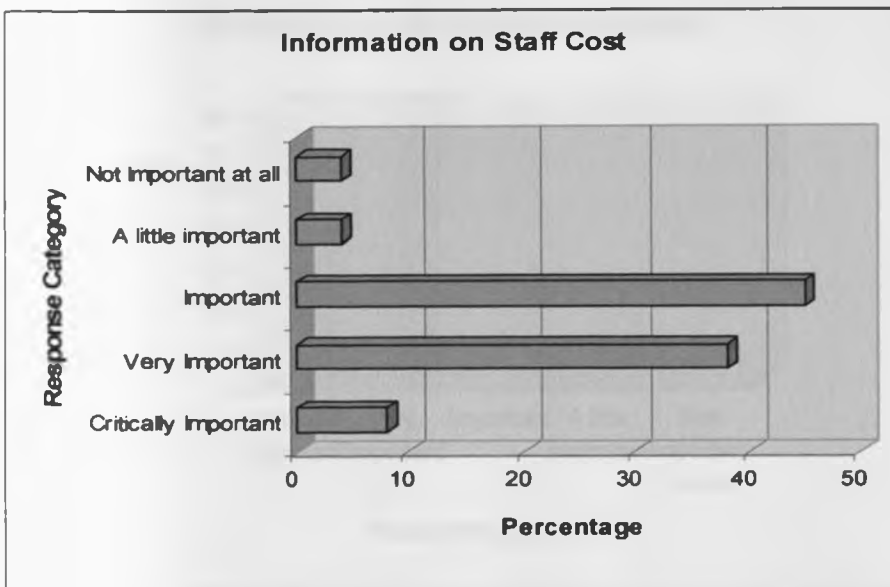
Source: Research data

From the data above, 8% of the respondents indicated that staff cost information is critically important for investment decisions. 38% of the respondents indicated that it is very important while 45% of the respondents indicated it is important. 4% of the respondents indicated that it is a little important while only 4% of the respondents indicated that it is not important at all.

4.2.12   Information looked for in an income statement (Administrative Expenses)

Table 4.12 Degree of importance of Administrative Expenses information

Response Category	Frequency	Percentage (%)
Critically Important	8	20
Very Important	14	35
Important	14	35
A little important	3	8
Not Important at all	1	2
Total	**40**	**100**

Figure 4.12 Degree of importance of Administrative Expenses information.
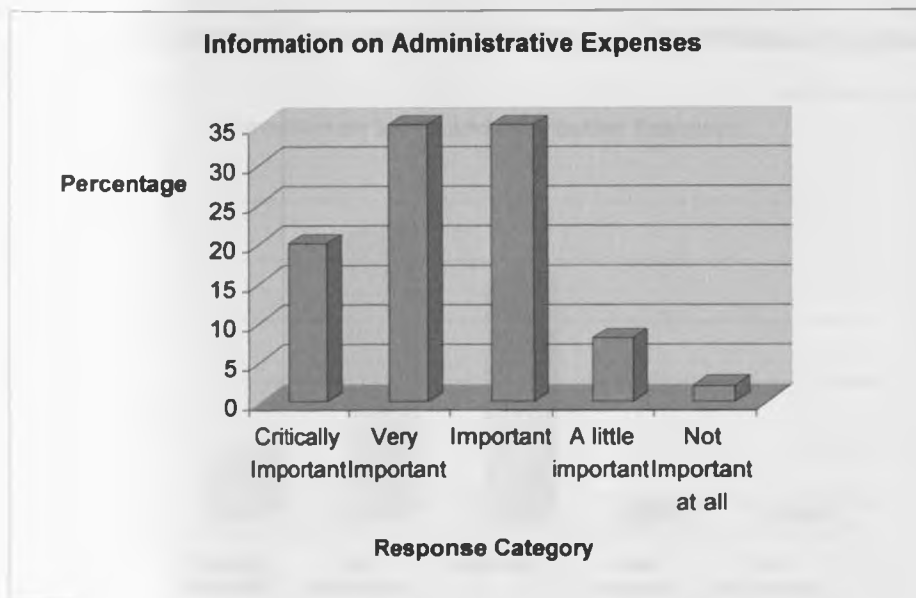
From the above table it is evident that 20% of the respondents regarded administration expenses information as critically important, while 35% of the respondents indicated that it is a very important factor and another 35% of the respondents indicated that it is important. 8% of the respondents indicated that it is a little important while 2% of the respondents indicated that it not important at all.

4.2.13 Information looked for in an income statement (Selling and Distribution Expenses).

Table 4.13 Degree of importance of Selling and Distribution Expenses information.

Response Category	Frequency	Percentage (%)
Critically Important	4	10
Very Important	19	48
Important	16	40
A little important	1	2
Not Important at all	0	0
Total	40	100

Figure 4.13 Degree of importance of Selling and Distribution Expenses information.
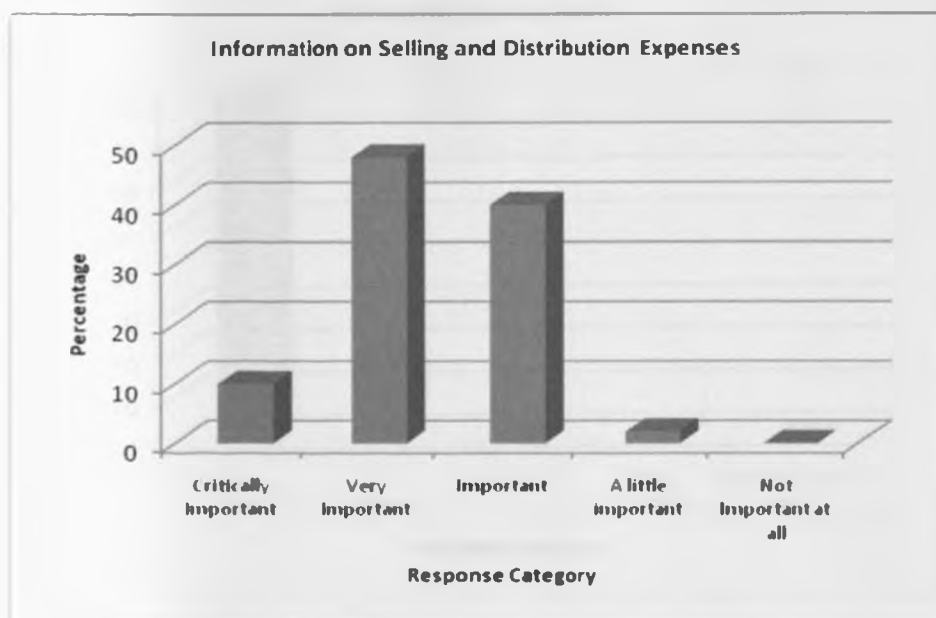
Source: Research data

From the above chart it is clear that 10% of the respondents support the fact that information on selling and distribution expenses is critically important, 48% of the respondents said it is very important, 40% of the respondents said it is important, 2% of the respondents said it is a little important. None said it is not important at all.

43

4.2.14 Information looked for in an income statement to (Net Profit).

Table 4.14 Degree of importance of Net Profit information.

Response Category	Frequency	Percentage (%)
Critically Important	32	80
Very Important	8	20
Important	0	0
A little important	0	0
Not Important at all	0	0
Total	**40**	**100**

Figure 4.14 Degree of Importance of Net Profit information
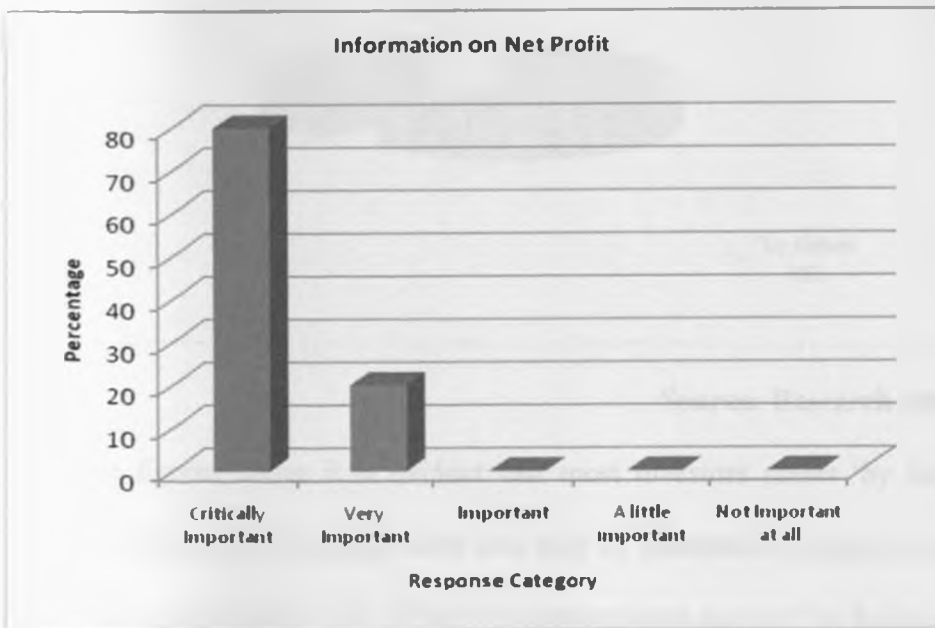
Source: Research data

The above table clearly indicates that net profit information is critically important to investors in investment decisions. This is evidenced by the fact that 80% of the respondents indicated that the net profit information is critically important while 20% of the respondents said that it is very important.

4.2.15 Preferred presentation format of income statement.

Table 4.15 Preferred Income Statement format.

Format Category	Frequency	Percentage (%)
'By Nature'	25	63
'By function'	15	37
Total	40	100

Figure 4.15 Preferred Income Statement format.

Preferred Income Statement format

'By Function'
37%
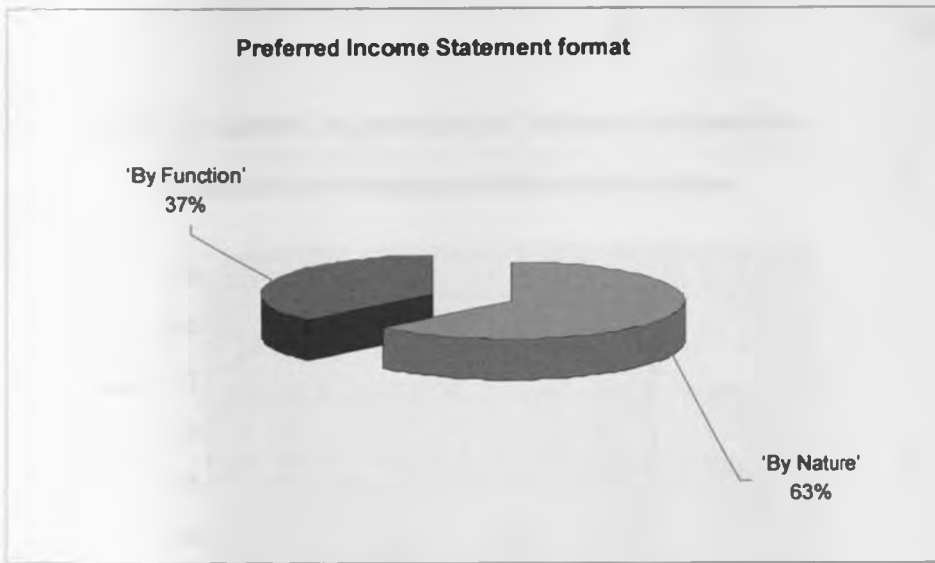
'By Nature'
63%

Source: Research data

From the figures above it is evident that most investors prefer 'by nature' format income statements because it provides more and easy to understand information and is supported by 63% of the respondents. Only 37% of the respondents support 'by function' format of income statement. Majority of the respondents gave reasons such as understandability, accountability and that 'by nature' format provides a better link to the other financial statements for their preference for 'by nature' format.

4.2.16 'By nature' income statement format in providing relevant information.

Table 4.16 'By nature' in Provision of relevant information.

Response Category	Frequency	Percentage (%)
Strongly Disagree	0	0
Disagree	2	4
Neutral	3	8
Agree	21	53
Strongly Agree	14	35
Total	**40**	**100**

Figure 4.16 'By nature' in provision of relevant Information.
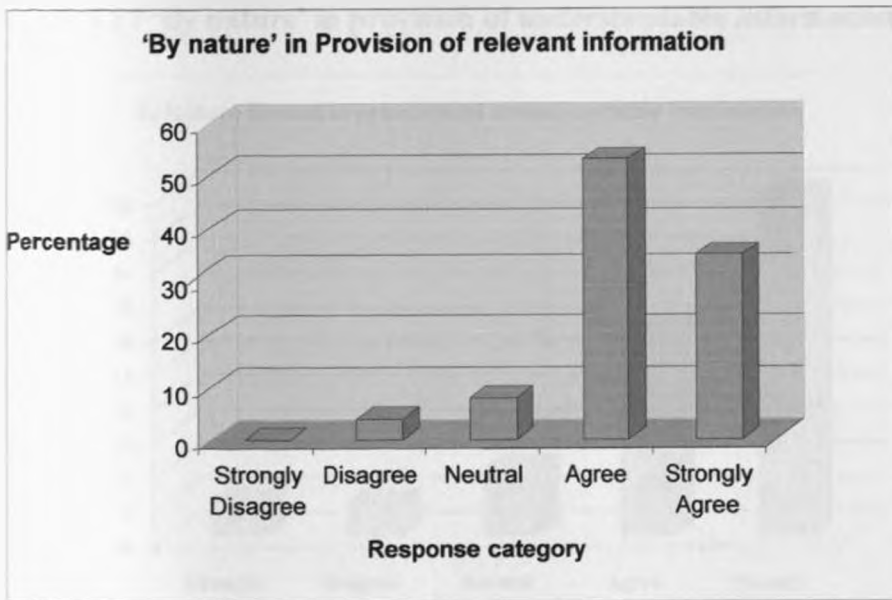
Source: Research data

From the above figures it is evident that 88% of respondents agreed that 'by nature' income statement format provides relevant information. This is supported by 53% of the respondents saying they agree and 35% of the respondents said they strongly agreed while 8% of the respondents were neutral and only 4% of the respondents disagreed.

4.2.17 'By nature' income statement format in providing understandable information.

Table 4.17 'By nature' in provision of understandable information.

Response Category	Frequency	Percentage (%)
Strongly Disagree	2	5
Disagree	2	5
Neutral	4	10
Agree	12	30
Strongly Agree	20	50
Total	**40**	**100**

Figure 4.17 'By nature' in provision of understandable information
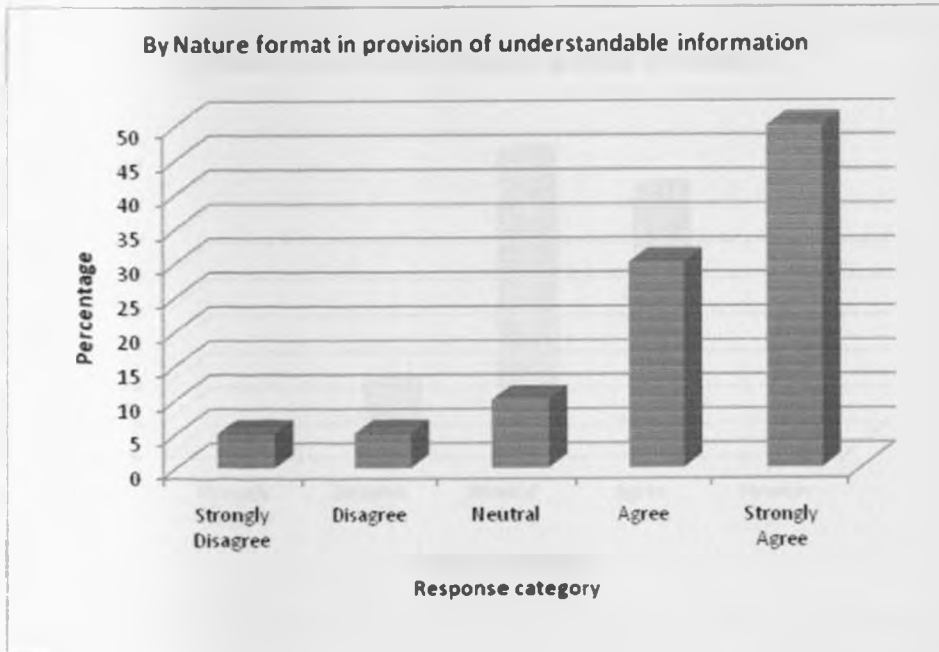
Source: Research data

80% of the respondents strongly agreed that 'by nature' income statement format provides understandable information while 10% of the respondents were on the neutral ground and the remaining 10% of the respondents disagreed.

4.2.18 'By nature' income statement format in providing comparable information.

Table 4.18 'By nature' format in providing Comparable information.

Response Category	Frequency	Percentage (%)
Strongly Disagree	1	2
Disagree	3	8
Neutral	16	40
Agree	14	35
Strongly Agree	6	15
Total	**40**	**100**

Figure 4.18 'By nature' format in providing Comparable information.
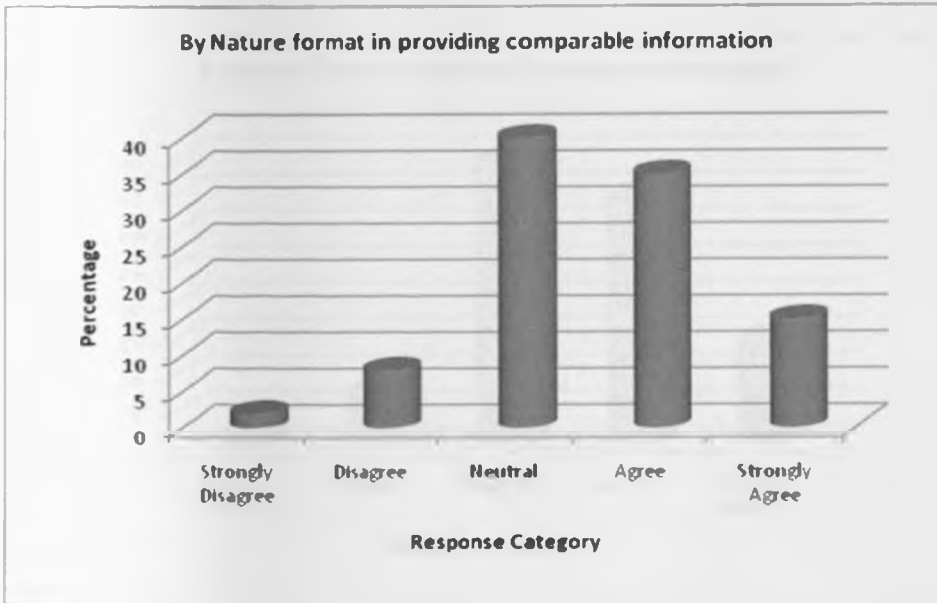
Source: Research data

The above table and the bar chart indicate that 15% of the respondents strongly agreed that 'by nature' format provides comparable information to investors while 40% of the respondents were neutral, 35% of the respondents agreed, 8% of the respondents disagreed and only 2% of the respondents strongly disagreed.

48

4.2.19 'By nature' income statement format in providing reliable information.

Table 4.19 'By nature' format in provision of reliable information.

Response Category	Frequency	Percentage (%)
Strongly Disagree	1	2
Disagree	3	8
Neutral	16	40
Agree	14	35
Strongly Agree	6	15
Total	40	100

Figure 4.19 'By nature' format in provision of reliable information.
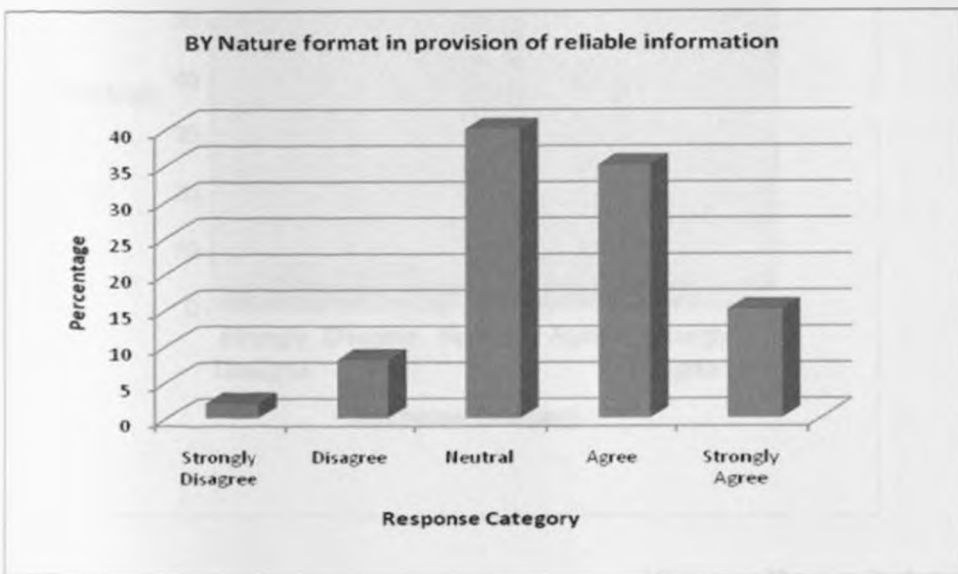
In terms of reliability, 15% of the respondents strongly agreed that the 'by nature' format provides reliable information while 35% of the respondents agreed. 40% of the respondents were neutral while only 8% of the respondents disagreed and 2% of the respondents strongly disagreed.

4.2.20 'By function' income statement format in providing relevant information.

Table 4.20 'By function' format in providing relevant information.

Response Category	Frequency	Percentage (%)
Strongly Disagree	2	5
Disagree	2	5
Neutral	20	50
Agree	16	40
Strongly Agree	0	0
Total	40	100

Figure 4.20 'By function' format in provision of relevant information.
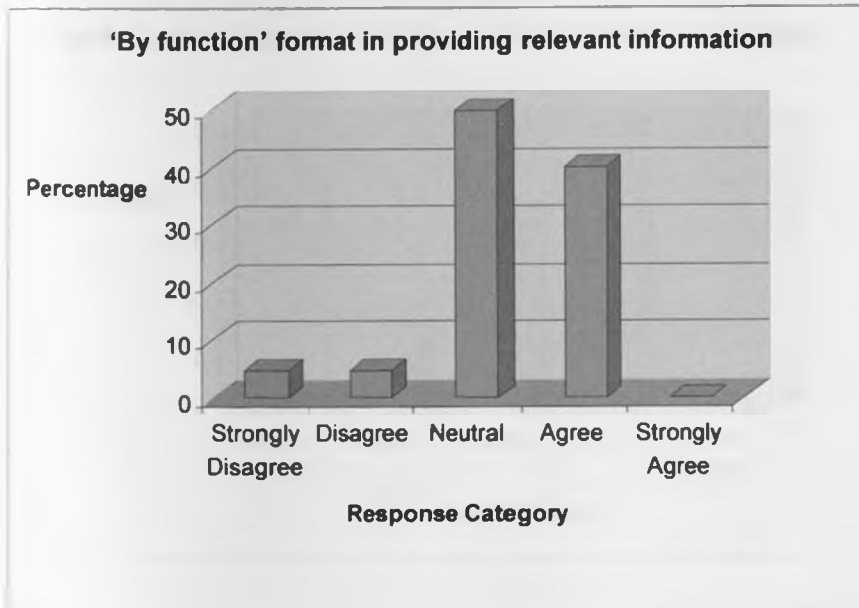
Source: Research data

From the above figures, 50% of the respondents were neutral on the ability of the 'by function' income statements in providing relevant information. 40% of the respondents agreed that it provides relevant information while only 10% of the respondents disagreed.

4.2.21 'By function' income statement format in providing understandable information

Table 4.21 'By function' format in provision of understandable information

Response Category	Frequency	Percentage (%)
Strongly Disagree	0	0
Disagree	6	15
Neutral	14	35
Agree	20	50
Strongly Agree	0	0
Total	**40**	**100**

Figure 4.21 'By function' format in provision of understandable information

'By function' format in providing understandable information
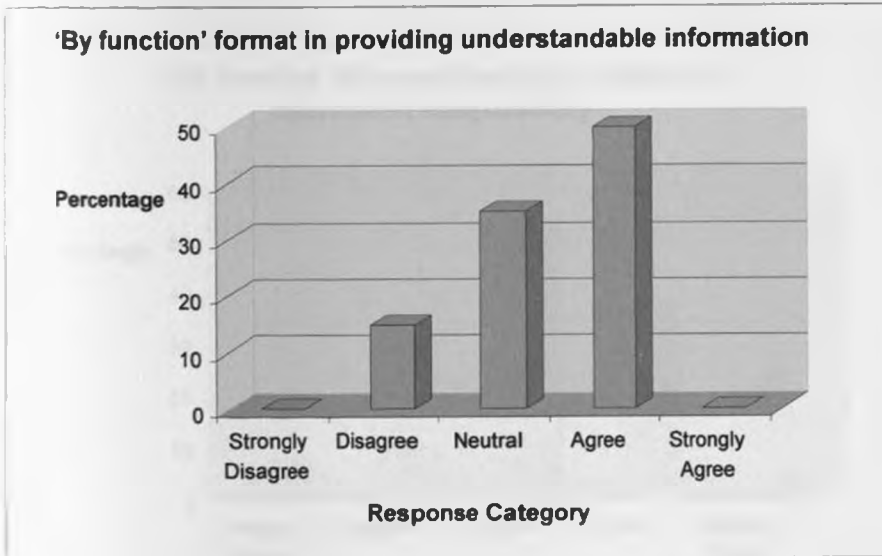
Source: Research data

50% of the respondents agreed that the 'by function' format is understandable, 35% of the respondents were neutral and 15% of the respondents disagreed that it provides understandable information.

4.2.22 'By function' income statement format in providing comparable information.

Table 4.22 'By function' format in providing Comparable information.

Response Category	Frequency	Percentage (%)
Strongly Disagree	2	5
Disagree	3	8
Neutral	21	52
Agree	14	35
Strongly Agree	0	0
Total	**40**	**100**

Figure 4.22 'By function' format in providing comparable information
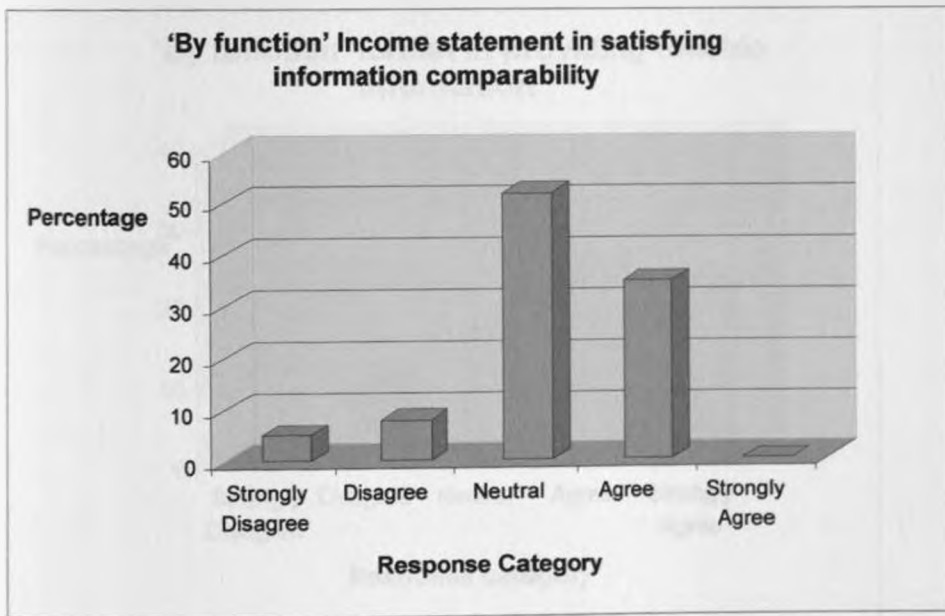
The table above indicates that 52% of the respondents were neutral on 'by function' format providing comparable information. 35% of the respondents agreed that the 'by function' format provides comparable information while 8% of the respondents disagreed and only 5% of the respondents strongly disagreed.

4.2.23 'By function' income statement format in providing reliable information.

Table 4.23 'By function' format in provision of reliable information.

Response Category	Frequency	Percentage (%)
Strongly Disagree	1	2
Disagree	4	10
Neutral	16	40
Agree	10	25
Strongly Agree	9	23
Total	40	100

Figure 4.23 'By function' format in providing reliable information
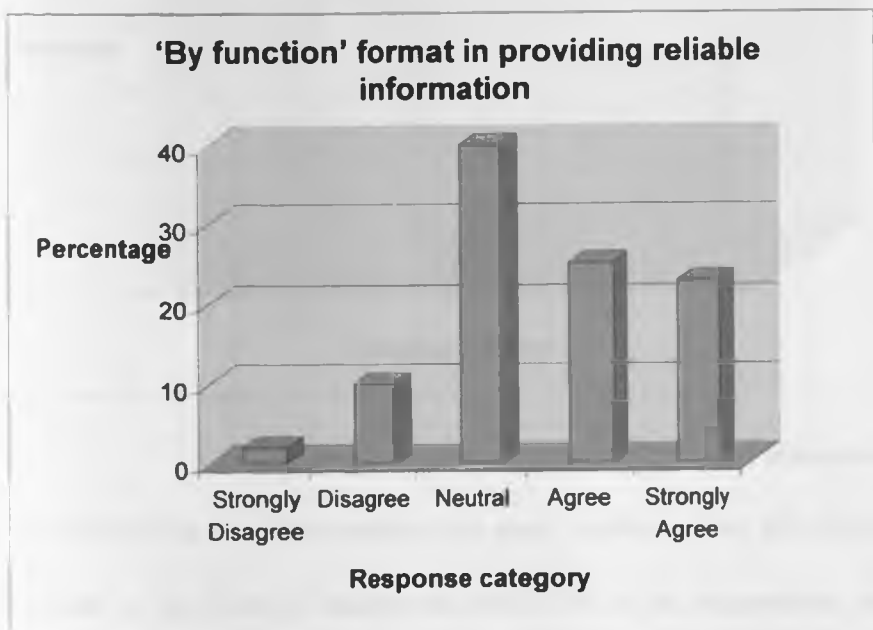
40% of the respondents were on the neutral ground about 'by function' format providing reliable information, 25% of the respondents agreed, 23% of the respondents strongly agreed, 10% of the respondents disagreed and only 2% of the respondents strongly disagreed.

4.2.24 Other information sought for beyond that provided in financial statements

Table 4.24 Other Information beyond that provided in the financial statements

Response Category	Frequency	Percentage (%)
Yes	25	63
No	15	37
Total	40	100

Figure 4.24 Other Information beyond that provided in the financial statement

Other information beyond that provided in the financial statement
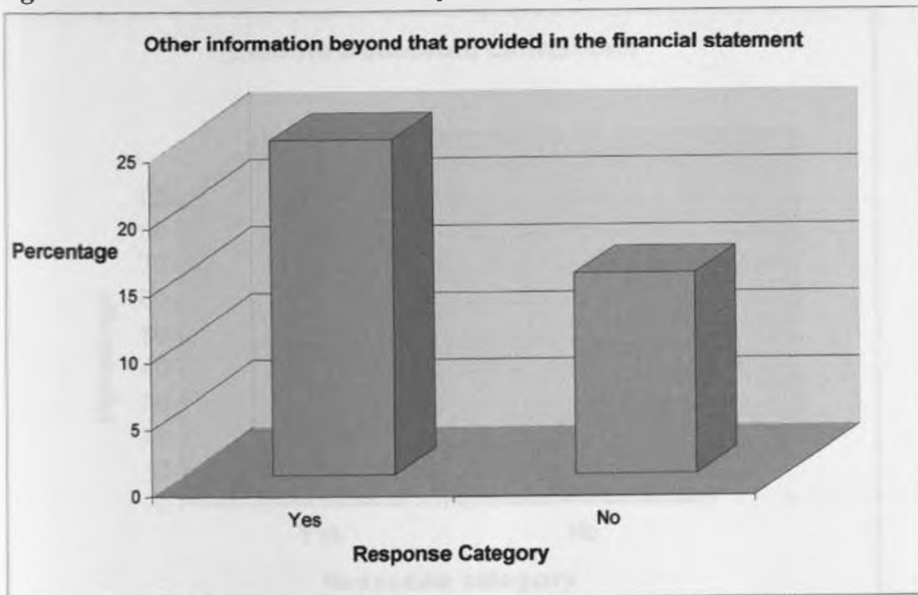
Source: Research data

From the above data it is evident that most investors look for other information beyond that provided in the financial statements with 63% of the respondents saying they look for other information and 37% of the respondents saying they do not look for other information. Respondents cited other sources of information such as prospectus, companies' newsletters and financial advisors.

4.2.25 Limitations of the income statement

Table 4.25 Income statement Limitations

Response Category	Frequency	Percentage (%)
Yes	33	83
No	7	17
Total	40	100

Figure 4.25 Income Statement Limitations
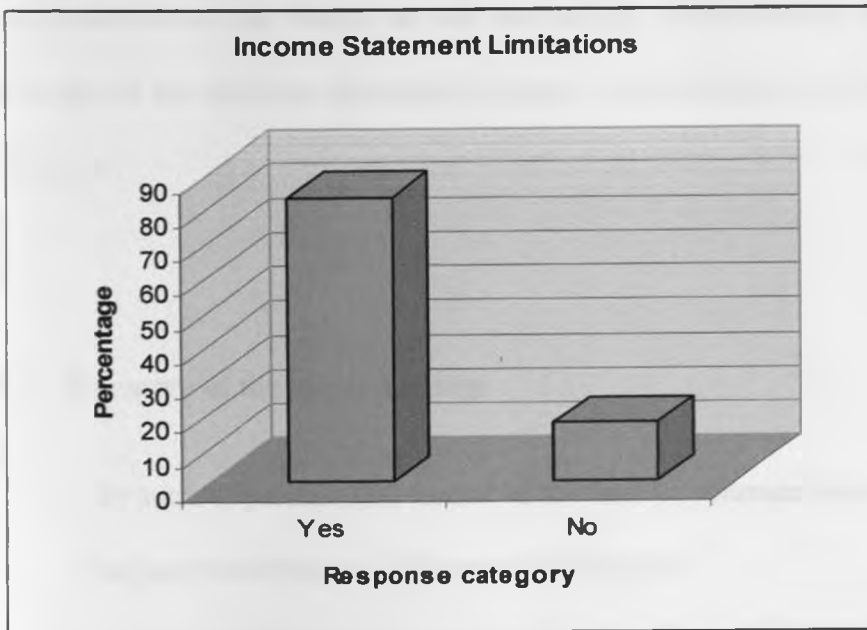
Source: Research data

The data indicated that the income statement has limitations. This is supported by 83% of the respondents saying that the income statement has limitations, while only 17% of the respondents said that the income statement does not have any limitations.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The conclusion made on this chapter is derived from the analyzed research findings. Recommendations are based on the conclusions. This research offers an insight into the adequacy of the preferred presentation format of income statement in providing information to investors.

5.2 Summary of the major findings

1. 'By nature' presentation format of the income statement was established to be the one that provides adequate information to investors.

2. The study established that the most preferred income statement presentation format by investors is the 'by nature' format since it is more informative, more understandable and more comparable.

3. It also emerged from the study that the income statement using both formats had limitations as it contains some estimates and full of manipulation risks by management.

4. The study also established that the income statement has to be used in conjunction with other financial statements and other relevant information to enable investors make sound decision.

5. The study confirmed that the income statement information in critically important in facilitating investors decisions. The presentation format therefore should be such as to meet the users' needs. The investors use the income statement information to make different types of investment decisions therefore the information should be presented in such a way as to meet a variety of users needs.

5.3 Conclusion

The income statement is at the heart of financial reporting and investors use it to evaluate the performance of the firm, to predict the nature and timing of future cash flows and this has a significant impact on the share prices in the stock exchange. A lot of attention should therefore be focused on the presentation of the elements of the income statement to enable the users make informed and quality decisions.

It was noted at the beginning of the study that income statement is not only used by management, but also by investors and creditors outside the company to evaluate profitability, performance and aid in the assessment of risk for the investor or creditor. Business investors tend to rely on the financial statements to signal the weight attached to both core and non-core information depending on presentation format adopted. Income statements information is used by various interested parties to assess the performance of managers and make economic decisions.

Non professional investors tend to rely on the financial statements to signal the weight of income statements are attached to both core and non-core information depending on presentation format adopted. The information set and the method chosen to process the information has an interactive effect on the quality of investor's decisions. Therefore, an information system should provide reports that contain timely and relevant information that enhances decision-making task. The income statement used in conjunction with other financial statement helped users predict the amount and timing of cash flows.

5.4   Limitations of the study

The study only considered the IAS I income statement format that is 'by nature' and 'by function' format. While the other formats such at the matrix format, tabular, graphical and other were not studies due to limed financial resources.

The study only considered financially literate investors.

5.5   Recommendations

The following are the study recommendations that will positively influence information provided in an income statement

1. The accounting standard setters should reduce the amount of discretion given to preparers of financial statements in selecting the presentation format to use.

2. The income statement is used by different investors and other users who have different information needs. The income statement therefore should provide detailed information in order to meet the different information needs of the users.

5.6 Suggestion for further study

The following points are suggested for further research:

1. The most preferred income statement presentation format by Kenyan firms.

2. Factors influencing the choice of income statement presentation format by Kenyan firms.

3. The role of educational institutions in the adoption and use of income statement presentation format.

REFERENCES

Abarbanell, J., Lehavy, R. (2003), "Biased forecasts or biased earnings? The role of reported earnings in explaining apparent bias and over/under reaction in analysts' earnings forecasts", *Journal of Accounting and Economics*, Vol. 36 No.1-3, pp.105-46.

Baker C R. Ding Y, and Stolowy (2005), *Advances in international accounting*, vol.18, pp 169-198.

Barry J. Epstein, Eva K. Jermakowicz (2007), *Interpretation and Application of International Financial Reporting Standards*.

Basu. S., Markov, S. (2004). "Loss function assumptions in rational expectations tests on financial analysts' earnings forecasts", *Journal of Accounting and Economics*, Vol. 38 No.1-3, pp.171-204.

Beaver.H.W MC Nichols, F.M and Rhie S (2005), "Have financial statements become less informative? Evidence from the ability of financial ratios to predict bankruptcy". *Review of accounting studies* pp 93-122.

Bell.J. (1984), "The effects of presentation form on the use of information in annual reports" .*Management science* vol. 30 pp 169-185

Blue Ribbon Committee on improving the effectiveness of corporate audit committees (1999), "report and recommendations of the blue ribbon committee on improving the effectiveness of corporate audit committee (New York)

Bradshaw, M., Richardson, S., Sloan, R. (2001), "Do analysts and auditors use information in accruals?" Journal of Accounting Research, Vol. 39 No.1.

Campbell D.E and Kain JM (1990), "personality type and mode of information presentation: preference, accuracy and efficiency in problem solving" journal of psychology 20 pp 47-51.

Chandran, C. (2004). *Research Methods with Illustrations from Christian Ministries*. Starbright Services Ltd.

Cooper, R. & Schindler, P. (2003). *Business Research Methods*. Tata McGraw Hill.

Ding Y, Jeanjean T. and Stoloway H (2005), Impact of firms' internationalization on financial statements: Some French evidence. Journal of accounting and economics.

Epstein, M.J., Pava, M.L. (1993), The Shareholder's Use of Annual Corporate Reports, JAI Press Inc., London.

Frishkoff P (1987), how do financial analysts make decisions? A process model of investment screening decisions. *Accounting organization and society* pp1-30.

Gupta S.P and Gupta M.P, Business statistics, Sultan Chand and Sons educational publishers, New Delhi, 14th edition.

Hard J.N and Vancock T.m (1991), "Implication of tasks and format on use of financial information" *journal of financial systems*

Harry I. Wolk, James L. Dodd, Michael G. Tearney (2004), *Accounting Theory: Conceptual Issues in a Political and Economic Environment*

Hirst, E., and P. Hopkins. (1998), "Comprehensive Income Reporting and Analysts' Valuation Judgments." *Journal of Accounting Research* 36 (Supplement): 47-75.

Hodder. L., W. Mayew, M. McAnally, and C. Weaver, (2006). "Employee Stock Option Fair-Value Estimates: Do Managerial Discretion and Incentives Explain Accuracy?" *Contemporary Accounting Research* 23 (Winter): 933-975.

International accounting standards board (2009), International Financial Reporting Standards. London:IASB.

Libby R and Lift J. (1993) ."determinants of judgment performance in accounting setting: ability, knowledge, motivation and environment". *Accounting organization and society,* vol 18 pp425-450.

Maines, L., and L. McDaniel. (2000). "Effects of Comprehensive-Income Characteristics on Nonprofessional Investors' Judgments: The Role of Financial-Statement Presentation Format." *The Accounting Review* 75 (April): 179-207.

Maines A L, Martin D R, Mc Daniels L (2000), Evaluating of financial reporting quality: The effects of financial expertise vs. financial literacy. *The Accounting Review* pg 77, quality of earnings conference pp139-167.

McClelland J.A and Mc clain B (2008) ,shaking up financial statement presentation: *journal of accounting*

Mugenda, M., O. & Mugenda, G., A (2003). *Research Methods: Quantitative and Qualitative Approaches*. Laba graphics services.

Obure J (2002) Handbook on data analysis using SPSS, M$O data expert training and consultants, Nairobi.

Phillips JJ and pandit M.G (2004), Comprehensive income: reporting preferences of public companies.*CPA journal.*

Reidl and Srinivasan (2009), Signaling firm performance Through Financial Statement Presentation: *An Analysis Using Special Items.*

Ramenyi, D., Williams, B., Money, A., and swartz, E. (2003). Doing Research in Business and Management. *An Introduction to Process and Method.* Sage Publications UK.

Robson, C., (2002). *Real World Research (2nd Ed.).* Oxford: Blackwell.

So, S and Smith M. (2003), the impact of presentation format and individual differences on the communication of information for management decision making. *Management auditing journal* pp 59-67.

Stickel, S. (1989), "The timing of and incentives for annual earnings forecasts near interim earnings announcements", *Journal of Accounting and Economics*, Vol. 11 No.2-3, pp.275-92.

Suh S.Y. (1990) communication and income smoothing through accounting method choice: *Management science vol* 36, pp 704 -723.

Smith M.Taffler and R.J White (2002), "Cartoon graphics in the communication of accounting information" *Journal of applied management accounting research.*

Tarca A, Brown P, Woodliff D, Bradbury M and Zijl V T (2001) identifying decisions useful information with matrix format income statement, *working paper series* working paper no 55.

Thacker J.R (1962) income statement form and classification: *Accounting Review* pp51-55.

Tilly S.V (1998) income statement and its significance in financial reporting: *Accounting review volume 23* pp 296-304.

This questionnaire is intended to elicit information on the preferred format of income statement presentation and its adequacy in providing information to investors using MBA student's as surrogate investors.

You are humbly requested to answer the questions outlined below as accurately as you can. Please be assured that the information that you provide is purely for academic purposes and will be treated with strict confidence.

Personal Details

1. Name of the MBA student   --
   (optional)

2. Gender: Male   [ ]   Female   [ ]

3. Employment : Self employed   [ ]   private Sector   [ ]   Public Sector   [ ]

   Others---

4. Age (years): Please tick (√) as appropriate

   21-30   [ ]   31-40   [ ]   41-50   [ ]   above 50   [ ]

Information investors look for in income statements

5. Do you or would you consider any information from income statement before making investment decisions? Please tick (√) as appropriate

   Yes   [ ]   No   [ ]

6. Which type of investment do you or would you undertake? Please tick (√) as appropriate

   Capital investment   [ ]   Speculative investment   [ ]   both   [ ]

7. Which information do you look for in an income statement, to facilitate your investment decision? Please tick as appropriate. (5-Critically important, 4-very important, 3-important, 2- a little important, 1-not important at all).

Information	5	4	3	2	1
Sales					
Cost of sales					
Gross profit					
Depreciation expense					
Staff cost					
Administration expenses					
Selling and distribution expenses					
Net profit					
Other information					
i)					
ii)					
iii)					
iv)					

Most favored presentation format by Investors.

8. Which presentation format of the income statement do you prefer? Please tick (√) as appropriate   (See attached income statement presented in the two alternative formats)

'By nature' income statement format   [   ]

'By function' income statement format   [   ]

Why?

i)   Provides more information   [   ]

ii)   It is easy to understand   [   ]

iii)   It enhances accountability   [   ]

iv)   It is more realistic   [   ]

v)   Others..

....

....

The adequacy of both formats in providing information to investors

9. State whether you agree with the following comments on 'BY NATURE' income statements. Please tick (√) as appropriate.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly agree
Satisfies *relevance* characteristics of information					
Satisfies *understandability* characteristics of information					
Satisfies *Comparability* characteristics of information					
Satisfies *reliability* characteristics of information					

10. State whether you agree with the following comments on 'BY FUNCTION' income statements. Please tick (√) as appropriate.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly agree
Satisfies *relevance* characteristics of information					
Satisfies *understandability* characteristics of information					

Satisfies *Comparability* characteristics of information					
Satisfies *reliability* characteristics of information					

12.   Do you look for other information beyond that provided in the financial statement? Please tick (√) as appropriate.

Yes [ ]   No [ ]

If yes, please list your sources and the reason (s) why?

i)   Financial advisors   [ ]

ii)   Newspapers   [ ]

iii)   Friends   [ ]

iv)   Companies website   [ ]

vi)   others..
....
....
....
....

13. Do you think Information on an income statement might have several limitations, thereby leading to wrong decision making. Please tick (√) as appropriate.

Yes [ ]   No [ ]

If Yes, state some limitations

i)   Provides only historical information   [ ]

ii)   Some figures are estimates   [ ]

iii)   Risk of deliberate manipulation by managers   [ ]

iv)   Its over summarized   [ ]

v)   Others..
....
....
....

'by function' format

Xyz Limited

Income statement

For year ended   31-December - 2008

	2008	2007
	sh000	sh000
Sales	1660	1500
Costs of sales	(840)	(700)
Gross profit	820	800
Other operating income	600	500
	1420	1300
Administration costs	(240)	(500)
Selling and distribution costs	(660)	(479)
Operating profits	520	321
Finance cost	(120)	(14)
Profit before taxation	4 00	307
Income tax expense	(180)	(130)
Net profit for the period	220	177

'by nature' format

Xyz Limited
Income statement
For year ended 31-December-2008

	2008 Sh000	2007 sh000
Sales	1660	1500
Other operating income	600	500
	2260	**2000**
Changes in inventory	840	600
Purchases	540	600
Employee benefit expense	80	80
Depreciation	40	40
Rent and rates	90	87
Discount allowed	50	45
Bad debts written off	100	130
Advertising	90	87
Directors remuneration	10	10
Interest expense	20	14
Total expenses	**1860**	**1693**
Profit before taxation	400	307
Less income tax expense	(180)	(130)
Net profit for the period	**220**	**177**