High Quality Financial Reporting: The Case of the Nairobi Stock Exchange

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Declaration of author's rights

Statement of originality

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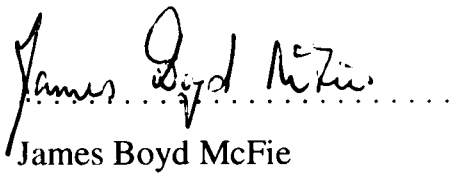

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ABSTRACT

This thesis investigates, firstly, the meaning of the phrase "high quality financial reporting". The use of the phrase in the academic literature, and by professional and regulatory bodies, is examined critically to contribute to a deeper understanding of the phrase.

Disclosure in the annual reports of all 47 companies listed on the Nairobi Stock Exchange is examined to see if it can be described as "high quality". "High quality disclosure" is measured in three ways: (1) a disclosure index is developed to measure compliance with International Financial Reporting Standards (this index is also used to measure disclosure in the interim report); (2) a disclosure index developed by Standard and Poor's to measure Transparency and Disclosure is used; (3) these are compared with the scores achieved by the same annual reports in the Financial Reporting Excellence Award 2003, decided by adjudicators in Kenya.

The thesis also investigates the association between selected corporate characteristics and "high quality disclosure". Testable hypotheses are formulated based on disclosure theories and prior studies: univariate and linear regression analysis are used to test whether significant independent variables explain "high quality disclosure", with the aim of contributing to understanding the applicability of disclosure theories to a capital market in a developing country.

Interview research is employed to explore further matters related to "high quality financial reporting" in this developing country setting and to complement the quantitative analysis, so as to contribute to understanding the relevance of International Financial Reporting Standards in achieving high quality disclosure in this capital market.

Conclusions are made as to the usefulness of accounting theories and other influences in explaining "high quality disclosure" by Nairobi Stock Exchange companies. A definition of "high quality disclosure" is proposed. The implications of the research, its contribution and its limitations are discussed. Suggestions for further research are presented.

ABBREVIATIONS

AAA	American Accounting Association
AFRC	Australian Financial Reporting Council
AICPA	American Institute of Certified Public Accountants
AIMR	Association for Investment Management and Research (CFA Institute)
APB	Auditing Practices Board
ASB	UK Accounting Standards Board
CBI	Confederation of British Industry
CFA	Chartered Financial Analyst
CSA	Canadian Securities Authority
ECM	Emerging Capital Market
EU	European Union
FAF	US Financial Accounting Foundation
FASB	Financial Accounting Standards Board
FASC	Financial Accounting Standards Committee (of the AAA)
FEI	Financial Executives International
FESCO	Forum of European Securities Commissions
GAAP	Generally Accepted Accounting Principles
GAO	General Accounting Office of the US Government
GFRAC	Global Financial Reporting Advocacy Committee (of the CFA Institute)
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation
IBRD	International Bank for Reconstruction and Development (World Bank)
ICAEW	Institute of Chartered Accountants in England and Wales
ICANZ	Institute of Chartered Accountants of New Zealand
ICPAK	Institute of Certified Public Accountants of Kenya
IFAC	International Federation of Accountants
IFAD	International Forum on Accountancy Development
IFC	International Finance Corporation
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standard on Auditing
JFSA	Japanese Financial Services Authority
KASNEB	Kenya Accountants and Secretaries National Examinations Board
NEPAD	New Partnership for Africa's Development
NSE	Nairobi Stock Exchange
OECD	Organisation for Economic Co-operation and Development
ROSC	Report on the Observance of Standards and Codes
S&P	Standard and Poor's
SEC	United States Securities and Exchange Commission
SSA	Sub-Saharan Africa
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
US	United States of America
WB	World Bank

CHAPTER 1
Introduction

1.1 Introduction.

In late 1998, the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), or the World Bank, initiated *Reviews of the Observance of Standards and Codes* (ROSCs) in member countries.

In February 2001, a team from the World Bank visited Kenya to carry out an ROSC in the country because

> "*it is a major economy in the east and central African region and because its success in improving economic performance is likely to have a significant demonstration effect on the region's economic development*" (WB 2001, p.1).

Kenya was also chosen because it was one of the first countries in Africa to formally adopt International Accounting Standards (IASs) or International Financial Reporting Standards (IFRSs), as they are now called (IASB 2001, p.1; 2002a, p.2).

Reporting on its findings, the World Bank pointed out that

> "*weaknesses in corporate governance practices, lack of pressure from the users of financial statements for high-quality information and the general absence of transparency in the corporate sector, pervade the corporate financial reporting regime in Kenya. The fact that a number of banks failed in the late 1990s, and the audited financial statements did not provide early warning signals, has raised concerns among the general public about the quality of accounting and auditing in the country*" (WB 2001, p.1).

In concluding its remarks on the quality of financial reporting by a sample of companies quoted on the Nairobi Stock Exchange (NSE) with financial year-ends in the year to 31 March 2000, the World Bank stated that

> "*financial accounting practices are perceived to have improved significantly since the Institute of Certified Public Accountants' decision to implement international standards in accounting and auditing*" (WB 2001, p.11).

However, it went on to point out that although compliance with the requirements of IFRSs and International Standards on Auditing (ISAs) was only partial - due to inadequate enforcement and insufficient resources - an action plan would bring about an improvement in compliance within a period of three to five years. Also the assessment exercise had

assisted in identifying changes in Kenya's institutional framework that were required "*to ensure high-quality financial reporting by the corporate sector*" (WB 2001, p.1).

1.2 Motivation.

1.2.1 Initiatives in Kenya

Kenya made the decision to adopt International Accounting Standards in 1997.

The Council of the Institute of Certified Public Accountants of Kenya (ICPAK) decided that it would cease developing Kenyan Accounting Standards for a number of reasons. In particular it had become clear to the Council of ICPAK that developing home-grown standards was not putting its limited resources to best use:

> "*Updating Kenyan Standards to comply with International Standards and to cover areas which are not covered currently is a monumental task. The Institute just does not have the resources, human or financial, to carry out this task to a satisfactory level of proficiency; and even if it did, what purpose would this serve? Council believes that an effort to update Kenyan Standards will merely reproduce International Standards under a different name. In the circumstances therefore, the resources available to ICPAK could be put to better use if they were used to interpret International Standards, to assess their implication on local practice and, where necessary, to issue technical bulletins and local guidance on those Standards*" (ICPAK 1997).

Kenya adopted International Accounting Standards in full with effect from 1 January 1999. It simultaneously adopted International Standards on Auditing (ISAs). For all accounting periods commencing on or after 1 January 1999, members of ICPAK are required to prepare the accounts of companies (whether quoted, public or private), parastatals and organizations such as co-operative societies, partnerships, sole traders, non-trading concerns such as sports clubs and charities, and estates and trusts in accordance with IFRSs.

1.2.2 ICPAK's comments on the ROSC

When the draft ROSC was sent by the World Bank to the Permanent Secretary in the Treasury in Kenya, with copies to the Accountant General, ICPAK, the Central Bank, the Capital Markets Authority and the Nairobi Stock Exchange, ICPAK voiced its concern that although

> "*the findings and conclusions are generally well founded ... the general slant of the presentation is too dismissive and unsympathetic of the local efforts being made to*

improve financial reporting in Kenya. ...the conclusion that many ISAs and IAS(s) are not being complied with is too general" (ICPAK 2001, p.1).

ICPAK went on to give a number of examples where a reading of the ROSC would give an erroneous view of the situation on the ground in the country. The ROSC speaks of "*the lack of implementation guidelines*" (WB 2001, p. 6, paragraph 26); ICPAK pointed to 7 actions it had taken and 6 publications it had made available to members of ICPAK to ensure implementation was facilitated.

ICPAK suggested that the Report should be amended by examining each key area, describing the ideal position, reviewing what was currently occurring in Kenya, identifying the constraints present and proposing how these constraints could be addressed.

However, ICPAK's submissions led to no change in the ROSC. If a judgement was to be made on the accounting of publicly quoted companies in Kenya from the ROSC, which is published on the Website of the World Bank, it may be different from the true position in the country. Unctad (2005, p. 24) suggests that self-assessment by countries, backed by a peer review process, is a better way of dealing with realities on the ground.

1.2.3 Exploring "high quality"

This thesis demonstrates from prior literature that the concept of "high quality financial reporting" is a rich one, which involves many different facets which go to make up the nexus which is the reporting process. It argues that the World Bank is ill-advised in using the phrase "high quality financial reporting" when, in reality, it examines only compliance with IFRSs. This thesis shows that many organizations around the world use this phrase with imprecise meaning. In order to do justice to the judgement process about financial reporting in any setting, an exhaustive examination would have to be made of all the different facets which in total, if they are individually high quality, go to make up "high quality financial reporting". These facets will be introduced and examined in chapter 2 of this study. This thesis recommends that greater care should be exercised in the use of the phrase "high quality financial reporting" after its full significance has been made clear.

The thesis also explores the question of whether IFRSs are appropriate to smaller companies on stock exchanges in developing countries. IFRSs have been developed by representatives of developed countries. But even in developed countries, the switch-over to IFRSs is not an easy one. In the UK, the Institute of Chartered Accountants in England and Wales (ICAEW) has proposed that the Accounting Standards Board's IFRS convergence

programme be delayed so that unlisted companies be saved "burdensome costs and significant uncertainties" (ICAEW 2005). If companies on the NSE are able to achieve total compliance with the disclosure requirements of IFRSs, and if preparers view the change-over to IFRS positively, it follows that the "appropriateness" of IFRS is not a contentious matter; it also shows that "ownership" of the IFRSs can be achieved in spite of the fact that Kenya has almost no influence over the formulation of IFRSs. In spite of Sarpong's (1999) word of caution as to the generalizability of the findings on any emerging capital market (ECM), this could act as an important example for other developing countries, especially in Africa.

This thesis replicates and extends the World Bank study. The corporate annual reports for financial years that end in the year to 31 March 2003 of *all* the companies quoted on the Nairobi Stock Exchange are examined in order to establish the position relating to compliance with IFRSs by companies quoted on this exchange.

Standard & Poor's used a "Transparency and Disclosure" checklist to rate disclosure in the corporate annual reports in the year to 31 December 2002 of companies quoted on a number of stock exchanges around the world (S&P 2003). This thesis uses this checklist to obtain scores for the companies quoted on the NSE, to see how they compare with companies in developed and emerging markets around the world. This will assist companies quoted on the NSE to compare their disclosure with that achieved by companies in the world's largest capital markets, using criteria laid down by a highly reputed US credit rating agency.

This study also aims to examine whether financial reporting disclosure by listed companies in Kenya in the third year after that examined by the World Bank is "high quality". In order to do this, it develops a tentative definition of "high quality accounting disclosure".

In April 2005, Donaldson, the then Chairman of the US Securities and Exchange Commission (SEC), announced at the end of a meeting with McCreevy, the EU Internal Market Commissioner, that the SEC had set out a road-map which established a goal of eliminating before 2009, at the latest, the 20-F reconciliation requirement for foreign companies listed in the US which report under IFRSs (SEC 2005a). Achieving this goal would depend on sufficient progress being made on the IASB-FASB convergence project, and "on a detailed analysis of the faithfulness and consistency of the application and

interpretation of IFRS in financial statements across companies and jurisdictions" (SEC 2005a). If it can be shown that companies on the NSE do achieve total compliance with the disclosure requirements of IFRS, in a small way it will help the process of eliminating the need for non-US companies to file the 20-F reconciliation, which will reduce the cost of capital for foreign companies listed in the US (Maroney and O hOgartaigh 2005).

This study also examines IFRS disclosure compliance in the interim financial reports, for the first half-year of the year considered, of all the companies quoted on the NSE. This is an area where Kenyan quoted companies need to take concrete steps to change current practice. This study clarifies the changes needed.

This thesis argues that potential investors from abroad obtain a distorted picture of IFRS disclosure practices among companies quoted on the Nairobi Stock Exchange by reading the World Bank's ROSC. Unctad (2005, p. 24) points out that the ROSCs may not be considered a reliable source of information by investors and credit-rating agencies, but the IMF has stated that major private sector financial institutions worldwide considered international standards important for decision making (Unctad 2005, p. 39). As a result of this study, individual companies on the Exchange can be advised of their shortcomings in relation to compliance with IFRSs, rather than being informed in general terms that their compliance was inferior. Thirty nine (39) of the forty seven (47) financial controllers of companies quoted on the NSE were interviewed for the purposes of this study. All of them have expressed a desire to know about the findings of this thesis. In addition, a number of shortcomings of the World Bank study will be highlighted.

1.2.4 Approach taken

The World Bank came to its conclusions about financial reporting in Kenya by examining the annual reports of those companies quoted on the Nairobi Stock Exchange which took part in the Best Presented Accounts Award, an annual competition run by ICPAK. The competition began in 1986. In 2001, the competition was renamed the Financial Reporting (FiRe) Award for Excellence, under the joint operation of ICPAK, the Nairobi Stock Exchange and the Kenya Capital Markets Authority. Following the approach adopted by Daske and Gebhardt (2006), this study will use the results of the Fire Award for Excellence 2003, which examines the annual reports of 35 of the 47 companies quoted on the NSE. FiRe Award scores, together with IFRS compliance and S&P's Transparency and Disclosure scores are used to decide which of the companies quoted on

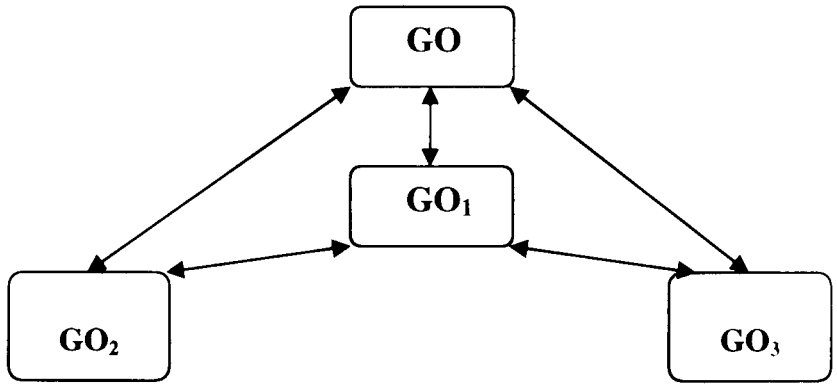
the NSE achieve high quality disclosure (HQD). In addition, the study will point out why companies have not achieved HQD if this turns out to be the case.

The remainder of this chapter is arranged as follows. Section 1.3 states the general objectives of this study. The methodology is outlined in Section 1.4. Research questions and a summary of the research methods used are presented in Section 1.5. The main contributions and limitations of this research are enumerated in Sections 1.6 and 1.7. Finally, the organization of the thesis is presented in 1.8.

1.3 General Objectives.

The main objective (**GO**) of this research is to make a contribution to understanding how preparers of financial statements that will be used in capital markets in developing economies can be assisted in achieving high quality financial reporting, and how regulators and other intermediaries can help them to do so. This objective is divided into three sub-objectives ($\mathbf{GO_1}$, $\mathbf{GO_2}$ and $\mathbf{GO_3}$) shown in Diagram 1-1 below.

Figure 1-1: Main objective and sub-objectives



$\mathbf{GO_1}$: The first sub-objective is to contribute to an understanding of the meaning of the phrase "high quality financial reporting", to clarify the distinction between "high quality disclosure" and "high quality measurement" in financial statements, and to develop a tentative operational definition of "high quality disclosure" for this study.

$\mathbf{GO_2}$: The second sub-objective is to contribute to understanding the applicability of disclosure theories to a capital market in a developing country with particular reference to high quality disclosure.

$\mathbf{GO_3}$: The third sub-objective is to contribute to understanding the relevance of International Financial Reporting Standards in achieving high quality disclosure in financial reporting to investors in a developing country.

1.3.1 GO_1: Sub-objective one.

Sub-objective one (GO_1) of this study is aimed at contributing to an understanding of the meaning of the phrase "high quality financial reporting", so that preparers, regulators and financial intermediaries can identify all the characteristics that are necessarily present in an annual report to ensure "high quality financial reporting".

Some observers of capital markets state that high-quality information is vital to the proper working of the market (Levitt 1999), to ensure that investors allocate capital efficiently (Levitt 2005). Akerlof (1970) shows that information asymmetry has an adverse effect on the market and may even lead to market failure.

An important aspect of "high quality financial reporting", but not the only one, is disclosure.

Botosan (1997) confirms that the extent to which companies benefit from increased disclosure remains unclear. In her study of companies in one industry for one year, she finds that for a sample of companies with relatively low analyst following, greater disclosure is associated with a lower cost of capital, holding cross-sectional variation in market beta and firm size constant; but for companies with high analyst following, no significant relation between disclosure and cost of capital is observed.

In a later study, Botosan and Plumlee (2002), using the disclosure rankings produced by the *Association for Investment Management and Research's Annual Reviews of Corporate Reporting Practices (AIMR reports)*, find that the cost of capital decreases in companies in which managers provide greater disclosure in the annual report but increases with the level of more timely disclosures in quarterly reports to shareholders.

Anctil et al. (2004) use analytical and experimental techniques to show that increased transparency can result in increased strategic uncertainty when individuals must coordinate with other decision makers. In certain cases, the costs of increased information transparency arising from this uncertainty outweigh the benefits arising from more precise information about the economic facts of the company. However, Walther (2004) questions whether the findings in Anctil et al. (2004) are generalizable. It can be concluded that there is still much research to be done in relation to the benefits of transparent information.

Byard and Shaw (2003) find that a policy of high quality, publicly available disclosures increases the precision of analysts' idiosyncratic (that is, their uniquely private) information about future earnings. The conclusion that may be drawn is that individual

analysts develop at least some of their private information from processing publicly available data.

Shaw (2003) finds that companies with better disclosure make use of the fact that their disclosure is superior to aggressively manage earnings in years when the news is bad. Levitt (1998), referring to US capital markets, declares "earnings management is on the rise and the quality of financial reporting is on the decline".

It is intended that this study will assist in remedying the lack of understanding that exists in relation to "high quality financial reporting". By having a clearer idea of what is meant by the phrase "high quality financial reporting", preparers, regulators, financial intermediaries and investors will be able to decide more easily whether financial reports are high quality or not.

1.3.2 GO_2:Sub-objective two.

Sub-objective two (GO_2) is to contribute to understanding the applicability of disclosure theories to a capital market in a developing country with particular reference to high quality disclosure.

Many studies have been conducted on disclosure in financial statements. Healy and Palepu (2001) conclude that financial reporting and disclosure choices are associated with contracting, political cost and capital market considerations and that disclosure is linked to share price performance, bid-ask spreads, analysts' reports and ownership of the firms' shares by institutions.

These conclusions have been arrived at in relation to developed capital markets. The theories that underlie these conclusions will be summarized in this study and will be employed to arrive at factors which can explain the production of financial reports with high quality disclosure. As a result, prior expectations can be formed about these factors and testable hypotheses can be formulated. Empirical results will assess the applicability of these theories to financial reporting in a capital market in a developing country.

It is intended that this study will shed light upon the relevance of theoretical models to financial reporting disclosure practices by companies listed on a capital market in a developing country setting. It is hoped that some of the misunderstandings that exist in relation to financial reporting practices in some developing countries can be dispelled.

1.3.3 GO_3:Sub-objective three.

Sub-objective three (GO_3) is to contribute to understanding the relevance of International Financial Reporting Standards in achieving high quality disclosure in financial reporting to investors in a developing country.

Shaw (2003) points out that high-quality information is essential to the proper functioning of capital markets. Ball et al. (2003) argue that adopting high-quality standards might be a necessary condition for high quality information, but not necessarily a sufficient one.

Healy and Palepu (2001) find that financial statements which are prepared in accordance with a set of regulations are informative to investors, and the amount of information varies systematically with firm and economy characteristics: but they question the "objective of disclosure regulation", the effect disclosure regulation has on capital market development and ask "what types of accounting standards produce high quality financial reports?"

It is intended that this study will contribute to shedding light on the relevance of international financial reporting standards in this developing country setting. However, Sarpong (1999) notes that emerging capital markets (ECMs) are not a homogeneous group and consequently generalizations should be viewed with caution. In his opinion, there is a need to conduct research into financial reporting in *each* (emphasis added) ECM to evaluate the quality of financial reporting. He advocates that "such studies should encompass the evaluation of the observance of IASC standards which have the potential to enhance the quality of financial reporting in ECMs" (Sarpong 1999, p.4).

1.4 Methodology

Jankowicz (1991) suggests that the choice of the method of research varies according to the nature and scope of the topic of the study, the sources of data that are used, the purposes of gathering the data, the amount of control exerted in obtaining these data and the assumptions made in analysing them.

As stated in section **1.3.1** above, sub-objective one (GO_1) of this study is aimed at contributing to an understanding of the meaning of the phrase "high quality financial reporting".

The ontological assumption underlying this study tends towards the objectivist end of the spectrum developed by Morgan and Smircich (1980, p.492). Their first category,

"reality as a concrete structure", where the accounting world would be viewed as a network of determinate relationships where accurate predictions can be made using appropriate observation and measurement, may be too rigid an ontological basis for this study. The second, "reality as a concrete process", moves to a more open system view; but studying reality would still emphasize measurement and stable statistical relationships. This study would be situated between this ontological assumption and Morgan and Smircich's third category in which reality is viewed "as a contextual field of information", in which human beings are assumed to be continually processing information, learning and adapting. This adaptation process may be harmonious and predictable but, also, it may not be so. Relationships are probabilistic. The approach taken in research within this ontological framework is to arrive at the likelihood of change in one part of the system producing changes in other parts of the system.

However, this study is exploratory from a number of points of view. Blumer (1978, p.39), as quoted in Tomkins and Groves (1983, p.363), states that, in exploration, the researcher forms a close contact with the field of study, "developing and sharpening his enquiry so that his problem, his directions of enquiry, data, analytical relations and interpretations arise out of, and remain grounded in, the empirical life under study". Tomkins and Groves reveal that this exploration phase is followed by "inspection". This entails a "deepening of the enquiry following themes that emerge from flexible, but close, observations of specific decision contexts". As the research progresses, different analytical elements of the study are focused on from different viewpoints. The fact that different people view events in different ways comes to be appreciated. The researcher can say that his understanding of a situation is not complete until he understands all the different views held by each person.

Denzin (1971), (describing Morgan and Smircich's fourth category, "reality as symbolic discourse"), states that social order is derived because individuals interpret reality within a basic stance of negotiation with each other and develop the same shared symbolic order of meanings. Tomkins and Groves (1983, p. 370) point out that in research based on this ontological outlook, the researcher starts from specific, real-world situations with the aim of answering the question "what is going on here"? If definitions of situations and responses prove to be widespread across locations and time, then grounded theories may be formulated (Glaser and Strauss 1967). But again, some findings are not generalizable.

This is the ontological background assumed when dealing with the first sub-objective of this research. The aim is to generate an understanding of quality from the accounting literature, from theory and from interviews.

One area that will be examined in some detail is the submission-literature of interested parties to the US SEC's Concept Paper (SEC 2000a) on *International Accounting Standards*. These submissions may provide criteria by which accounting standards can be judged to gauge whether they are "high quality".

In any human activity, some groups of people perform activities in an exemplary manner, others in a mediocre way and others poorly. In this study, hypotheses testing will be performed to test the bigger issues. The aim of the study is not to merely reveal that some financial statements exhibit "high quality disclosure" and others do not. The aim is rather to try to come to an understanding of what makes one group of companies achieve high quality disclosure and what needs to be done so that all achieve this. This part of the study will be empirical.

1.5 Research questions.

1.5.1 General research questions

The three general research objectives reported in section 1.3 above are used to enunciate three general research questions.

GQ_1: General Question 1

What is meant by high quality financial reporting and how can this meaning be used in the design of the research method?

GQ_2: General Question 2

Which disclosure theories could be applied to a developing country capital market to form expectations about high quality disclosure practices by quoted companies?

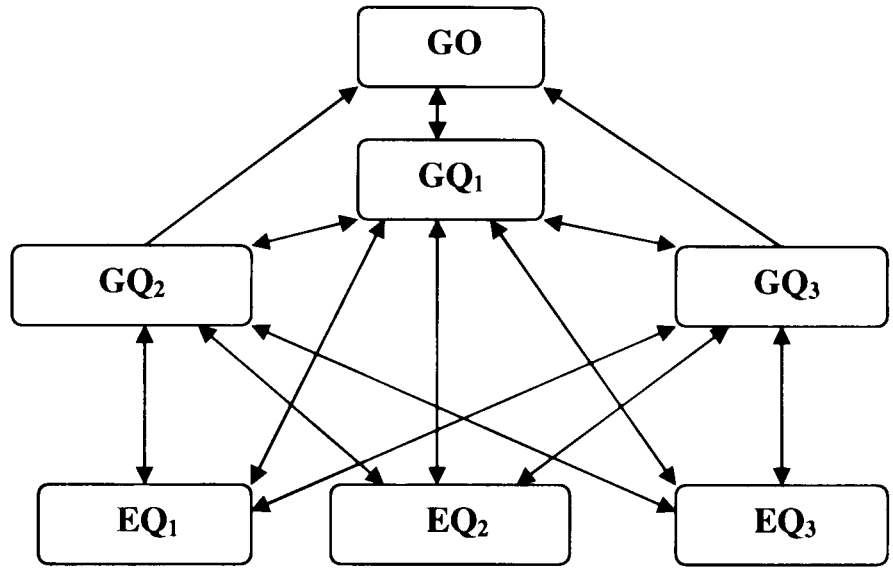
GQ_3: General Question 3

What are the influences that enable companies to achieve high quality financial reporting disclosure in a developing country?

GQ_1 is first used to tentatively develop an operational definition of "high quality disclosure". Once this has been done, these three general research questions are used to develop three empirical research questions, each of which is influenced by all three general research questions so that their dependence can be shown by diagram 1-2 below. Just as each of the empirical research questions is influenced by the general research questions, so

too the general research questions are influenced by the empirical research questions. The arrows in Figure 1-2 are therefore shown in both directions, except for $\mathbf{GQ_2}$ and $\mathbf{GQ_3}$, which are influenced primarily by $\mathbf{GQ_1}$. Both $\mathbf{GQ_2}$ and $\mathbf{GQ_3}$ influence the general research question. By the end of the study, a clearer idea of "high quality disclosure" is obtained, so that the tentative definition developed to carry out the study can itself be critically evaluated, and a more definitive definition provided.

Figure 1-2: Dependence of empirical research questions on general questions



1.5.2 Empirical research questions

The main empirical research questions investigated in this study are as follows:

(i) **EQ_1:** *What is the extent of high quality disclosure among companies quoted on the Nairobi Stock Exchange?*

(ii) **EQ_2:** *Is there a significant association between high quality disclosure and company characteristics on the basis of expectations derived from prior research and theoretical models?*

(iii) **EQ_3:** *What are the perceptions of preparers, auditors, regulators and analysts of "high quality disclosure" and how do these observations help the interpretation of the quantitative results of this study?*

1.5.3 Summary of Research Methods.

The first empirical research question ($\mathbf{EQ_1}$) involves developing a checklist for compliance with the disclosure requirements of the International Financial Reporting Standards (IFRSs) and using it to identify the extent of compliance of the corporate annual reports of companies listed on the NSE with the requirements of IFRSs.

Then a checklist drawn up by Standard and Poor's is used to evaluate another set of disclosure items in the same corporate annual reports of the same companies. The scores achieved by these companies according to this researcher's interpretation of the Standard & Poor's (S&P) 2003 checklist are compared with scores achieved by companies listed on different stock exchanges around the world, arrived at by the staff of S&P.

The IFRS disclosure compliance scores and the S&P's scores achieved by companies listed on the NSE (as awarded by this researcher) are compared to scores achieved by the listed companies which took part in the annual Financial Reporting (FiRe) Award for Excellence 2003 organized by the Institute of Certified Public Accountants of Kenya (ICPAK), the Kenya Capital Markets Authority (CMA) and the Nairobi Stock Exchange (NSE). An evaluation is made of the results using exploratory data analysis.

The second empirical research question ($\mathbf{EQ_2}$) involves statistical testing and the evaluation of factors that influence high quality disclosure amongst companies quoted on the NSE.

Then interview research is used to analyze and interpret high quality disclosure in financial statements from the perceptions of different market participants ($\mathbf{EQ_3}$).

Lastly, conclusions can be arrived at as to how companies can ensure that their reporting is moved closer to high quality financial reporting.

1.6 Contribution to Knowledge.

In meeting the first general sub-objective, this research contributes to an understanding of the meaning of "high quality financial reporting". It contributes to understanding that financial reporting can be described as "high quality financial reporting" only if each of the many different facets that make up the reporting process is high quality. The study reveals that many organizations and individuals around the world today are doing a disservice to accounting when they use the phrase "high quality financial reporting" when in reality they refer to only one element of the nexus that makes up "financial reporting". Nachmias and Nachmias (1996, p.28) point out that "if concepts are to serve their functions, they have to be clear, precise and agreed upon". By deepening the understanding of this phrase, a contribution to the literature is made.

In meeting the second general sub-objective, this research contributes to an understanding of the applicability of disclosure theories to a developing capital market. Empirical evidence of the association between company-specific variables and high

quality disclosure is provided, which contributes to further understanding of the way high quality disclosure is achieved. By analyzing company characteristics in relation to disclosure, insights into the explanatory power of theories are obtained.

In meeting the third general sub-objective, a deeper understanding of the relevance of International Financial Reporting Standards to financial accounting in Kenya is obtained. Sarpong (1997) cautions against generalizations of the findings of studies of financial reporting in ECMs, but the methodology developed in this study could be used to examine the financial reporting of other countries.

1.7 Limitations of this Research.

The main limitations[1] of this study are:

- Quality is largely subjective and is context dependent. A primary facet of disclosure quality is taken to be the amount of disclosure, given the complexity of the company's operations and organization. However, a company may disclose all that is required to be disclosed but still produce an annual report which is far from being described as high quality, even from a disclosure point of view.
- The relevance of an item of disclosure, given the transactions a company engages in and its assets and liabilities, can be know with a high degree of certainty only by persons who have an intimate knowledge of the company's operations and finances. Hence, there is a certain amount of subjectivity in scoring disclosure using the checklists that have been used in this study.
- The IFRS checklist was checked against a similar one developed by PricewaterhouseCoopers, but this does not give 100% certainty that it would be the same as one developed by the International Accounting Standards Board. Similarly, the scoring of disclosure using S&P's methodology could give a result which is slightly different from that arrived at by the staff of S&P.
- The annual reports and interim financial reports examined in this study are not the only medium of financial reporting used by NSE companies. As a result, conclusions have to be treated with caution, since all sources of information would have to be examined to obtain a comprehensive view of reporting.
- Although the half-year and annual financial statements of all the companies that were quoted on the Nairobi Stock Exchange as at March 31, 2003, were examined

[1] For further discussion see 10.6.

in this study in order to conclude whether financial reporting was high quality or not, it gives a snapshot at a particular date. People in Kenya sometimes state that there is no Swahili word for "maintenance" and that is why the infrastructure is so dilapidated. IFRSs are new in Kenya. When their novelty wears off, accounting quality may decline. A longitudinal study would give a more comprehensive picture of financial reporting on the NSE.

- The views of the persons interviewed may be somewhat different from those that would have been expressed by more junior managers or by directors in the companies concerned.
- Bias is present in interview research despite all the measures to prevent it.

1.8 Organization of the Thesis.

The thesis, including this introductory chapter, is arranged into ten chapters. The nine chapters following this introductory chapter set out to achieve the main objective and the three sub-objectives of this study, as laid out in Table 1-1 below.

Table 1-1: General sub-objectives

Ch.	Chapter titles General sub-objectives:	GO_1	GO_2	GO_3
2	Review of the Literature.	•	•	•
3	The meaning of the phrase "high quality financial reporting".	•		•
4	The accounting environment in Kenya.		•	•
5	Research Methodology and Methods.	•	•	•
6	Development and formulation of testable hypotheses.		•	
7	Corporate Annual Report (CAR) IFRSs compliance scores; scores using S&P's survey method, and comparison of Kenya scores with those of other countries around the world; FiRe Award scores; interim financial report IFRS compliance scores.		•	
8	Univariate and multivariate analysis.		•	
9	Perceptions of High Quality Accounting amongst experts in Kenya.	•		•
10	Summary; implications; contribution; limitations of this research; suggestions for further research.	•	•	•

The three empirical research questions in section **1.5.2** above are addressed in the chapters indicated in Table 1-2 below.

Table 1-2: Empirical research questions

Empirical Questions	Chapters
EQ_1	7
EQ_2	8
EQ_3	9

The 10 chapters of this thesis deal with the following areas of the study:

Chapter 1 presents an introductory outline of the thesis. It presents the motivation for the thesis. It introduces the general objectives of this study and follows through to sub-objectives, research questions and then on to empirical questions. The contributions and limitations of the study are discussed briefly. The organization of the thesis is then reported.

Chapter 2 presents a review of the literature. The diverse facets of the concept of high quality financial reporting are discussed. The distinction between "high quality disclosure" and "high quality earnings" is explained. The literature relating to "high quality disclosure" is reviewed. Disclosure theories are summarized. A brief review is made of the "high quality earnings" literature. A definition of "high quality disclosure" is proposed as a starting point for the empirical investigation.

Chapter 3 explains the background to the use of the phrase "high quality financial reporting". It briefly traces its gradual coming into use and shows how widely the phrase is used by capital market regulators, accounting bodies and international organizations. It collates submissions on whether International Accounting Standards (IAS) should be accepted without reconciliation to US GAAP for foreign companies quoted on US stock exchanges, and whether IASs are "high quality". These submissions were made to the United States (US) Securities and Exchange Commission (SEC) by different interested parties from around the globe. This study evaluates the use of the phrase "high quality financial reporting" by these organizations.

Chapter 4 introduces Kenya and gives an overview of the political, legal, economic and financial systems in the country, with special reference to accounting by companies quoted on the Nairobi Stock Exchange. It states why this country has been chosen for this study. It shows why the accountancy profession is important to the economy of the country. The accountancy profession is described briefly. The regulatory system is explored. This chapter indicates the tensions in this developing country which could affect the applicability of disclosure theories.

Chapter 5 presents the research methodology and methods employed in this study. Procedures to obtain the primary sources of data are described briefly. Research instruments and procedures are explained. These include the creation of the IFRS disclosure checklist; the method of application of the IFRS and the S&P disclosure checklists; the logic underlying the Financial Reporting (FiRe) Excellence 2003 Award.

The interview structure and process are explained. The econometrics used in testing the hypotheses formulated are outlined.

Chapter 6 reports on the formulation of testable hypotheses. Expectations on the associations among the various dependent and independent variables are presented.

Chapter 7 presents the results of the measurement process for compliance with International Financial Reporting Standards and for the Standard & Poor's Survey Methodology. FiRe Award scores are also reported. Comparisons are made between the different measures used to measure high quality disclosure. Also presented are the results of the measurement process for compliance with IFRSs for interim financial reports. Conclusions are drawn.

Chapter 8 presents the results of univariate and multivariate regression analysis and provides interpretation and analysis. Associations are reported for all three measures of high quality disclosure in the annual reports of companies and for compliance with IFRS for interim reports.

Chapter 9 reports the perceptions of preparers (financial controllers), auditors, regulators and analysts on "high quality financial reporting" by companies quoted on the Nairobi Stock Exchange. The results of the measurement processes as they are explained by the regression analyses are compared to those obtained from the interview research. Insights are arrived at and a better understanding of the applicability of theories to accounting in an emerging capital market is achieved.

Chapter 10 summarizes the objectives, the research questions and the research methods. The main research findings are reported. A more definitive definition of high quality disclosure is given. The main implications, contributions and limitations of the study are presented. Finally, suggestions for further research are discussed.

CHAPTER 2
Review of the literature

2.1 Introduction

This chapter responds to the first sub-objective ($\mathbf{GO_1}$, section 1.3) of this study: to contribute to an understanding of the meaning of the phrase "high quality financial reporting", to clarify the distinction between "high quality disclosure" and "high quality measurement" in financial reporting, and to develop a tentative operational definition of "high quality disclosure" for this study.

The phrases "high quality disclosure", "high quality measurement" and "high quality financial reporting" are not used extensively in academic accounting literature but are often substituted by the terms "quality disclosure", "quality earnings" and "quality financial reporting". The review of the literature will focus on all of these phrases.

An initial point to clarify is that "quality financial reporting" and "the quality of financial reporting" are different concepts. While "the quality of financial reporting" can vary along a continuum from "low or poor" to "high or excellent" (Wallace, Naser and Mora 1994, p.43), "quality financial reporting" refers to financial reporting which is at the "excellent" end of this continuum (Francis 2004). If a study of "the quality" of some aspect of financial reporting finds that this aspect is "excellent", this aspect contributes to the financial reporting being "high quality"; the financial reporting is "high quality" on the assumption that all the other aspects, in addition to the aspect being considered, of the financial reporting are high quality. If the "quality of financial reporting" is represented in a study by a single proxy, it is doubtful that the "quality of financial reporting" can be proved to be high on the basis of the single proxy being "excellent".

This chapter is arranged as follows. Section 2.2 sets the scene. Section 2.3 briefly examines why financial reporting quality is important. Section 2.4 reports on studies that have examined the quality of disclosure. Theories of disclosure are summarized in section 2.5. Section 2.6 reports a brief review of the earnings quality literature. Section 2.7 presents an evaluation of the quality of disclosure literature. Section 2.8 presents a tentative definition of high quality disclosure and concludes the chapter.

2.2 Setting the scene

2.2.1 The occurrence of the word "quality" in the literature

In order to trace the use of the word "quality" in the accounting literature, I carried out an electronic search in *The Accounting Review*. 260 articles were selected, the earliest

Table 2-1: Earliest references to "quality" aspects of accounting in "*The Accounting Review*"

Issue	Author	Topic	Remarks
1938 Mar Vol. 13, No. 1.	Hosmer, W. A.	Judgement.	"The accuracy with which income is measured is determined by the *quality* of judgment and the nature of the accounting principles applied in the solution of these problems".
1942 Oct. Vol. 17, No. 4.	Tannery, F. F.	Auditing	"In *quality* and extent, municipal independent auditing has not equalled auditing in the fields of business".
1968 Jul Vol. 43, No. 3.	O'Donnell, J. L.	Earnings	"The statistical evidence gave strong support to the view that investors regarded flow-through earnings as being of substantially lower *quality* than normalized earnings".
1970 Jul Vol.45, No. 3.	Barefield, R. M.	Forecasts	"...the model provides a link between a fore-caster's biasing behavior and the *quality* of his forecast as an input to an accounting system".
1971 Jan Vol. 46, No. 1.	Singhvi, S. S. & Desai, H. B.	Disclosure, Investment Decisions	"The *quality* of corporate disclosure influences to a great extent the *quality* of investment decisions made by investors".
1972 Jul Vol.47, No. 3.	Moore, M. L. & Buzby, S.	Disclosure	"... they prefer to conclude that their study empirically demonstrates that the *quality* of disclosure is associated with the six characteristics".

being the first article in the first issue of the journal. An electronic word-search of the early editions of the journal is not possible. Each article had to be read to locate the word "quality" and to find the way the word was used. A number of articles dealt with "quality" in relation to accountants' logic, to the importance of their good moral character, to services rendered by accountants, to the products produced by the organization for which they worked, and to the training and teaching of accountants. Although all of these factors contribute to the quality of financial reporting, limitations of time and space in this study precluded considering their effect on financial reporting. As a result, they were eliminated from further consideration.

The table above displays the earliest articles that appeared in *The Accounting Review* that dealt with "quality", used as "having excellence or superiority", when applied more directly to aspects of financial reporting. The search was extended to other recognised journals, listed in Appendix 2-2, that deal with accounting. This revealed that "quality" is used to denote a wide variety of subjects in the accounting literature. By far the largest proportion deals with excellence in auditing, used all over the world, from DeAngelo, L. (1981) to Rajendran and Devadasan (2005). "Quality" used in relation to auditing was beyond the scope of this study.

The second most popular topic to be described as "quality" is earnings, which is again used on a worldwide basis, from O'Donnell (1968) to Negakis (2005).

In the third place come both "quality disclosure" and "quality financial reporting". "Quality" has been used extensively in the US in relation to "disclosure", from Singhvi and Desai (1971) to Karamanou and Vafeas (2005), and to a much lesser extent in Europe (Hail 2002).

In Australian academic accounting journals, "quality" is seldom used and its use tends to be confined to describing auditing, information and standards. Chambers' (1965) and Dean's (2001, 2002, 2003) use of the word "quality" (2.4.8 below) in relation to accounting possibly exhaust its use in relation to the subject.

The occurrence of the word "quality" used to describe excellence in different areas of accounting is shown in Appendix 2-1.

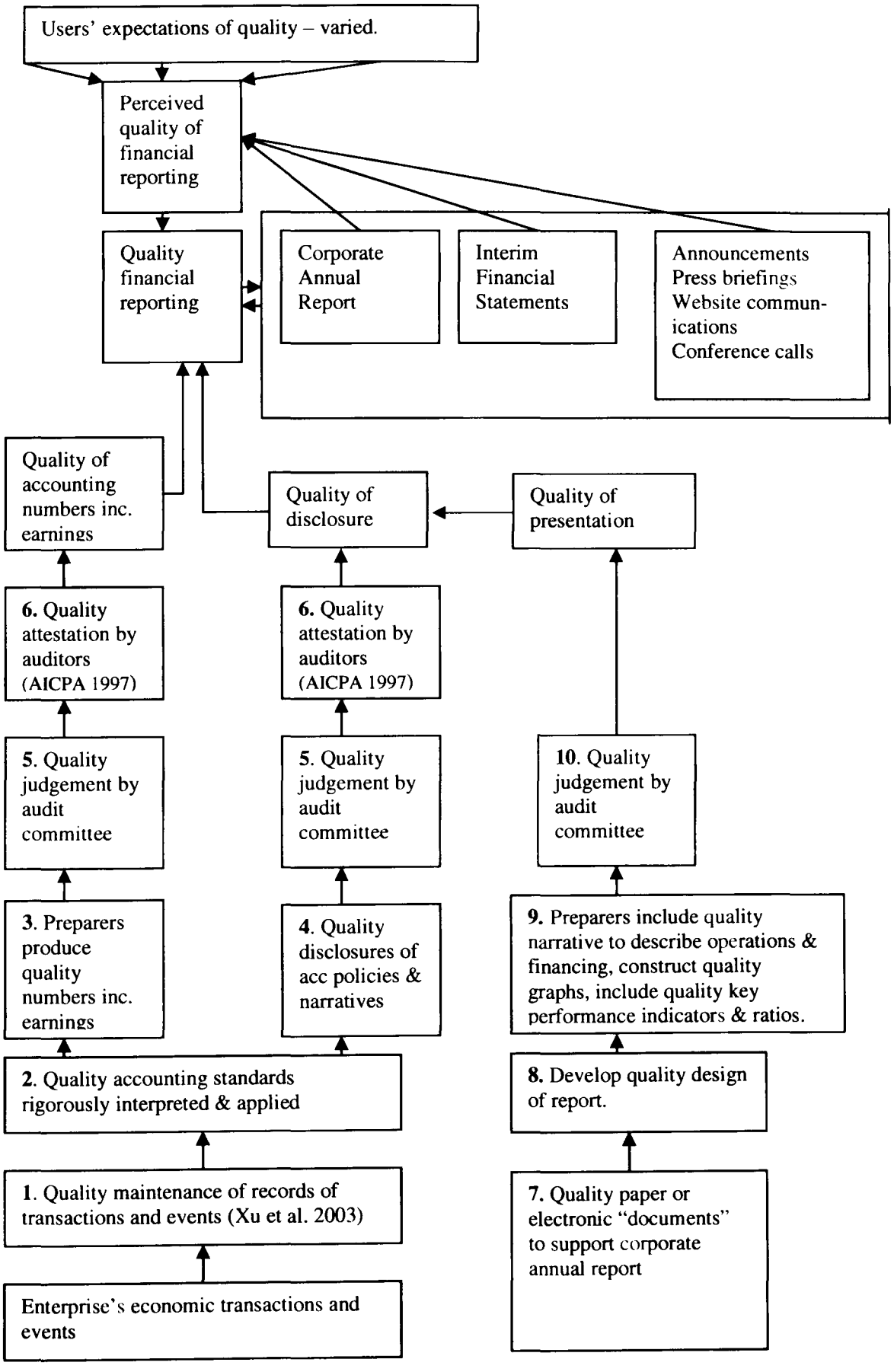
Since the aim of this part of this study is to contribute to an understanding of "high quality financial reporting", an overview of the process of producing "quality financial reports" is shown in Figure 2-1.

2.2.2 The elements necessary to achieve "high quality financial reporting".

Figure 2-1 is adapted from *Figure 1: Audit gaps* from Duff (2004) and *Figure 1: The Financial-Reporting Process* (Jonas and Blanchet 2000 – J&B). The purpose of this diagram is not to lay down all the areas of this study. Its purpose is to clarify the connections between "high quality financial reporting", "high quality disclosure" and "high quality earnings". Once these relationships have been made clear, it is easier to decide on the relevance of the literature to this study.

J&B stress that financial reporting is not only the output of a set of procedures, but the set of procedures themselves. The quality of the output depends on the quality of each step taken to produce it (George 2003). Ijiri (2003) notes that a financial report is "the tip of an iceberg which contains a huge collection of records based on double-entry book-keeping". In other words, it is not sufficient for a set of financial statements to comply with US GAAP or IFRS, because this compliance could be a veneer of "respectability" (Street and Needles 2002, p. 257) which actually hides the financial performance and position of the enterprise being reported upon. Each aspect of the whole reporting process is important in ensuring that financial reporting is high quality. Saudagaran (2004) emphasizes that high

Figure 2-1: Elements necessary to achieve "high quality financial reporting"



quality accounting systems produce comparable, reliable and relevant information for decision makers.

Ishikawa, one of the Japanese fathers of "Total Quality Control" and "Total Quality Management", states that "to practice quality control is to develop, design, produce and service a quality product which is most economical, most useful, and always satisfactory to the consumer" (Ishikawa 1985, p.44) - in summary "to control quality in its every manifestation is our basic approach" (ibid., p.45).In Figure 2-1, ten possible constituent elements of "high quality financial reporting" are enumerated. This numbering system is by no means unique and financial reporting could possibly be broken down into more elements, or in a different way.

In Figure 2-1, the preparation of the "accounting numbers" and the preparation of the quality disclosures of accounting policy and financial-statement narratives are shown as two separate procedures. Once both have been completed, the audit committee examines the composite product. This is numbered as a single operation in Figure 2.1. Similarly, the examination by the external auditors is numbered as a single operation The Elliot Committee in the US has pointed out that "(a)ssurance services are independent professional services that improve the quality of information, or its context, for decision makers" (AICPA 1997). Once the audit by external accountants has been completed, the final approval of the annual report by the audit committee of the Board of Directors is shown as a separate quality judgement, since the committee now examines more than what they examined earlier. The revised disclosures and numbers (revised by the auditors, if agreed to by the audit committee or the board), together with the other reports contained in the annual report, the lay-out and the presentation are all evaluated before the annual report is issued to its users. "Quality disclosure" thus has eight constituent elements (according to the break down in Figure 2-1 above): quality disclosure in the financial reports of the: (a) Box 4: (1) note of accounting policies; (2) notes to financial statements; (b) Box 7: (3) paper or electronic documents: (c) Box 8: (4) design; (d) Box 9: (5) narratives to describe operations and financing; (6) graphs; (7) key performance indicators; (8) ratios

"Quality earnings" encompasses the selection of the accounting policies and estimates, and their application to the numbers recording income, expenditure, assets and liabilities. "Quality disclosure" and "quality earnings" sometimes overlap, for example, as Jonas and Blanchet (2000) note, when core earnings are distinguished from non-core earnings, quality "numbers" are "disclosed" separately, and when peripheral financial items or business results are segregated from those integral to the business.

2.2.3 What is "quality"?

The *1999 Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (AICPA 1999) states that Generally Accepted Auditing Standards require a company's outside auditor to "discuss with the audit committee the auditor's judgements about the *quality*, not just the acceptability, of the company's accounting principles as applied in its financial reporting (emphasis added)". Jonas and Blanchet (2000 - J&B) were partners in one of the (then) Big 5 firms. They faced a practical problem: "What is meant by the quality of financial reporting?" The US Auditing Standards Board admitted that "objective criteria have not been developed to aid in the consistent evaluation of the quality of an entity's measurements and disclosures" (US ASB 1999). J&B were convinced that it was "both essential and possible to develop a common framework for assessing (the) quality of financial reporting". They proposed a framework that drew on the work done by many different individuals, committees and organizations in prior studies. But their "predominant consideration" was to align the framework so that users, "the customers of financial reporting", were catered for.

Emphasizing the consumer, Santema and Van De Rijt (2004) define the "quality" of an annual report as "how the annual report fulfils the expectations of the reader". Clarkson et al. (1999) test to ensure that there is a high correspondence between "disclosure quality" and the usefulness, to analysts, of the Management Discussion and Analysis (MD&A) section of the annual report. Crotty and Bonorchis (2005) reveal that some Johannesburg Stock Exchange listed companies cross-listed on the London or New York Stock Exchange have a superior "quality of disclosure" to others that are also cross-listed: South African analysts point out that those that have a greater exposure to non-South African shareholders, who tend to be more demanding, achieve a higher quality. Haniffa and Cooke (2002) state that companies are unlikely to provide "high-quality information" if the demand function does not exist. Crowther (1996) notes that the determination of the "quality" of something depends on the person evaluating the thing and the perspective of that person.

2.2.4 A possible framework to assess quality

J&B's "quality framework" was by no means a single construct. It was a multi-dimensional model which is shown in a simplified outline in Table 2-2: J&B claim that the component elements are "distinct yet interdependent".

Table 2-2: Jonas and Blanchet Model to Assess Quality of Financial Reporting

FASB & other characteristics	Focus of characteristic	Questions to assess the quality of the company's reporting.
1. Relevance/ Predictive Value/ Earnings Persistence	Distinction between components of earnings: unusual or non-recurring vs. those expected to persist in the future – can the investor evaluate the company's future prospects?	1.1 What elements of the financial statements' (FS) format, note disclosure, etc. & related disclosures, including MD&A (M), press releases, etc are useful? 1.2 Are unusual gains & losses given equal importance? 1.3 Was timing of transactions managed? 1.4 For what purpose? 1.5 Did timing affect predictive value of results?
2. Relevance/ Predictive Value/ Disaggregated Information	Segment info: can the user identify & assess the differing opportunities & risks in the company's various businesses?	2.1 What aspects of the disaggregated info communicate a sufficiently complete understanding of the various opportunities & risks? 2.2 Does the M & other reports complement the segment info? 2.3 Do examples complement different disclosures? 2.4 Does the segment info convey a real picture of underlying businesses?
3. Relevance/ Feedback Value	Does the info confirm or correct prior expectations, show effect of management's past actions on present results & position?	3.1 What specific disclosures in FS, M, press releases & other communications show info adequate to confirm previous expectations? 3.2 Do reported results & financial position provide feedback as to how market events & transactions affected the company? What illustrates this?
4. Relevance/ Timeliness	Would info have been more useful if it had been available earlier?	4.1 Does the co go beyond merely complying with regulator? How? 4.2 How does its timeliness compare with its competitors'? 4.3 What new ways of communicating info used (Internet)? 4.4 Are all users informed simultaneously?
5. Reliability/ Verifiability	Would a knowledgeable third party arrive at the same result?	5.1 What measurement areas are judgemental? Are users made aware? 5.2 What info in FS & M conveys estimates & assumptions? 5.3 If possible outcomes a range, is this revealed? How? 5.4 Does co use best info & reliable methods to assess estimates? 5.5 What thresholds used to decide on materiality? Are these thresholds communicated to all?
6. Reliability/ Completeness	Does the info tell the whole story?	6.1 Are all significant events of past year communicated in an even-handed way – do specific elements in FS & M show this? 6.2 Process followed to ensure picture fair & impartial? 6.3 Negative & positive events presented with balance?
7. Reliability/ Substance	Is the info an honest & clear portrayal of what happened?	7.1 Do acc. principles (ap) selected convey underlying economics? If ap changed, how were they assessed? 7.2 If complex transaction contracted, how does co assess whether ap sound & what is management's philosophy? 7.3 Does co enter transactions to achieve specified result? If so, is acc honest picture of substance & purpose? 7.4 If acc is not orthodox, is this explained?
8. Reliability/ Neutrality	Does info convey facts without intent to influence investor's opinion or behavior?	8.1 Were likely outcomes of 5.1 judgements assessed impartially? 8.2 Is co's acc for & disclosure of significant events & transactions neutral? 8.3 Was neutrality used in selecting management's acc policy in 7.1?
9. Comparability	Are similar/ (different) events & transactions acc for in the same/(different) ways?	9.1 How do co's acc policies, disclosures, format of FS, & other communications compare with competitors'? 9.2 In what specific respects (in this model) are they judged to be of better or worse quality? 9.3 Are acc policies in accord with GAAP & prevailing industry practice?

Characteristics	Focus	Questions to assess the quality of the reporting.
10. Consistency	Do FS conform from period to period with constant policies & procedures?	10.1 If there are any changes in acc policies, estimates & judgements, are these improvements (as per this model)? 10.2 Have these been disclosed properly? 10.3 Does any change help achieve a desired result?
11. Clarity	Is fin info presented in a clear, organized, concise way, balancing brevity with sufficiency?	11.1 Do disclosures go beyond absolute min GAAP? 11.2 Is info organized & easy to follow? 11.3 Is language easily understood by non-accountants? 11.4 Do simple, clear graphs & charts enhance understandability? 11.5 Are FS & other disclosures (eg.,MD&A) comprehensive, cohesive & coherent? Do they tell the whole story?

Source: Modified from Jonas & Blanchet (2000)

J&B wanted to air their model to "help everyone involved look beyond the requirements of compliance to the requirements and expectations of investors" (p. 358). But they have another aim.

2.2.5 A common understanding about "quality"

J&B think it is crucial and feasible to build a model for assessing the quality of financial reporting. But why?

> *"A common framework would promote a common vocabulary and understanding about quality among audit committee members, management, and auditors. It would, over time, promote benchmarks among companies and encourage improvements in reporting by setting a high standard. Our framework is an attempt to generate the level of discussion and debate needed to develop a framework that is generally accepted among auditors, audit committees, and boards" (p 358).*

But if J&B wished to develop this framework for practitioners, why did they not approach FASB, the AICPA, the US ASB or the SEC. There is, in my view, another reason for their publishing their views in *Accounting Horizons*.

In an earlier paper, Jonas and Young (fellow partners in a Big 5 audit firm) (1998 – J&Y) had lamented that the accounting standard setting process was suffering from a systemic problem. There was insufficient user focus. The Jenkins Report (AICPA 1994) had stated that this was a problem – few users respond to exposure drafts (ICPAK found the same when it was formulating Kenyan Accounting Standards; it is experienced in other countries, see Sutton, T. 1984, Tutticci et al. 1994). But J&Y deal with the problem in more detail. J&Y state that the quality of a standard should be measured by the "decision usefulness of the information required by the standard". The keepers of the reporting model, the standard setters, must become experts in the "decision usefulness of information" – they

must adopt a user focus in their work. One key proposal was that the academic community should direct its research energies towards studying the information needs of users and the decision usefulness of information. They stress that academics could bridge the gap between users and standard setters. They believe that research would clearly show that "high quality standards" lower the average cost of capital.

However, Stiglitz (2001) points out that the preferred article in the economics research literature deals with a narrowly defined subject, making a single point. Leisenring and Johnson (1994) echo this for accounting research. Thus, it is difficult to find articles which carry the whole model forward, because it may be impossible to achieve this. Practitioners tend to be more interested in broader questions.

2.2.6 Bridging the standard setter/user gap

Perhaps Jonas and Young were unaware that standard setters have greater access to academic research than most practitioners and tend to see more of it on a day-to-day basis (Leisenring and Johnson 1994 – L&J). L&J disclose that FASB subscribes to virtually all the major academic research and professional journals and major newspapers that have a business, finance or accounting focus; they follow what is being presented at accounting conferences and ask for pertinent working papers. L&J distinguish "decision usefulness" from "decision making". They claim that "decision usefulness" is "the quintessential characteristic of accounting information" (in complete agreement with Jonas & Young).

FASB and IASB also examine the concept "high quality" - because it appears in the FASB Mission Statement and the International Accounting Standards Committee Foundation Constitution - and decide that "high quality" is not a qualitative characteristic of financial information, but the phrase "high quality" describes information that "meets the objectives and qualitative characteristics of financial reporting", "the overall goal to be aspired to" (FASB 2005a).

Leftwich (2004) complains that Barton and Waymire (2004) had used the phrase "market crash" 82 times in the conference version of their paper without defining the term. The US accounting profession had used the phrase "high quality financial reporting" for approximately eleven years without defining it.

2.3 Why is financial reporting quality important?

Herring and Santomero (1999) state that financial markets will provide better price signals and allocate resources more efficiently if participants have access to high quality information on a timely basis. Frost, Gordon and Pownall (2005) find that "financial

reporting and disclosure quality" is positively associated with emerging market companies' access to global capital markets: and is associated with greater market liquidity and lower cost of capital, for single country settings and also from limited multiple country studies. Healy and Palepu (2001) ask what type of accounting standards produce "high quality financial reports"? Barth et al. (2005) find that IAS adopting companies evidence higher accounting quality after adoption than before, suggesting that IAS adoption is associated with an improvement in accounting quality and may enjoy a lower cost of capital. Miller and Bahnson (2002) argue repeatedly that "quality financial reporting will reduce uncertainty and the cost of capital, thus bringing about an increase in the economic profit".

2.4 Studies that examine the quality of disclosure

Disclosure quality is studied in a variety of ways, frequently by using a disclosure index. A number of studies use financial analyst generated indices; others use researcher-generated ones.

2.4.1 US studies that use the AIMR ratings

A number of US studies have used financial analysts' evaluations of corporate "disclosure quality" of a fairly stable set of 400-500 companies. Their "disclosure quality" scores were contained in the *Association for Investment Management and Research (AIMR) Corporate Information Committee Reports* (unfortunately, this annual process was discontinued in 1997). Subcommittees of, on average, 13 leading analysts specializing in a particular industry assess disclosure in the annual and quarterly reports, proxy statements, other published information such as press releases and fact books, and direct disclosures to the analysts in the form of meetings and responses to analysts' enquiries. The timeliness, detail and clarity of information are weighed up, and a percentage score is assigned to each company on its total disclosure efforts, with separate scores for different disclosure categories – such as annual reports (where both voluntary and mandatory disclosures are measured), quarterly reports, other public releases and discussions with financial analysts. The AIMR provides a detailed checklist of criteria to be used for scoring disclosure and guidelines for the weights to be used for the different disclosure categories. Each committee member assesses all the companies selected within that industry. The committee meets to total the scores of all the members of the committee. The average is

the final score for each company (Lang and Lundholm 1993, 1996; Healy, Hutton and Palepu 1999; Ettredge et al. 2002; Dunn and Mayhew 2004).

Healy, Hutton and Palepu (1999 - HHP) claim that one important advantage of the AIMR ratings is that they provided a comprehensive measure of disclosure, reflecting the "quality" of both formal disclosures (e.g., annual reports) and informal disclosures (e.g., management communications at analyst meetings). They assert that researchers would find it difficult to incorporate informal disclosures in self-constructed ratings and would not have the expertise and experience of top financial analysts. HHP point out that the *AIMR Reports* focus on companies with "high-quality and improving disclosure practices". Lang (1999) discusses HHP's (1999) findings but makes no reference whatsoever to their use of the term "quality". Bushee (2004) states that AIMR scores show much more variation for US companies than the Center for International Financial Analysis and Research (CIFAR) or the Standard and Poor's Transparency and Disclosure index, consistent with AIMR's aim of assessing "quality" in addition to "quantity of disclosures".

One group of researchers refers to the scores as measures of "disclosure quality":

(i) Sengupta (1998) finds that companies with "high disclosure quality" enjoy lower effective interest costs when issuing loan capital;

(ii) Mazumdar and Sengupta (2005) find a statistically significant negative association between "high quality overall disclosure" and the loan spread that companies are charged by banks on private loans (with voluntary disclosure quality contained in the annual report having the strongest negative relationship with loan spreads);

(iii) Dunn and Mayhew (2004) find an association between audit firm specialization and "disclosure quality" for companies in unregulated industries but not for companies in regulated ones; they conclude that the choice of an industry-specialist auditor is a signal of enhanced "disclosure quality";

(iv) Healy, Hutton and Palepu (1999) show that disclosure rating increases are accompanied by increases in sample companies' share returns, institutional ownership, analysts' following and share liquidity but warn that the AIMR Reports focus on companies with "high-quality and improving disclosure practices" and therefore companies with decreasing disclosure quality will likely not be represented;

(v) Ashbaugh et al. (1999) use AIMR Reports to locate companies that place a premium on "high-quality external reporting" and find that 70% of the companies in their sample practise Internet Financial Reporting (IFR); studying these companies' websites, they find a substantial variation in the "quality" of companies' IFR practices which they claim is consistent with "other assessments of (companies') financial reporting qualities"; they give a detailed example of what they regard as "high-quality" IFR;

(vi) Ettredge, Richardson and Scholz (2002) find that companies with "higher quality disclosure" in their traditional reporting media tend to disclose more on their websites, and deduce that AIMR analyst ratings can therefore be viewed as a measure of overall company "disclosure quality".

A number of researchers use the AIMR "disclosure scores" and refer to them merely as disclosure scores (Lang and Lundholm 1993), comprehensive measures of the informativeness of companies' disclosure policy (Lang and Lundholm 1996), or simply as disclosure policy (Welker 1995).

Mercer (2005) cautions against using AIMR scores as measures of disclosure quality. The scores are arrived at a significant time after the companies' disclosure decisions and, on the basis of her findings, reflect companies' recent financial *performance* rather than disclosure quality (emphasis added).

2.4.2 International studies that use the CIFAR index

Hope (2003a) uses the phrase "the extent of annual report disclosure", measured by the Center for International Financial Analysis and Research (CIFAR) total disclosure scores, when he finds that analysts' forecast accuracy is positively related to company disclosure and strong enforcement of accounting standards. He agrees with Kothari's (2000) view that "the quality of financial information" is a function of both "the quality of accounting standards" and the regulatory enforcement of those standards – without enforcement, even the best accounting standards are of no consequence and remain requirements only on paper. Reviewing Hope (2003a), Pope (2003) notes that the disclosure index captures variations in disclosure levels; it measures the "size" of annual report disclosures, a dimension which determines the "richness" of the earnings forecast information environment. Pope stresses that the index does not directly measure the "quality" or relevance of disclosures for informing earnings forecasts, and states that Hope, "well aware of this issue", studiously

avoids the phrase "disclosure quality" – because some of the CIFAR disclosure items may be irrelevant for forecasting earnings. Both Hope (2003b and 2003c) also use the CIFAR index. Hope (2003b) notes that CIFAR had measured the "extensiveness of disclosure" using an index of 20 items: he states that this is standard in the disclosure literature but points out that "disclosure quality" is "also" important but difficult to assess, as stated by Botosan (1997), who goes on to say that researchers tend to assume that the "quantity" and the "quality" of disclosure are positively related. Hope (2003c) reiterates that disclosure indices measure the extent but "not necessarily the quality of disclosure". But he quotes Marston and Shrives (1991), who, he claims, point out that a disclosure index which satisfies the requirements of reliability and validity, is useful also for measuring "disclosure quality". However, it is impossible to find this assertion in Marston and Shrives (1991) – they state that an index score gives a measure of the "extent of disclosure" but not necessarily its "quality". Bushman and Smith (2001, p.312) propose that the CIFAR index is an "obvious candidate for the quality of the financial accounting regime".

2.4.3 International studies that use the Standard and Poor's index

Khanna, Palepu and Srinivasan (2004 - KPS) use Standard and Poor's (S&P) Transparency and Disclosure scores applied internationally as an index of convergence to US disclosure practices, rather than an absolute measure of disclosure level. Bushee (2004), discussing KPS, questions this: these companies may adopt global best practices that are highly correlated with US practices; furthermore, Bushee finds that no US company earns the maximum S&P score possible. He concludes that the S&P measure includes some voluntary disclosures that are universally absent from US companies' reporting, suggesting that US practices are not necessarily the best possible. KPS make the point that the scores measure whether a particular financial statement item or governance mechanism is disclosed rather than evaluating the "quality" of the disclosure itself. But they add that the financial transparency and disclosure category includes information on the "quality of accounting standards" used by the company – that is whether US GAAP or IAS are used or not. Bushee (2004) suggests that the study's results about the desirability or the status of convergence in domestic governance systems are limited because KPS do not separately examine mandatory disclosure regimes.

Frost, Gordon and Pownall (2005 - FGP) examine "access to capital" by Latin American and Asian companies using five proxies for "financial reporting and disclosure quality":

(i) the financial transparency and information disclosure component of Standard and Poor's Transparency and Disclosure index (5 of the 35 items in this disclosure index ask whether IAS or US GAAP are used);

(ii) accounting principles used in the annual report (national GAAP, IAS, reconciliations to US GAAP, and US GAAP);

(iii) the auditor (global versus domestic);

(iv) whether the annual report is available in English;

(v) a categorical variable representing the extent of information on the company's website, from 0 (no company website) to 8 (conference calls are provided on the website).

Healy, Hutton and Palepu (1999) perform a comprehensive examination of the "quality" of their disclosure proxy (they use increases in analysts' ratings in the *AIMR CIC Report* as a proxy for improved company disclosure). Bushee (2004) notes that KPS have difficulty identifying suitable proxies in their study. Are FGP's proxies for financial reporting quality "high quality", especially when the scoring system is examined in more detail (see below)? Have they examined endogeneity thoroughly enough in their model construction? FGP claim that their "analysis uses a comprehensive set of financial reporting and disclosure measures ... (that) offers the important advantage of providing evidence on both strictly voluntary disclosure ... and financial reporting and disclosure in annual reports". They claim further that using five proxies enables them to address the incremental role played by different elements of financial reporting and disclosure quality. They find that global equity offering and listing activity (proxied by a polychotomous variable where 5 represents the company has made a public offering in the US, 4 it is listed in the US, 3 it has made a private US placement, 2 its ADRs are traded OTC in the US, 1 a public offering or listed on the London Stock Exchange and 0 it is not listed in the US or London) is positively correlated with website information dissemination, S&P T&D ranks, accounting standards and whether an English annual report is available.

A closer examination of their model would seem to indicate that FGP have pre-arranged that the model produces the result they seek, possibly quite unintentionally.

If a company is listed in the US (dependent variable value 2 to 5), there is a higher likelihood of the company using US GAAP (score 4) – if not it *must* have a 20-F reconciliation to US GAAP (score 3); if the company is listed in London (dependent variable 1), it is likely to use IAS since this is acceptable without reconciliation there (score 2); if it is not listed abroad (dependent variable 0), it is likely not to use any foreign GAAP (score 0). This is irrespective of whether the company's financial reporting is "high quality" or not. Khanna, Palepu and Srinivasan (2004, p. 479) state that we can expect companies that list in the US to be more likely to adopt US disclosure practices (and hence US GAAP) than those that do not. If a company is listed in the US or the UK (dependent variable 1 to 5), its annual report *must* (emphasis added) be translated into English (score 1); if it is not listed in the US or London (dependent variable 0), its annual report need not be translated (score 0) and probably will not be translated (Parker 2001, p.144). Again, this relationship occurs irrespective of the quality of the financial reporting.

If a company is listed in the US or the UK (dependent variable 1 to 5), it is more likely to have a website (scores 1 to 8); if the company is not listed abroad (dependent variable 0), it is less likely to have a website (score 0). The "quality" of financial reporting of the company is again irrelevant.

It is perhaps fortunate for FGP (in that it lends credibility to their model) that a foreign listing (dependent variable 1 to 5) is not associated with a Big five auditor (score 1), and that no foreign listing (dependent variable 0) is not associated with a local auditor (score 0) – it would again seem to be reasonable that they *should* be associated, irrespective of the "quality" of the financial reporting. However, although Street and Gray (2002) find that compliance with IAS is associated with being audited by a Big 5 + 2 (AA, D&T, E&Y, KPMG, PWC: BDO & Grant Thornton) audit firm, Street and Bryant (2000) point out that Muis (Vice President and Controller of the World Bank) states that the World Bank has asked the (then) Big 5, in the interest of their "quality brand naming", to ensure that they do not confuse investors by allowing their names to be associated with financial statements which are far below international standards.

FGP conclude that "financial reporting and disclosure quality" remains low in emerging markets because "the median Latin American sample firm does not provide financial statements on its website, and only rarely do sample firms provide US or International GAAP financial statement data". Later in their study, they conclude that

"these companies exhibit surprisingly low financial reporting and disclosure quality, considering their size and importance". Chan and Seow (1996) find that earnings prepared under companies' home-country GAAP are value relevant to US investors and that they are even more value-relevant than US GAAP-based accounting information. Admittedly this finding is for companies incorporated outside the US which have a US listing, and which therefore may have a higher level of disclosure than companies which do not have a US listing (Choi 1973). Leftwich (2004) states that terms used in a scientific study have specific meanings and can have strong persuasive effects if used indiscriminately. Users of the FGP paper are likely to repeat their finding without further thought. Dean and Clarke (2004) make the point that if something is said often enough it becomes accepted as if it were true.

But what if the company does not have a website or does not have financial reports available on the website? Debreceny and Rahman (2005) study a disclosure system pioneered in Australia in 1994 (Brown and Howieson 1998), continuous disclosure data, over a 15 month period for 334 companies in eight countries which have continuous disclosure reporting regimes (the UK, France, Germany, Denmark, Norway, Finland, Singapore and Hong Kong). They source their data from *stock exchange* websites, which are widely accessible to investors. They point out that the distribution of information on individual company websites makes it difficult for regulators to scrutinize, and for market participants to monitor, disclosures and to evaluate the relative importance of a vast number of disclosures. Hence, a stock exchange website is often more important than an individual company one, although Debreceny and Rahman (2005) claim that the Internet is rapidly becoming the most important information source for investors, especially to provide "good quality information" in continuous disclosure. Chang and Most (1985), Vergoossen (1993), and AIMR (2000) find that, both in the US and elsewhere, the annual report is a vital, but not a sufficient, source of information to analysts, the most important users of financial reports (Schipper 1991). In addition, the proxy statement in the US, which conveys a substantial amount of non-financial information, is still a paper based document. The SEC proposed as late as at the end of November 2005 to introduce the possibility of an electronic proxy statement (SEC 2005b). So it could probably be concluded that having a web presence is a poor proxy for "high quality financial reporting" in an emerging market – although this may soon change.

Moreover, Hope (2003a) – an international study - finds that annual reports play a greater role in the communication process for companies followed by few analysts, which is likely to be the case in emerging markets, such as South America and Asia. Taylor (1998), studying demand among investors for possible sources of information about companies, ranked the internet at 13th place out of 26 possible. Beattie and Pratt (2003) reveal that in a major telephone survey of 1,000 users in the UK for ProShare (1999), only 16% used the Internet as an information source when buying shares. Oyelere et al. (2003) make the point that users may not regard Internet reporting as an acceptable substitute for print-based annual reports. Jones and Xiao (2004) find that UK companies will probably continue to send out printed annual reports to shareholders in 2010, because even in the UK, access to the Internet will not be universal, but also because the hard copy is easier to read. The use of websites to communicate company information is important in countries with mature securities markets (Lymer and Debreceny 2003). Marston (2003) finds that the majority of large Japanese companies have an English language Website with full annual reports. But on the basis on this finding she does not extrapolate that Japanese companies' reporting is "high quality". She admits that Japanese companies that publish their financial statements in Japanese were not given credit for it in her study, while pointing out that English is the international language of business. 34 out of the 99 Japanese companies in Marston's (2003) study were listed either in the US or the UK; 65 were not, and therefore probably did not "provide US or International GAAP financial statement data". Would this single fact on its own imply that "financial reporting and disclosure quality" in Japan is low? Marston and Polei (2004 – M&P) note that disclosure has two dimensions, the amount of information and the presentation of the information. They go on to state that "the presentation dimension is important because it can *improve* the timeliness and verifiability of information and thus the quality of disclosure" (emphasis added). M&P report that Gowthorpe and Amat (1999) find that only 9% of Spanish quoted companies provide some form of financial reporting on their Websites in 1998 and conclude that there are significant differences in the use of the Internet for financial disclosure across countries. Clearly, no one can dispute the logic of these conclusions.

2.4.4 Other international studies

Recent cross-country research suggests that countries with stronger regulations to protect minority shareholders' rights, including mandatory financial reporting, have more

liquid stock markets, more effective corporate governance and superior economic performance (La Porta et al., 2000; Bushman and Smith, 2001). Barton and Waymire (2004) point out that these studies do not examine directly the extent to which beneficial investor protection can result from market forces that evolve over time in advanced market economies. Hence, a statistical association between financial reporting "quality" and investor protection in a cross-country study could be observed if regulators promulgate new reporting rules to solve inefficiencies in the market for information or write new rules that simply codify existing efficient practices that emerge as market arrangements evolve (Watts and Zimmerman 1983). In both cases, there would be a positive association between the "quality" of financial reporting and investor protection, and inferring causality from such an association would be difficult (Sloan 2001).

Mitton (2002) uses an external audit by a (then) Big 6 auditor and a US ADR listing as two company-specific proxies for accounting "quality"; he finds a positive relation between "reporting quality" and returns on companies' shares during the 1997-1998 East Asian crisis, contrary to Johnson, S. et al. (2000) finding no relation.

2.4.5 Quality mandatory disclosure

Arnold and Matthews (2002 - A&M) perform an empirical study of "disclosure levels and quality" of annual reports for the years 1920, 1935 and 1950 of a sample of companies quoted on the London Stock Exchange. They do not define the term "quality" but they note that the UK Companies Act in 1948 was a "substantial piece of legislation" that made major alterations to the financial reporting practices and disclosures of limited companies. Edwards (1989, pp. 127-129) has argued that criticisms evoked by the Royal Mail Case of 1931 (*Rex v Kylsant and another*) had a greater impact than all previous legislation on "the quality of published data" but A&M, examining the terminology used and the details of items presented in the profit and loss account and the balance sheet, find that most of the substantial increase in disclosure levels that took place between 1920 and 1950 did so in the second half of the period, probably due to the 1948 Companies Act.

Owusu-Ansah and Yeoh (2005) note concerns about the "quality" of accounting information in New Zealand due to lax enforcement mechanisms and find that the enforcement regime introduced by the Financial Reporting Act of 1993 appears to cause an improvement in corporate disclosure compliance levels.

Ali, Ahmed and Henry (2004) state that emerging countries looking to raise funds from overseas have been under pressure "to improve the quality of corporate financial reporting". Their study focuses on compliance with 14 national accounting standards (in reality almost photocopies of IAS) in India, Pakistan and Bangladesh to inform investors about "the quality of reporting by companies in these countries". They use a "total compliance index", a disclosure index of 131 mandatory items, to measure compliance. One point of note is that they find high disclosure compliance levels for items which are required to be disclosed by the Companies Acts of the countries, in addition to IAS. The Companies Acts are based on the 1908 UK Companies Act, but they have been modified over time. Abayo et al. (1993) use 88 equally weighted items to measure "the quality of mandatory disclosure" by companies in Tanzania. Owusu-Ansah (1998) studies the adequacy of mandatory disclosure in Zimbabwe and makes a passing reference to the fact that adequate disclosure is "a function of the quantity and quality of information disclosed".

Wallace (1988) states that a study of the financial statements may provide more meaningful information about the "quality" of financial reporting in a country than the study of selected items of information. The main conclusion of Wallace's (1988) study is that "there are a number of areas where preparers and regulators can improve the quality of their disclosure in annual reports".

Wallace, Naser and Mora (1994) claim that the "quality of disclosure" in corporate annual reports has been represented in the literature by several constructs. The first they list is adequacy in Buzby (1974). However, Buzby (1974) assiduously avoids any mention of the phrase "quality of disclosure". Wallace and Naser (1995, p.316) equate the "quality of disclosure" with the "extent of disclosure" in annual reports. They point out that index disclosure methodology has been used to evaluate the "quality of corporate interim reporting" in the US (Leftwich et al. 1981), although this phrase is never mentioned in the original article. But then they think twice and point out that "financial disclosure" is an abstract concept that cannot be measured directly because it does not possess inherent characteristics by which its "quality" can be measured (p.326). They again do an about-turn, and claim that the literature shows that the "quality of disclosure" can be measured to determine whether the information in annual reports has one of a number of qualitative characteristics, each of which is a proxy for disclosure. Each of these characteristics is a

separate construct and each refers to "a standard of disclosure excellence" which can be measured along a continuum from poor to excellent. They mention the problem of associating higher quality of disclosure with a greater quantity of detail – that at some point, information overload occurs, at which point, more detail leads to lower quality disclosure. They then select 30 mandatory items disclosed by all the companies quoted on the Hong Kong Stock Exchange in their sample, and score comprehensiveness of disclosure by examining the details given for each of the 30 items. They suggest that future research on "disclosure quality" should endeavour to use financial analysts' evaluation rather than researcher-generated scores.

Givoly et al. (1978) and Alford and Edmonds (1981) examine the quality of US interim financial reporting and suggest that the failure to find improved quality of reporting with increased auditor involvement may result from an inability to measure quality.

2.4.6 Quality voluntary disclosure

Bushee (2004) makes the point that researcher constructed disclosure indices allow the author to choose the exact items, the weighting of the items, and the companies to tailor the index to the research question (Botosan 1997; Guo, Lev and Zhou 2004). He suggests that because the Botosan scores show significant variability for US companies, this checklist (and ones similar to it) can be used to measure "quality differences".

A number of earlier researchers make no distinction between the extent of disclosure and the quality of disclosure, and use disclosure indices to measure either construct. They use "extent" and "quality" interchangeably (e.g., Singhvi and Desai 1971, 1972; Moore and Buzby 1972; Barrett 1976), or they use the phrase "the extent (or quantity) and quality of disclosure" to mean some intuitive but undefined construct (e.g., Dhaliwal et al. 1979; Firth 1980). Choi (1973), Stanga (1976), Belkaoui & Kahl (1978), Chow & Wong-Boren (1987), Mak (1991) and Arya et al. (2005) use the phrase "the extent of voluntary financial disclosure", or a phrase close to it, but avoid reference to the "quality of disclosure". Dhaliwal, Spicer & Vickrey (1979) state that, whereas "a quantitative increase in disclosure does not imply that there has been an improvement in the quality of disclosure", for a diversified company, "both intuitive arguments and empirical evidence support the view that segmental disclosure adds materially to the overall quality of disclosure" (p.248). Emmanuel, Garrod and Frost (1989) speak of "the quality of disclosure" when they refer

to the "richness of the report (data)", meaning the completeness of the numerical data and the detailed qualitative data in segment reporting.

Nagy (2005) uses the phrase "Financial Reporting Quality" in the title to his article on audit quality, but makes only a passing reference to financial reporting. Mirshekary and Saudagaran (2005) point out that much research has been undertaken into the "quality of disclosure" in corporate annual reports in developed countries: they then investigate the perceptions of users of annual reports in Iran.

Coy et al. (1993) use Wiseman's (1982) and Giroux, G.'s (1989) system of using weights for different "qualities of disclosure" (1 for poor, 2 for satisfactory or 3 for excellent) and for the importance of each item (1 for low, 2 for medium or 3 for high); they compute a percentage score for each of 8 constituent statements in annual reports and an overall mean which gives equal standing to each statement, which they equate to an "overall quality of disclosure" of the report. Coy and Dixon (2004) develop this further to measure the "quality of annual reports" - the method is similar but disclosure is tested more comprehensively by using 58 information items as opposed to the 26 previously. Hooks, Coy and Davey (2002) use a similar index, but with weights allocated by stakeholders, to examine the extent and the "quality" of annual report disclosures among electricity companies in New Zealand.

Barton and Waymire (2004 – B&W) use a sample of 540 NYSE companies during the stock market "crash" of 1929, when financial disclosure in the US was voluntary, to show that managers have incentives to report "higher quality financial" information (economic forces in advanced markets give managers incentives to produce "higher quality financial reporting" without regulations) and that such reporting is beneficial to investors. They find that investors in companies which have "higher quality financial reporting" suffer smaller losses. B&W admit that "widely accepted definitions of financial reporting quality do not exist" and so they use disclosure scores to measure income statement transparency (coded 0 to 5 based on the count of separate disclosure of sales, cost of sales, depreciation expense, tax expense, other operating expenses), balance sheet transparency (coded 0 to 5 based on the count of separate disclosure of fixed assets, accumulated depreciation, intangibles, surplus, reserves), accounting conservatism (coded 1 if the company reported intangibles at a nominal amount, 0 otherwise) and the presence of an external audit (2 for a Big 9, 1 for any other, 0 for no auditor), and equate the index

to "financial reporting quality". They admit that their findings rely on proxies for unobservable constructs and that the period they examine is radically different to the present, and so it would be inappropriate to generalize their results to the present.

Discussing Barton and Waymire (2004), Leftwich (2004) agrees with their claim that "the 'quality' of accounting information is a nebulous term in the accounting literature". B&W have provided information about companies that voluntarily reported financial information, but the arguments that "high quality reporting" protected investors during the 1929 stock market price decline are less convincing.

Rennie and Emmanuel (1992 – R&E) compare the extent and "quality" of segmental disclosure by some of the largest companies quoted on the London Stock Exchange over a period before segmental disclosure became regulated by SSAP 25. In spite of Balakrishnan et al.'s (1990) finding that predictions of annual income and turnover improved when geographic segment data are provided, R&E find that the extent of disclosure declines and the "quality" improves or remains the same; for business activity, the amount of data remains unchanged but the "quality" improves. R&E determine "quality" by consulting the various parts of each company's annual report to gauge whether business activity and geographic market segments are consistently identified.

Watson, Shrives and Marston (2002) examine ratios provided voluntarily (they therefore omit the earnings per share number which is required by FRS 3) by a sample of the largest companies listed on the London Stock Exchange. They believe that the inclusion of ratios assists users to analyse the financial statements either by emphasizing information and drawing attention to it or providing additional information, thus improving the information communication process and the "quality" of the annual report.

2.4.7 Mixed mandatory and voluntary disclosure

Schleicher (1998) measures the "disclosure quality" of UK annual reports using a disclosure index of 404 equally-weighted mandatory and voluntary items, each of which is assigned to one of 12 sub-indices, which cover the entire report. He finds that "disclosure quality" between 1975 and 1996 increases in all areas except for "inflation accounting", the greatest increases being in corporate governance, the profit and loss account and the balance sheet (in that order). The Operating and Financial Review (OFR) and Operating and Financial Projections (OFP), both composed of voluntary items during the entire period, show small "quality improvements", which occur in 1993 and in 1996. Schleicher,

noting that the UK Accounting Standards Board issued its OFR Statement in July 1993, asks how this can be reconciled with information economics theory. He explains that information asymmetries apply in both directions. Finance directors need guidance on what information is decision-relevant before they are able to communicate insider information. This is in agreement with empirical results obtained by Forker (1992) who tests a model he develops using Verrecchia's (1990) definition of "disclosure quality" as "the distributional characteristic or variance of an uncertain event". Williamson (1985a, p.47) defines opportunism as providing "incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, obfuscate or otherwise confuse". Managers influence the uncertainty of shareholders' estimates of any given variable by varying the quality of the information disclosed in financial statements. Greater uncertainty reduces shareholders' ability to monitor the actions of management. For share options, for example, shareholders need to compare the costs of granting them to the actual and anticipated benefits (an improvement in share price performance) of granting them. Reducing the quality of information increases the scope for opportunistic behaviour – shareholders may have objected if clearer information had been given them. Forker integrates Williamson's (1985b) analysis of transaction costs with the positive theory of agency (Jensen and Meckling 1976): managers are assumed to balance their potential benefits from less disclosure (by reducing "the quality of information disclosed") against costs in the form of lower share prices and the increased threat of takeover to choose the "quality of disclosure" which minimises the costs they incur. Adopting internal control measures (e.g., audit committees, non-executive directors, the separation of the roles of the chairman and the chief executive) enhances "monitoring quality" and reduces benefits from withholding information: as a consequence, the "disclosure quality" of financial statements is improved. The findings of his empirical study are that administrative costs of disclosure and dominant personalities adversely affect "share option disclosure quality".

2.4.8 The Management Review or the MD&A

Clarkson et al. (1999) find that the "Management Discussion and Analysis of Financial Condition and Results of Operations" (MD&A) in annual reports of Toronto listed companies is part of a company's overall disclosure package, is a source of new and useful information, and is used by sell-side analysts, but that there is considerable variation in MD&A "disclosure quality". Clarkson et al. measure sell-side analysts' perceptions of

disclosure quality by getting them to allocate scores of between 0 and 2 to 30 items in the MD&A, but give the analysts no guidance as to how they should interpret "disclosure quality" – is that because they do not have a clear definition of the concept themselves or are they relying on the expertise of the analysts? It is difficult to conclude. Can they speak validly about a variation in "disclosure quality"? Again it is difficult to say. Are all 30 items applicable to all the companies? Is there any overlap in the 30 items? Could some of the items not apply in certain circumstances and yet apply in others? Furthermore, a number of researchers make the point that there is a distinction between analysts' perceptions of "disclosure quality" and the abstract construct of disclosure in the MD&A.

Barron, Kile and O'Keefe (1999) find that the type of information found in "high-quality MD&As" (this phrase is used repeatedly throughout their article) is of particular relevance to enabling analysts to forecast earnings with less error and less dispersion. The "quality" of the MD&A is proxied by the level of compliance with MD&A standards, as rated by the SEC, of a sample of US companies (the SEC concludes that no change is needed in the MD&A at the time but a higher level of compliance with existing MD&A requirements is needed – which indicates that some US listed companies fail to comply with mandated disclosures). The construct used by Barron et al. is quite different to that used by Clarkson et al. but in both cases there is considerable variation in "disclosure quality". "High quality MD&As" as measured by the SEC may not be "high quality" to analysts. But their finding does tend to show the relevance of the SEC's disclosure regulations for the MD&A.

Hussainey et al. (2003) use a new scoring system to show that one particular aspect of "the quality of (voluntary) disclosure" in the annual report OFR, forward-looking information on profits, helps the market to predict future earnings changes more accurately. They use the text analysis software program *Nudist* to search annual reports in electronic form, from which they have deleted financial statements, notes and standardized reports that serve a stewardship function. They admit that their methodology equates "disclosure quality" with the amount of information provided, because it counts the number of text units with forward looking themes.

Beattie et al. (2004) state that the crucial factor in achieving the desired improvement in the "quality of financial reporting worldwide" is annual report narrative communication. It is for this reason, they claim, that regulators are giving attention to the operating and

financial review (OFR) or, in the US and Canada, the MD&A. Could it be inferred that there is no problem with the reporting of earnings?

Perhaps a look at "earnings quality" would reveal that there are problems there too. Dean (2001) quotes Chambers' (1965) recommendation that an "improvement in the quality of published financial information" is needed to remove many of the uncertainties that plague securities markets. Dean (2002) states that concerns about the "quality of accounting" continue in Australia and around the world. He quotes Schuetze (2001), in which the former chief accountant of the US SEC states that "[c]orporations today continue to manipulate their earnings without objection from their external auditors. ...The SEC knows it is going on. ...The external auditors can't stop it. ...The SEC's Office of Chief Accountant and Division of Enforcement can't stop it because the accounting rules allow it". Revsine (2002) states that the largely arbitrary, contrived and flexible reporting rules that make up GAAP are not an accident: they are a deliberate consequence of the wishes of the various financial reporting parties. Dean (2002) points out that accounting practitioners claim there is no real evidence of any problem with "the quality of fundamental accounting and auditing practice". The problem lies with the expectations of users. Dean (2003) emphasizes that "specifying compulsory rules (standards)" poses a serious threat to accountants' claims to professional status; financial statements should show, in accord with an accountant's professional judgement, a true and fair view of a company's wealth and progress, so that "serviceability", which he equates to "fitness for use", is the primary "quality criterion", as it is in virtually every other field. It can be concluded that there is a problem even with the numbers in financial statements, not only with the narrative reporting.

2.5 Theories of disclosure

The main purpose of this study is not to examine disclosure in detail. Rather it accepts the main tenets of disclosure theories. This section outlines agency, signalling, political cost, legitimacy, stakeholder and institutional theory. Capital need theory will not be considered since no NSE company intended to raise capital at the time of this study (chapter 9, interviews with CFOs).

2.5.1 Agency theory

The amount of information transmitted in the reporting process is determined by regulation and by the forces of demand and supply. Accounting information is supplied by

management: its quantity and quality are determined by management to meet regulations, and to achieve perceived benefits, subject to the costs of doing so (Radebaugh and Gray 1997, p. 213). Demand is determined by users: FASB (1978) lists 27 classes of potential users, the principal ones being analysts, investors and creditors. They use the information provided to make rational investment, credit and similar decisions (FASB 1978, p. 5).

Agency arises when a principal contracts an agent to perform a service and gives the agent decision making authority (Jensen and Meckling 1976). An economics-based assumption (the "rational economic person assumption") of agency theory is that all action by individuals is motivated by self-interest: the main interest of individuals is to maximize their own wealth; loyalty, morality and similar notions are not incorporated in the theory (Deegan and Unerman 2006, p.207-224). Agency theory posits that because managers (agents) do not act in the best interests of shareholders (principals), but try to further their own interests, agency costs are incurred, such as: (i) monitoring costs to supervise managers; (ii) bonding costs to prevent managers from harming shareholders' interests; and (iii) the residual loss – the difference in wealth due to the actions not being carried out by the principals themselves. According to agency theory, the main purpose of financial reporting is to monitor the efficiency of managers; managers may use disclosure to try to convince shareholders they are acting optimally (Watson, Shrives and Marston 2002).

2.5.2 Signalling theory

Information asymmetry exists in capital markets because managers know more about the value of the company than investors. Investors will tend to undervalue high quality companies' shares and overvalue those of poor quality companies. High quality companies have an incentive to leave the market (Akerlof 1970), unless they can signal their companies' superior quality to investors, which must be confirmable after purchase, which impacts the perceived validity of the signal in the future (Morris 1987). A high quality company can give a costless signal, which attracts scrutiny by investors (investors bear the cost of separating high from low quality); the poor quality company will not mimic the high quality one because it will not gain from being discovered; but this works only if the benefits to scrutiny are high. A high quality company can also give a costly signal (the cost is borne by the company); the poor quality company will again not mimic, because the signal is costlier for the poor quality company (Bhattacharya and Dittmar 2003). Management will likely disclose "good news" to increase corporate value (Penman 1980;

Milgrom 1981) but even "bad news", since investors screen non-disclosers and may evaluate non-disclosure as an adverse signal (Milgrom 1981). This tends to result in full disclosure (Patell 1976; Trueman 1986). "Why does better disclosure increase management's credibility in the eyes of the market? A management team that has confidence in both its own abilities and its strategy will not shy away from telling the market its plans for the future and how well it is doing today" (Eccles et al. 2001, p.192).

2.5.3 Political cost theory

Watts and Zimmerman (1978, p.115) note that third parties sometimes use accounting information in a competitive attempt to re-distribute resources among themselves at the expense of companies. This redistribution may be brought about by regulation, eg., new taxes, price controls, government contracts, etc., and/or by lobbying, eg., union demands for higher wages, (in Kenya) persuading companies to "adopt" and financially assist schools and public works such as roundabouts, street lighting, etc. Any successful redistributions of resources away from companies are known as "political costs". Companies that are subject to high levels of public or government scrutiny are likely to suffer additional "political costs" if they operate in a manner that can be exploited by the public, (eg., the media run a campaign against the company for unjustified reasons, etc.) or by the government; Jensen and Meckling (1976) argue that politicians have incentives to create a "crisis" and offer "solutions" through simple legislative actions to maximize their votes. A company operating in a high political cost environment will have incentives to signal to those stakeholders the benefits of the company operating in the economy, its adherence to the laws of the country (especially those which are more visible, such as reporting to shareholders and to the public) and the credibility of its financial statements.

2.5.4 Legitimacy theory

Legitimacy theory states that organizations continually attempt to ensure that they are perceived as operating within the bounds and norms of their respective societies: they must appear to consider the rights of the public at large, not merely those of their investors (Deegan and Unerman 2006, p. 271). Shocker and Sethi (1974, p. 67) point out that "an institution must constantly meet the twin needs of legitimacy and relevance by demonstrating that society requires its services and that the groups benefiting from its rewards have society's approval". Dowling and Pfeffer (1975, p. 122) state that organizations will attempt to establish congruence between "the social values associated

with or implied by their activities and the norms of acceptable behaviour in the larger social system of which they are a part". Patten (1992, p. 475) argues that "it appears that at least for environmental disclosures, threats to a firm's legitimacy do entice the firm to include more social responsibility information in its annual report".

2.5.5 Stakeholder theory

Stakeholder theory posits that different stakeholder groups have different views about how an organization should conduct its affairs; the organization negotiates various "social contracts" with different stakeholder groups, rather than one contract with society in general (Deegan and Unerman 2006, p. 285). Gray, Owen and Adams (1996, p.45) state that "stakeholders are identified by the organization of concern by reference to the extent to which the organization believes the interplay with each group needs to be managed in order to further the interests of the organization. . . .The more important the stakeholder to the organization, the more effort will be exerted in managing the relationship. Information is a major element that can be employed by the organization to manage the stakeholder in order to gain their support and approval, or to distract their opposition and disapproval".

2.5.6 Institutional theory

Institutional theory posits that social culture and environment are important determinants of accounting; managers adopt accounting practices as rationalizations to maintain appearances of legitimacy; it is possible to decouple these rationalizing accounting practices from the actual technical and administrative processes (Dillard et al. 2004). Institutional theory provides a complementary perspective to both stakeholder theory and legitimacy theory (Deegan and Unerman 2006). There are two dimensions to institutional theory: the first is "isomorphism" – the adaptation of an institutional practice (eg., financial reporting) by an organization (Dillard et al. 2004). DiMaggio and Powell (1983) specify three types of isomorphic processes: firstly, coercive isomorphism: an organization changes only due to pressure from stakeholders; secondly, mimetic isomorphism: it seeks to emulate or improve upon the institutional practices of other organizations for reasons of competitive advantage in terms of legitimacy; thirdly, normative isomorphism: it adopts particular institutional practices due to pressures arising from group norms, eg., the professional expectation that accountants in the organization will ensure that the organization's financial statements (an institutional practice) comply with accounting standards. Another dimension of institutional theory is decoupling - when

managers perceive a need for their organization to be seen to adopt certain institutional practices and even institute formal processes to implement these practices, but actually carry out practices which are very different to the formally sanctioned and publicly announced processes and practices (Deegan and Unerman 2006).

2.6 Earnings quality

Leftwich (2004) is cautious in using the phrase "disclosure quality" but seems to be at ease using the phrase "earnings quality". This dichotomy may seem strange at this point; possibly there is an explanation, which will be investigated below.

In 1998, Levitt, the Chairman of the US SEC stated:

> *"In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation. . . As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. ... These practices aren't limited to smaller companies struggling to gain investor interest. It's also happening in companies whose products we know and admire"* (Levitt 1998).

Healy and Wahlen (1999) argue that if financial reports are to convey managers' information on the performance of their companies, accounting standards must allow managers to exercise judgement when preparing reports. But managers may be tempted to choose methods and estimates that do not portray their companies' real economics. About earnings manipulations, regulators are likely to want to know: (1) how big are they and how often are they used? (2) how are earnings manipulated? (3) why are they manipulated? (4) what are the economic consequences?

Dechow and Skinner (2000) argue that practitioners and regulators view earnings management as pervasive and problematic, but academic research has not demonstrated that earnings management is a real problem nor that it should concern investors. Academics often choose to study large samples of companies and use statistical methods which are not very powerful in identifying earnings management. These methods do not identify the companies that practise earnings management, whereas regulators observe actual cases of what they call earnings management.

2.6.1 High quality earnings.

Dechow and Schrand (2004, p. 5) define earnings to be of "high quality when the earnings number accurately annuitizes the intrinsic value of the firm". Bodie et al. (2002,

p. 628), Revsine et al. (1999, pp.224-225) and Penman (2001, p.623) state that earnings are "high quality" when they are sustainable. Richardson (2003), working on the basis that more persistent earnings are of "higher quality", points out that if current earnings are temporarily inflated by, for example, insufficient provisions for doubtful debts or for slow moving inventory, or by including future revenues in the current period, without the actual flow of cash being affected, the earnings are "low quality". In a very similar vein, Sloan (1996) defines "high-quality" earnings as earnings composed primarily of operating cash flows; "low-quality" earnings are those composed principally of accruals.

Dechow and Dichev (2002) define "earnings quality" in terms of the relation between accruals and cash flows. They note that accruals shift the recognition of cash flows over time so that earnings, which are adjusted numbers, better measure the performance of the company. If an assumption on which an accrual is made is wrong, future earnings must be corrected. They argue that estimation errors and their subsequent corrections are noise that reduces the beneficial role of accruals. Therefore, the "quality of accruals", and hence the "quality of earnings", decreases as accrual estimation errors increase in size. "Accrual quality" is measured by the extent to which working capital accruals map into operating cash flow realizations, where a poor match signifies "low accrual quality". Cohen, D. (2002) interprets the "quality" of reported earnings as the degree to which the accounting numbers arrived at using the company's accounting policies more accurately represent its underlying economic fundamentals and the extent to which they map into operating cash flow realizations: reported earnings of higher quality are defined as earnings that better predict future operating cash flows.

Palepu et al. (2000) note that estimation errors reduce "accounting quality"; estimation accuracy depends on company characteristics, such as the complexity of its transactions and the predictability of its environment. Myers, J. et al. (2003) point out that poor-quality earnings can mislead investors, resulting in a misallocation of resources.

2.6.2 The importance of earnings.

Research shows that the market pays a lot of attention to earnings. Graham et al. (2005) find that, for CFOs in the US, "earnings" is the key metric considered by investors. Dechow (1994), Dechow et al. (1998), Liu et al. (2002) find that "earnings" is a better measure of performance than the underlying cash flows. Healy and Wahlen (1999) state that this finding has been replicated over long periods of time and in many different

countries. Barth et al. (1999) find that companies that report continuous increases in annual earnings are priced at a premium to other companies, all other things being equal, and that this premium grows with the number of increases and diminishes when the increases stop. Skinner and Sloan (2002) demonstrate that growth companies that fail to meet earnings benchmarks (for example, analysts' projections) suffer large negative price reactions on the date earnings are announced. Dechow and Skinner (2000) conclude from the extreme reactions to simple benchmarks (e.g., analysts' earnings forecasts) that investors use simple heuristics to measure economic performance, implying that information processing costs are high, which is hard to reconcile with technology advances which should have lowered the cost of public information dissemination to investors. Bartov et al. (2002) discover that companies that meet or beat analyst expectations are expected to report superior future accounting performance.

2.6.3 Measuring earnings quality

Collins and DeAngelo (1990) state that earnings management reduces the "quality" or informativeness of reported earnings. If earnings management can be detected, it can be inferred that earnings quality is low. Healy and Wahlen (1999) reveal that the primary focus of earnings management research prior to their study had been on detecting whether and when earnings management takes place. They state that although popular wisdom claims that the practice takes place, it has been remarkably difficult for researchers to convincingly prove it. A major difficulty in doing this is to predict what the earnings would have been if they had not been managed.

Cohen, D. et al. (2004) report that earnings management behaviour in the US increased steadily from 1987 until the passage of the Sarbanes-Oxley Act in 2002; US companies reduced both the "quality of their accounting earnings" and the informativeness of earnings to the stock market. They also show that earnings management was greatest in poorly performing industries and in companies whose managers had large stock options. Lee and Mande (2003) find that corporate clients of Big 6 audit firms increased their abnormal accruals after 1995, which reduced their "earnings quality", after *The Private Securities Litigation Reform Act of 1995* was passed in the US. Francis (2004) concludes that both "earnings quality" and "audit quality" in the US have declined in the 1990s.

McNichols (2000) points out that there are three research designs commonly used in the earnings management literature: (1) aggregate accruals models: Healy (1985),

DeAngelo (1986), the Jones (1991) model; Dechow et al. (1995) develop the modified Jones model by adjusting revenue for changes in receivables in the event period; (2) specific accruals models, which focus on a specific industry and use facts about institutional arrangements to identify likely non-discretionary and discretionary accruals – McNichols and Wilson (1988) and Scholes et al. (1990) examined banking and Petroni (1992) property and casualty insurance; (3) the frequency distribution approach, based on the distribution of earnings after they have been managed, developed by Burgstahler and Dichev (1997) and Degeorge et al. (1999).

2.6.4 The Jones model and the modified Jones model

In Jones (1991), managers had no incentive to decrease reported earnings prior to the period of study but had a number of incentives to do so in the period under review, and were able to report increased earnings in the period after review. This identification of managers' reporting incentives is critical in research design (Healy and Wahlen 1999, McNichols 2000), but Dechow and Skinner (2000) claim that capital market incentives for earnings management have been ignored as a consequence, and that they need to be considered. Secondly, the effects of managers' use of accounting discretion in unexpected accruals or accounting method choice have to be measured, inevitably with some degree of error. To estimate unexplained accruals, many studies take total accruals (reported net income less cash flow from operations – Healy 1985, DeAngelo 1986) regressed on variables that are proxies for normal accruals (revenues or cash collected from customers) to allow for normal working capital needs (inventory, receivables and trade payables) and gross property, plant and equipment to allow for normal depreciation. Unexpected accruals are the residual components of total accruals. Jones (1991) used a regression approach to control for non-discretionary factors influencing accruals, specifying a linear relationship between total accruals and change in sales and property, plant and equipment. McNichols (2000) points out that whether accruals are linear in the change in sales in the absence of earnings management is an open question. In addition, 10 years of data are needed to estimate the relation between total accruals and explanatory factors; there is no assurance that companies have not managed their earnings during this period, if the data are available in the first place. If a cross-sectional estimation approach is used (obviating the need for a time-series for each company), the benchmark for each company's accruals is the behaviour of the other companies in the sample. Dechow et al. (1995) examine the accrual

behaviour of companies subject to SEC enforcement actions; they find that the accrual proxies they examine faithfully portray the situation. But Beneish (1997) finds that the modified Jones model does not perform well in identifying GAAP delinquents.

Using the Jones' (1991) model, Francis et al. (1999) show that US clients of Big 6 audit firms have lower abnormal accruals, and therefore higher "earnings quality". Teoh and Wong (1993) find that earnings surprises in US clients of Big 6 firms are valued more highly by the stock market - Big 6 clients have higher "earnings quality". Francis (2004) points out that there is a potential difficulty in deducing that (now) Big 4 audits are of higher quality. It may be that "good" companies, which are less likely to manage earnings (and therefore have "higher quality earnings"), are also more likely to choose Big 4 auditors. That is, it is not "high-quality" auditing that causes the "high quality earnings"; auditor choice could be endogenous. Francis (2004) expresses it by saying that "good firms with good earnings quality hire high-quality auditors" – possibly he meant "Big 4 auditors" or he could be using DeAngelo's (1981) finding that Big 4 auditors are "higher quality".

Frankel et al. (2002) report that companies which pay their auditors relatively more non-audit fees have larger abnormal accruals and are more likely to meet or beat analysts' forecast earnings, and thus have "lower earnings quality".

Johnson, V. et al. (2002) examine audit-firm tenure and "the quality of financial reports". They find lower reporting quality for short audit tenures. Ghosh and Moon (2005) use earnings response coefficients from returns-earnings regressions as a proxy for investor perceptions of earnings quality. They find a strong positive association between auditor tenure and "earnings quality". Myers, J. et al. (2003) find that longer audit tenure is associated with higher earnings quality, using absolute discretionary accruals and absolute current accruals to proxy for earnings quality. In general, these studies are important because they show that auditor tenure is a factor that influences the "quality of financial reporting".

2.6.5 The specific accruals model

McNichols and Wilson (1988), Moyer (1990), Petroni (1992), Beaver and McNichols (1998), Nelson (2000) and Petroni et al. (2000) all model a specific accrual which is sizable in the industry studied and which requires judgement. The behaviour of the specific accrual is modelled to identify its discretionary and non-discretionary components.

2.6.6 The frequency distribution approach

Burgstahler and Dichev (1997) and Degeorge et al. (1999) produce evidence that managers of companies in the US use accounting discretion to avoid reporting small losses or reporting decreases in earnings. Using annual earnings (scaled by commencing market value) for companies in the US for the years 1976-1994, Burgstahler and Dichev (1997) produce a relatively smooth single-peaked bell-shaped distribution except just below zero, where the frequency is much lower than would be expected from the remainder of the distribution, and just above zero, where the frequency is much higher than would be expected. The conclusion is that companies hide small losses but they are not able to hide large losses in the same way. Burgstahler (1997) finds the same pattern for quarterly earnings and Degeorge et al. (1999) do likewise for analysts' earnings forecasts. These studies do not have to estimate potentially noisy abnormal accruals and enable an estimate to be made of the pervasiveness of earnings management at the point where they occur. But also, they do not indicate the magnitude of earnings management nor the specific methods by which earnings are managed.

However, Durtschi and Easton (2005) show that while the frequency distribution of net income deflated by lagged market capitalization, total assets, sales revenue or number of employees shows the discontinuity mentioned above, the frequency distribution of reported earnings per share does not show a discontinuity at zero – they find that the number of companies reporting a one cent per share loss is greater than the number reporting a one cent per share profit, with a peak in the frequency distribution at zero cents per share. They conclude that the discontinuity shown in earlier studies could be due to deflation, sample selection problems, differences between the characteristics of observations to the left and to the right of zero, or a combination of these effects, rather then the properties of earnings.

2.6.7 Other findings

Graham et al. (2005) achieve a much deeper insight into earnings quality using survey research backed by in-depth interviews. In a survey of 401 financial executives and in-depth interviews of an additional 20, all in the US, they find that CFOs consider earnings and not cash flows to be the key metric considered by outsiders, with two vital earnings benchmarks being the quarterly earnings for the same quarter in the previous year and the analyst consensus estimate. Meeting or exceeding benchmarks is very important; not being able to find one or two cents to meet analysts' forecast earnings per share figures could be

interpreted as indicating that the company has hidden problems; if the company has provided guidance on the forecast EPS figure, failing to meet it means the company is poorly managed – managers are unable to plan for the future. The result is that managers are ready to sacrifice economic value so that EPS forecasts are met – to avoid the severe market reaction of failing to do so.

Francis et al. (2005) find that investors price shares in a way that reflects their awareness of accruals quality (the standard deviation of residuals from regressions relating current accruals to cash flows): lower-quality accruals are associated with higher costs of debt, smaller price multiples on earnings and larger equity betas. The capital market consequences of differences in "accruals quality" arise because "accruals quality" proxies for information risk, which theoretical research shows cannot be diversified away in equilibrium (e.g., Easley and O'Hara 2004; O'Hara 2003; Leuz and Verrecchia 2004).

A number of studies use accruals as a good leading indicator of subsequent earnings, making them a useful summary of "earnings quality". Generally, the findings are that the market does not impound earnings quality information. Information in accruals about future earnings is ignored by investors (Sloan 1996), by analysts and auditors (Bradshaw et al. 2001) and by short sellers (Richardson 2003). Pownall and Simko (2005) find, for NYSE listed companies in the period 1989-1998, that the mean abnormal return around a period when unusual increases in short sales are announced is significantly more negative for companies followed only by a single analyst – short sellers provide information when there are limited sources of information available. For companies followed by a number of analysts, market responses depend on companies' earnings' levels – investors see an increase in short sales as providing information about the sustainability of earnings. Do market responses depend on "earnings quality"? Further analyses indicate that neither the larger negative returns for companies followed by a single analyst nor the responses depending on companies' earnings' levels, if they are followed by a number of analysts, are driven by companies' "earnings quality" or by the relative size of the increase in short sales.

2.6.8 Conclusions on the earnings quality literature

It can be seen that many researchers use the phrase "earnings quality" and do so with a variety of slightly different meanings. However, because a number of researchers have defined the meaning of the phrase, it sits much more comfortably in the academic literature than does "disclosure quality". In spite of no major advances having been made in

identifying the magnitude of earnings management and the specific methods used, findings do confirm that the practice is engaged in, which detracts from "earnings quality". Jonas and Blanchet will have to wait some time before academics enable standard setters to lay down rules which ensure that reported earnings are "high quality".

This study will not consider earnings quality among NSE companies due to time constraints. This survey of the literature is included so that earnings quality can be contrasted against disclosure quality.

2.7 Evaluation of the literature

2.7.1 Overall evaluation of the literature

The review of the literature reveals that the use of the word "quality" is much more prevalent in the area of earnings than it is in disclosure. This seems to be the case because a number of researchers have attempted to define the phrase "earnings quality" whereas there has been no real attempt to define "disclosure quality". The result is that when the phrase "financial reporting quality" is used, researchers tend to understand by it "the reported earnings quality". Some understand it in its full depth; that is, "financial reporting quality" is made up of "disclosure quality" and "earnings quality". But it is easy to ignore one component at the expense of the other.

Few academic studies refer to "high quality financial reporting" as such. The accounting standard setting bodies labour at arriving at definitions which can be used with precision and with understanding. A number of researchers refer to "quality earnings" without having a unanimously-agreed-upon definition; some use "quality disclosure" to mean whatever they wish to mean by the phrase.

The conclusion is that the phrases "quality disclosure", "quality earnings" and "quality financial reporting" are sold cheaply by academics. They are not given their proper status by a number of the academic community with the result that Akerlof's prediction occurs – there is market failure in the use of the word.

2.7.2 Evaluation of the disclosure quality literature

From the literature on "disclosure quality", it can be deduced that there is no "common vocabulary and understanding about quality" (2.2.5 - Jonas and Blanchet 2000 –J&B). Beginning with "financial reporting" as a whole (2.2.6), FASB (2005a) states that "high quality financial reporting" is that which meets the "objectives and qualitative characteristics of financial reporting". But surely all financial reporting that meets the "standard" should do this.

Is FASB equating "high quality" with what should be "standard"? Or is FASB admitting that the "objectives and qualitative characteristics" are so difficult to achieve that only few financial reports do achieve them? FASB adds that "high quality financial reporting" is "the overall goal to be aspired to". Does FASB mean that "financial reporting" today is not "high quality" because it has not achieved the goal to be aspired to? Or that the "financial reporting" of some companies is so good that it has achieved the goal to be aspired to? Or that once the goal has been achieved, a new goal is aspired to (as is the habit of the human spirit) rendering the goal achieved to be less than "high quality"? Both "interpretations" are extremely difficult to operationalize. Perhaps this difficulty arises because of the richness of the reality which is "financial reporting" and the inability of the human mind to deal with the totality of the complexity simultaneously. It can be concluded that it is difficult to measure overall quality, especially if it is to be done objectively. In order to move forward in the discussion, I shall assume that "high quality financial reporting" is currently possible.

However comprehensive is the model that has been developed to assess the quality of financial reporting, some aspect of the process can be discovered to have been omitted. For example, Rennie and Emmanuel (1992) measure the "quality" of segment reporting (2.4.6) by measuring the consistency with which business activity and geographic market segments are identified throughout the report. Hussainey et al. (2003) use the amount of forward looking information on profits to gauge the quality of an aspect of voluntary disclosure (2.4.8). These constructs need to be added to J&B's model (2.2.4). In addition, a number of redundancies can be found in J&B's model, e.g., in Table 2-2, question 1.2 is covered by question 6.1; question 6.3 is covered by question 6.1; etc. These details show how difficult it is to develop an all embracing model, but also, how difficult it is to ensure that some aspect of reporting is not "measured" twice.

A financial report is made up of a large number of elements (Figure 2-1). If any one of these elements is improved, the overall quality of the report is raised, but the financial report may still not be "high quality". Much research in the literature deals with only a part of the whole model. Watson, Shrives and Marston (2002) state that the inclusion of ratios *improves* the quality of the annual report (2.4.6). Marston and Polei (2004) note the two dimensions of "disclosure", the amount of information, and the presentation of the information: they point out that the presentation can improve the quality of disclosure (2.4.3) – but even an increase in the amount of information can improve the quality, if the quantity given is below the

optimum. The fact that the quality of the whole reporting process is improved by improving the part considered is clear in these cases. But is this made clear in all cases? Beattie et al. (2004) speak of the crucial factor in achieving an improvement in the "quality of financial reporting" – narrative communication (2.4.8) – perhaps, a single part of the reporting process is stressed rather than putting this part into its proper perspective.

But if one constituent element is "low quality", it may so detract from the whole that the report is not "high quality". It can be difficult to decide the point at which the label "high quality" can no longer apply. Healy, Hutton and Palepu (1999) claim that the AIMR ratings reflect the "quality of disclosure" (2.4.1), precisely because these ratings are so comprehensive. A number of researchers agree and use these ratings as if they were synonymous with measures of disclosure quality (2.4.1). Other researchers use other indices to measure some aspect of the "quality of accounting": eg., Bushman and Smith (2001) – the "quality of the financial accounting regime" (2.4.2), Frost et al. (2005) – "financial reporting and disclosure quality" (2.4.3), Abayo et al. (1993) – "the quality of mandatory disclosure" (2.4.5), Wallace and Naser (1995) – "the quality of disclosure" (2.4.5), Coy and Dixon (2004) – the "quality of annual reports" (2.4.6), Barton and Waymire (2004) – "financial reporting quality" (2.4.6), and Schleicher (1998) – "disclosure quality" (2.4.7). Bushee (2004) stresses the importance of the variability in disclosure scores (2.4.6): the researcher can construct a disclosure index to address the research question and if the index varies significantly for US companies, it measures "quality". But others ask for greater precision (Lang and Lundholm 1993; Pope 2003; Marston and Shrives 1991; Khanna, Palepu and Srinivasan 2004). They stress that a disclosure index does not measure the quality of disclosure and refer to disclosure scores as simply "disclosure scores" (2.4.1), "variations in disclosure levels" (2.4.2), the "extent of disclosure" (2.4.2), or "whether items are disclosed" (2.4.3). However, Botosan (1997) notes that researchers assume that the "quantity" and "quality" of disclosure are positively associated (2.4.2). Sometimes researchers state clearly that they are dealing with only part of the whole financial reporting process. But even then, agreement would not be full on the proxies they use. Barron et al. (1999) use the level of compliance of companies' MD&As as assessed by the SEC as a measure of "high-quality" MD&As (2.4.8). Clarkson et al. (1999) measure "disclosure quality" in MD&As using an index, the weightings of the items being decided by analysts (2.4.8). But researchers who press for greater precision would likely not agree that these indices measure "quality". The use of disclosure indices remains divisive.

Healy, Hutton and Palepu (1999 - HHP) note that AIMR selects companies with "high-quality disclosure practices" (2.4.1), possibly confirming to FASB that "high quality disclosure" is possible. They go on to say that AIMR selects companies with "high-quality and improving disclosure practices". At first sight, this may appear to be a contradiction. But what HHP are pointing out is that "high-quality financial reporting" is constantly changing. As technology changes and as types of transactions and financial instruments become more sophisticated, so does quality, making it a constantly moving "target" and clarifying FASB's second "interpretation". But this does not make the operationalization of the FASB "definitions" any easier.

Another point to be considered is whether the *absence* of some element of the "financial reporting process", as laid down in figure 2-1, results in reporting that cannot be classified as "high quality". In the US, if a listed company does not hold conference calls, its financial reporting may be classed as not being "high quality", since the US financial community is widely dispersed geographically and it is claimed that the US "corporate disclosure system is the best in the world" (Sutton, M. 1996, Pitt 2001, Herdman 2002) and has "set the standards by which all others are judged" (Pitt 2001). In a developing country, not holding a conference call would likely not detract from "high quality financial reporting" because *users* in that market may be unaware of the possibility of a conference call – their expectations in that regard would be nil. However, there is no essential difference between a conference call and a press briefing. In a country as small as the Netherlands, an analysts' briefing may make more sense. In a developing country, more reliance would be placed on traditional means of communication – which continue to be very important (2.4.3), in even the most technologically advanced societies (Oyelere et al. 2003; Jones and Xiao 2004). In a developed country, a website with full financial reports may be a necessity (Lymer and Debreceny 2003: Marston 2003: Marston and Polei 2004): in an emerging market, it may be a luxury (Gowthorpe and Amat 1999). Researchers need to take particular care in selecting proxies for "quality disclosure"; otherwise they may measure nothing more than keeping up with the latest fashion.

"Quality" is a relative term, and subjective – but not so subjective as to make it meaningless. Crotty and Bonorchis' (2005) findings would confirm that quality is relative (2.2.3). But Santema and Van De Rijt's (2004) definition (2.2.3) of the quality of an annual report ("how the annual report fulfils the expectations of the reader") is so subjective as to

render it almost devoid of any criteria at all. However, Mirshekary and Saudagaran (2005) do have a valid point in investigating the perceptions of users of annual reports in Iran (2.4.6) because without this knowledge, it is difficult to gauge whether users value annual reports, whether the content is relevant for them and whether there are factors that cause investors to question the validity of reports. They also take into account different groups of users, in line with Crowther's (1996) point that determining "quality" depends both on the person evaluating and his perspective (2.2.3). Interview research may be one way by which the quality of standards in terms of their decision usefulness (2.2.5) is discovered (Jonas and Young 1998).

Hope (2003a) deals more with how to achieve "quality financial information" (2.4.2). "Quality financial information" is a function of the "quality of accounting standards": Barth et al. (2005) find that companies that adopt IAS experience an improvement in accounting quality (2.3), but this does not imply that adopting IAS ensures "high quality financial reporting". Kothari (2000) adds that "quality financial information" is also a function of regulatory enforcement of those standards (2.4.2).

Arnold and Matthews (2002) find that the Companies Act of 1948 was probably responsible for the substantial increase in disclosure that occurred between 1935 and 1950 in the UK (2.4.5). Ali et al. (2004) find that there is a high level of compliance with IAS for those items required to be disclosed by the Companies Acts in the countries they examine (2.4.5). These findings point to the importance of legislation on disclosure compliance (2.4.4): laws confer legal rights to shareholders; in an environment where courts function, even weakly, directors seem to take greater care to comply (La Porta et al. 2000). Bushee (2004) stresses the importance of examining the mandatory disclosure regime (2.4.3).

This review of the disclosure quality literature shows that the use of the phrase "quality of disclosure" in its various forms seems to be increasing. Some authors, in seeking to be as precise as possible, avoid using the word if they can (Leftwich 2004). In his opinion, Barton and Waymire's (2004) choice of the term is unfortunate given the ambiguity of the term in the extant literature. A number of researchers speak of an enhancement of some aspect of disclosure resulting in improved "disclosure quality". At the other end of the spectrum, Core (2001) speaks extensively of "disclosure quality" and even suggests that "improved measures of disclosure quality also need to be developed". A number of researchers use proxies to represent "disclosure quality" in its entirety. Beattie

et al. (2004) caution against this approach. They identify several dimensions of disclosure quality that can be expected to gain widespread support but emphasize that no definitive set of quality attributes exists since "quality is subjective and context-dependent".

2.8 Conclusion

This chapter outlines the components of "high quality financial reporting" and examines the academic literature dealing with "disclosure quality" and "earnings quality". It finds that no real attempt to define "disclosure quality" has been made but a number of definitions of "earnings quality" have been proposed. "Financial reporting quality" is used in the literature to mean either "earnings" or "disclosure quality" as the researcher wishes; one component is often ignored at the expense of the other. The phrases "quality disclosure", "quality earnings" and "quality financial reporting" are sold cheaply by academics, fulfilling Akerlof's (1970) prediction.

IASB claims that IFRSs require (i.e., impose as a necessity) "high quality" information in financial reporting (IASB 2003, p. P-2): it is implicit that full compliance with IFRSs ensures "high quality financial reporting disclosure". Bushee (2004) and Frost et al. (2005) claim that a higher score achieved by disclosing more items from S&P's check-list results in "higher quality disclosure". ICPAK, the Kenya Capital Markets Authority and the Nairobi Stock Exchange claim that "high quality disclosure" results in a higher score in the FiRe Award. This thesis uses these claims to measure high quality disclosure and seeks associations between these measures of high quality disclosure and company characteristics.

In addition, in an attempt to answer Core's (2001) call for "creating better measures of disclosure quality", this study proposes a tentative definition of "high quality disclosure" which will be able to be operationalized in the empirical part of this study.

If financial statements are in full compliance with high-quality accounting standards, they meet the "objectives and qualitative characteristics of financial reporting" (2.2.6). If the standard setting body maintains the standards up to date, the need for constant improvement in standards is met (2.4.1). Full compliance ensures that a company's financial reporting is tracking improving standards.

If in addition to full standards compliance, (a) a clean audit report is issued, and (b) the audit is carried out by a registered auditor in the company's jurisdiction, and (c) the

Institute to which the auditor belongs is a member of IFAC, it can be assumed that all the material items that should be disclosed are actually disclosed.

If, in addition, a company achieves, on an internationally recognized disclosure index, the overall mean score of the S&P 500 companies in the US, its disclosure on a US rating is high. It is assumed that the disclosure standards of the S&P 500 companies are likely higher than the 16,000 (Thornton 2002) listed companies in the US. In this case it would be defined to be "rated highly" by this index (2.4.3).

If, in addition, the company achieves a score, on a nationally recognized disclosure index which is comprehensive enough to be similar to the AIMR index (2.4.1), at least equal to that achieved overall by an average S&P 500 company in the internationally recognized disclosure index, it will have met the need for users in the environment in which its shares are traded and it would be considered to be "rated highly". On account of Mercer's (2005) findings, these scores must be arrived at shortly after companies have released their financial statements.

Using these benchmarks, an operational definition of "high quality disclosure" can be formulated for this study.

Table 2-3: Tentative definition of "high quality disclosure"

A financial report exhibits "high quality disclosure" if it has received a clean audit report, if it is in full compliance with high quality Accounting Standards, if it is rated highly using an internationally recognized disclosure index and if it is rated highly using a nationally recognized disclosure index in the country in which it is incorporated.

It can be observed that this definition is restricted. It cannot be used in reference to the whole financial reporting process (Figure 2-1). For example, it is likely that it will not be able to be used immediately to decide whether an interim financial report exhibits "high quality disclosure". It will have to wait until recognised national and international disclosure indices are developed for interim financial reporting.

This tentative definition of "high quality disclosure" ends the chapter. This definition is needed at this point because without an adequate definition, "high quality disclosure" cannot be measured. While not contributing directly to Jonas and Blanchet's (2000) model, the definition provides a methodology by which a variety of facets are measured: if each of these facets is high quality, disclosure can be said to be high quality.

CHAPTER 3
"High Quality Financial Reporting" as viewed by regulators, practitioners, professional bodies and users

3.1 Introduction.

This chapter continues to respond to the first sub-objective GO_1: "to contribute to an understanding of the meaning of the phrase 'high quality financial reporting'". It shows the extensive use of the phrase "high quality financial reporting" by regulators, practitioners, professional bodies and users. It traces the origin of the phrase. It examines whether the use of IFRSs is a basis for "high quality financial reporting".

This chapter is necessary in this study because it will be seen that the phrase "high quality financial reporting" is used widely, although its use is confined to certain groups of capital market participants. There is a dichotomy between the wide usage of the phrase by capital market regulators, international and national accounting standard setting bodies and individual accounting firms, and the lack of its usage by a large number of professional accounting bodies, except in certain circumstances. A search of a wide variety of books on accounting reveals that a small number of authors deal with "high-quality accounting", "quality accounting" or "quality disclosure " (Beattie et al. 2002; Bloomer 1996; Bodie et al. 2002; Giroux, G. 2004; Penman 2001; Revsine et al. 1999: Scott 2003). Miller and Bahnson's *Quality Financial Reporting* (Miller, P. and Bahnson 2002) is one of the few books that refers specifically to the subject.

The phrase "quality auditing" is used by regulators, all the professional bodies and many practising accountants. In 1977, the Metcalf Subcommittee and the Cohen Commission called for the preparation and issuance of "quality control reports" on the work of auditors of publicly quoted companies in the US (GAO 1996, p. 82). In the same year, the AICPA established an SEC Practice Section to oversee the activities of firms that audit quoted companies to improve the "quality" of their accounting and auditing work and in 1979 the AICPA established "quality control standards" governing audit work as a whole (GAO 1996, p.83).

Section 3.2 gives examples of the use of the phrase "high quality financial reporting", and its variants, by important bodies associated with accounting. Section 3.3 shows its use by the Jenkins Report. Section 3.4 reports its being adopted by the US SEC. Section 3.5 presents views on the importance of US GAAP: the US SEC claims that US GAAP are

high quality: do others share this view? Section 3.6 presents FASB's view of the future of international accounting setting. Sections 3.7 and 3.8 deal with the SEC Concept Release on International Accounting Standards and responses to the Release. Section 3.9 reports events leading up to the Memorandum of Understanding between FASB and IASB. Section 3.10 presents conclusions.

3.2 Present use of "high quality financial reporting"

3.2.1 International organizations

The Constitution of the International Accounting Standards Committee Foundation (IASCF), which was revised in mid-2005 in accordance with its mandated five yearly review, retained, as its principal objectives: (1) the development of "a single set of high quality, understandable and enforceable global accounting standards that require high quality ...information in financial statements ..."; and (2) bringing "about convergence of national accounting standards and IFRSs to high quality solutions" (IASCF 2005b, p. 2). Board members of IASB should have an understanding of the global economic environment because "high quality financial reporting" was affected by this environment (IASCF 2005b, p. 11, paragraph 5).

Graham Ward, the President of the International Federation of Accountants (IFAC), addressing the World Federation of Exchanges at a conference in Mumbai, India, stated that having a multiplicity of accounting standards around the world was against the public interest. IFAC was working on guidance for international convergence towards high quality accounting standards, and was leading a new study on enhancing the quality of the financial reporting supply chain (IFAC 2005b).

The World Bank explains its *ROSC (Reports on the Observance of Standards and Codes) Accounting and Auditing Program* as an initiative to strengthen the institutional framework in member countries, which would promote "high-quality accounting and auditing practices" (WB 2004b, p.3).

One of the principles of the International Organization of Securities Commissions (IOSCO) for the regulation of securities markets is that "accounting and auditing standards should be of a high and internationally acceptable quality" (IOSCO 2003, p. 22). In addition, "high quality accounting and auditing standards provide a framework for other disclosure obligations" (ibid., p. 25).

The Chartered Financial Analysts (CFA) Institute (formerly the AIMR) found that 38% of analysts in Malaysia, 35% in Singapore, 29% in Korea and Hong Kong, 27% in mainland China and 19% in Australia rate "quality financial statements" "extremely important" for investment decisions (CFA 2005). Writing to Commissioner Frits Bolkestein, Member of the European Commission, in support of introducing IAS 32 and IAS 39 as well as the other IFRSs in 2005 in Europe, AIMR stated that investors require information to be provided "according to the highest quality reporting and disclosure standards" (AIMR 2004).

The International Forum on Accountancy Development (IFAD) was wound up after the publication of *GAAP Convergence 2002* (Street 2003). IFAD had been created in 1999 as a working group by the Basel Committee on Banking Supervision, the (then) seven largest accounting firms, IASC, IFAC, the IMF, IOSCO, OECD, UNCTAD, UNDP, the US SEC, the World Bank and regional development banks, to improve financial reporting internationally (Deloitte & Touche 2005a). The principal finding of *GAAP Convergence 2002* was that IASB was viewed as the appropriate organization to develop global standards that provide "high-quality financial information": of the 59 countries surveyed, 95% had adopted, intended to adopt or intended to converge with IFRS (Street 2003, p. 7).

It can be concluded that the phrase "high quality financial reporting", and variations of it, have become the benchmark to denote the level of excellence at which accounting standards should be set and to which preparers of financial statements should aim in the preparation of interim and annual corporate reports.

3.2.2 National organizations in developed countries

One of the countries that *GAAP Convergence 2002* identified as not converging to IFRSs was Japan, but the Japanese Financial Services Authority (JFSA) claimed that Japanese GAAP were "high quality accounting standards" equivalent to IFRS, and admitted that convergence was an important goal (JFSA 2004). The CFA Institute found that 42% of analysts rated the "quality of financial information disclosure" by Japanese companies to be excellent or good; none rated the "quality of financial information" to be poor (CFA 2005).

Both the Australian Accounting Standards Board and the Australian Financial Reporting Council referred to their making progress towards a single set of "high quality global accounting standards" (AFRC 2001, p.18) to maintain the "quality of financial

reporting in Australia" (AFRC 2003, p.9 & p.15), but more recent emphasis was on audit standards "of the highest quality" (AFRC 2005, p.47).

The Canadian Securities Authority states that a US listed company that requests to file financial statements in Canada prepared under US GAAP can do so provided its audit committee and management maintain "the level of expertise in US GAAP necessary to prepare reliable, high quality financial statements" (CSA 2003, p.2).

An extensive search of institute websites (assisted by a Google daily web alert for references to "quality financial reporting" and "quality accounting" over a three year period) indicate that the Institutes of Chartered Accountants (Australia, Canada, England and Wales, India, Ireland, Scotland and South Africa) rarely use the phrase "high quality" in relation to financial reporting; most use it to describe some aspect of auditing. However, the Institute of Chartered Accountants in New Zealand (ICANZ) develops financial reporting standards and represents New Zealand in international forums dealing with convergence and harmonization of IAS (ICANZ 2002, p.12). ICANZ makes extensive reference to the "quality of corporate reporting in New Zealand" and "high-quality financial reporting" (ICANZ 2003, p.28).

Leslie Murphy, the Chairman of the American Institute of Certified Public Accountants (AICPA), opening the AICPA's 33rd annual national conference on 5 December 2005, referred to the SEC and the Public Company Accounting Oversight Board (PCAOB) as "the regulators and standard setters ... (who) play a vital role in setting the bar for quality business reporting" (Accountingweb.com 2005).

When Jenkins, the Chairman of FASB, issued a press release after the collapse of Enron, he stated that FASB's Vision was to "to serve the public through transparent information resulting from high-quality financial reporting standards, developed in an independent, private-sector, open due process". "High-quality financial reporting" was essential to maintaining an efficient capital market – not all the information required by investors was produced by "high-quality financial reporting", but financial reporting was essential to the process (Jenkins 2002).

3.2.3 Conclusions on the use of the phrase

It can be deduced that the phrase "high quality financial reporting" is used widely by international and national financial organizations and regulators. IASB aims to develop "high quality accounting standards": are IFRSs presently in use "high quality"? When was

the phrase "high quality financial reporting" used first? Which organization could be said to have introduced it? And how did that organization define "high quality financial reporting"? The sections below reveal the answers to these questions.

3.3 The Jenkins Report

AICPA formed a Special Committee on Financial Reporting in 1991. It published its report, *Improving Business Reporting – A Customer Focus* (the Jenkins Report), in September 1994. The report has become extremely influential (Beattie et al. 2004), although Seidler (1995) was scathing in his review of it; he summed up his remarks by stating that "some of the specific suggestions are reasonable, but they are neither new nor significant" (Seidler 1995, p.124).

Seidler points out that the 40-page example of the new "Business Report" "contains very little than cannot now be found in a combination of current annual reports, proxies and Forms 10-K" (p.121). It also contains errors in the note on income tax expense and on deferred tax, in spite of the fact that the AIMR, "the most important organization of financial analysts" (p. 123), had complained to the Committee about confusing and sometimes incorrect deferred tax accounting in annual reports. Seidler quotes Borelli (1994) who wrote on behalf of "the most significant regional group of the Financial Executives Institute (FEI)" (p.123) that "... one wonders if the AICPA's initiatives are designed more for the benefit of the members of the AICPA as opposed to the reporting parties, investors and prospective investors" (Borelli 1994).

The Jenkins Committee, almost at the beginning of its report, revealed that "businesses everywhere have renewed their focus on the needs of their customers. ... The insights gained from the renaissance of customerfocused (sic) activity are driving critical improvements in the quality, cost, and responsiveness of products and services around the globe". The Committee would "concentrate on the information needs of users" - although Seidler (1995) accused it of ignoring any views that did not fit the Committee's model. The Committee rejected company-prepared forecasts for fear of litigation, but the US Government's General Accounting Officer (GAO) thought these forecasts would result in improved information; but the GAO thought the Committee's proposals catered for a number of information needs that the model in use at the time omitted (GAO 1996, p.112).

"Quality" was a new buzz word in the field of business and management. Poling, the CEO of Ford Motor Company, as quoted by Ishikawa (1985), stated that "in 1981, Ford

Motor Company began a very intense effort to improve product quality to achieve "Best-in-Class" levels in all world automotive markets". *In Search of Excellence* by Peters and Waterman, was published in 1982, but *What is Total Quality Control? The Japanese Way* (Ishikawa 1985) and *Out of the Crisis* (Deming 1986), have possibly had a longer lasting effect on businesses. Deming (1986, p. 5) stated "quality should be aimed at the needs of the customer, present and future". Ishikawa (1985, p.44) says the same. In 1985, the US Navy coined the phrase "Total Quality Management" (Giroux, H. 2006, p. 1245).

In addition, "quality" was being used frequently in relation to the "audit". DeAngelo (1981) entitled her study "Auditor Size and Audit Quality". although, from section 2.2.1 in chapter 2 of this study, it is clear that this was not the first reference to "audit quality" in accounting literature. In 1986, when the US Government's General Accounting Office (GAO) revealed that 34% of a sample of 120 CPA audits of Government funds contained departures from applicable auditing standards, AICPA set up, in March 1987, a "Task Force on the Quality of Audits of Governmental Units" (Apostolou 1989). In August 1993, the GAO published *An Audit Quality Control System: Essential Elements* (GAO 1993). Emphasizing the importance of audit quality, it states "a high-quality job greatly increases the probability that audit results will be relied on ...Reputations are built over time by producing consistent, high-quality work (p.6). ...High-quality recommendations pinpoint needed changes (p.31). ...Does the quality control system help ensure that quality is maintained each time, every time? (p.32)".

It was inevitable that at some point the phrase "quality financial reporting" would evolve. And it did. The AICPA Jenkins Committee introduced the phrase "the importance of highquality (sic) business reporting" (AICPA 1994, Chapter 1, p.3). George (2003) claims that the Jenkins Committee did not refer to the "quality of financial reporting" (which is true if one goes no further than the words themselves, rather than the concepts behind the words), but to the "quality of reported earnings". The Committee wrote that earnings are "higher quality" if they "already are realized or do not depend on the occurrence of highly uncertain future events" (Chapter 6, p.25), which George says is not very instructive – so she gives her own explanation: "it appears that quality is related to both the ability to predict and the relevance of the information". There is little wonder that IFAC (1993) states that "quality, like excellence, is a concept that is easy to visualize but exasperatingly difficult to define", and adds "it remains a source of confusion to

managers". The Jenkins Committee's definition of "quality earnings" is very close to that of Sloan (1996) and Dechow and Dichev (2002), see section 2.6.1. But the Jenkins Committee never defined was it meant by "highquality business reporting".

3.4 SEC: "high quality accounting standards"

Roberts (1995a), a Commissioner of the US SEC, referred to the "quality of accounting and financial reporting" in relation to companies reporting liabilities for remedying environmental degradation and noted that disclosure in separate environmental reports was often of "higher quality" than those in financial statements and SEC disclosure documents. He noted that staff of the SEC were disappointed at the "extent and quality" of the disclosure about derivatives in 1994 annual reports and stunned by the great differences in the "quality of disclosure", but hoped that FASB's Statement 119 would make a substantial improvement to the "quality of disclosure" of derivatives by companies (Roberts 1995b). Wallman (1995), another Commissioner of the SEC, extolled FASB's independence, integrity and wisdom and stated that these virtues were essential for FASB to be able to promulgate "high-quality accounting standards". However, the US Congress seemed to have a different view. In September 1996, when the GAO reported to Congress after Dingell asked for an investigation into accounting, the GAO revealed that the SEC thought that the 1994 FASB statement on disclosures of financial instruments was inadequate and in December 1995 proposed regulations to broaden these disclosures. FASB admitted that users had not participated as much as preparers and auditors. In spite of FASB having a staff of 40 to 50 professionals, some preparer and user groups claimed that FASB was slow in addressing emerging accounting issues and issuing standards; FAF and FASB accepted this and resolved to improve. At the same time, the GAO stated that "more progress could be achieved in resolving the major issues facing the standard setters if the SEC would exert more of a leadership role in working with the standard setters" (GAO 1996, p. 124)

Sutton, M. (1996), the Chief Accountant of the SEC, spoke in support of the international harmonization of accounting standards. He stated that the success of the plan of the International Accounting Standards Committee (IASC) to develop a comprehensive core set of standards would depend not only on the "quality" of the standards, but also whether they would be accepted by the members of IOSCO. (The last part of this statement was not as transparent as it would seem. The only member organization of

IOSCO which had the personnel with the training necessary to make a judgement on IAS was the US SEC. If the SEC accepted IAS, so would IOSCO. The UK had already accepted financial statements prepared in accordance with IAS at this time, see Kenny and Larson 1995). He stated that the SEC staff would "insist that the standards proposed for the comprehensive core be of high quality". These standards might be different to US standards, but the SEC staff would demand that they be applied with the same rigour as US GAAP and with the "same degree of adherence to the spirit and intent of the standard that we now expect of US registrants applying US standards".

Hunt (1996), an SEC Commissioner, stated that IAS would be acceptable only if: (1) they included a "core set of accounting pronouncements that constitute a comprehensive, generally accepted basis of accounting"; (2) they were "of high quality – they must result in comparability and transparency, and they must provide for full disclosure"; and (3) they must be "rigorously interpreted and applied". But were US GAAP "high quality"?

3.5 The importance of US GAAP.

This section shows the importance of US GAAP, even outside the US.

Nicolaisen (2005), the Chief Accountant of the US SEC, stated:

"the SEC has determined that the FASB financial accounting and reporting standards are recognized as 'generally accepted' for purposes of the US federal securities laws. And, I personally consider financial statements prepared in accordance with US GAAP to be of ***high quality****".*

Implicit in the Canadian Securities Authority's statement in section 3.2.2 above, (if a US listed company wishes to report in Canada using US GAAP, the audit committee and management should maintain "the level of expertise in US GAAP necessary to prepare reliable, high quality financial statements", see CSA 2003) is the fact that US GAAP are "high quality". When authorities in a country other than that which promulgates standards acknowledges that those standards are "high quality", it is a more reliable indicator than a claim by the authorities in the home country; at the same time, there is the danger that the less powerful country acts in a subservient way; if those authorities thought that tighter rules were required, they may be afraid to lay down and enforce these tighter rules because they may realize that to do so would probably encourage companies to de-list in the less powerful country. Peasnell (1982) points out that a number of accountants in Canada take the view that the most cost effective approach to accounting standards is to simply adopt FASB's standards unless there are compelling reasons not to do so.

In Australia, the group of 100 (G_{100}), an organization of senior finance and accounting professionals from large companies, stated that the Australian Accounting Standards Board undertook an international harmonization program which selected IAS which were *consistent* (emphasis added) with US GAAP (SEC 2000b).

When Volker appeared before a committee of the US Congress in June 2001, as Chairman of the Trustees of the reconstituted IASC, he stressed that the restructured body had a clear aim: a single set of "high quality accounting standards". The core standards demanded by IOSCO had been completed by the "old" IASC in 1999 but they were not acceptable in US capital markets, the most important in the world. The new IASB would ensure that foreign competitors would "live up to the same high quality requirements imposed on US" companies (Volker 2001).

A short case study of Philips, the Dutch electrical multinational, will illustrate that what the US accounting regulators do determines what other bodies do.

Hommen, the CFO of Philips, noted that approximately 30% of the company's shareholders were in the US (Cohen, J. 2002). At the beginning of 2002, US GAAP changed to require that goodwill be tested for impairment, rather than being systematically amortized. Dutch rules continued to require its amortization. Management in Philips chose to switch their primary financial reporting to conform to US GAAP. Most of Philips' competitors reported under US GAAP; Hommen stated that it was "of utmost importance that a true comparison should be made possible". Philips was aware that IASB had announced that it wished to change its mandated treatment of goodwill to agree with US GAAP, and that Philips would have to adopt IAS with effect from 1 January 2005. Increasing convergence between IAS and US GAAP was expected in the near future, and was fully endorsed by Philips. By changing to US GAAP in 2002, Philips would ensure consistency then and in the future. Philips did not state that it did not want a goodwill amortization charge to appear in its primary financial statements, which would be removed in the 20-F reconciliation to US GAAP, but this was possibly the real reason for the change. Even when Philips produced its first balance sheet using IFRS, the order of presentation of assets and liabilities was based on the degree of liquidity, which is common practice in the US but against Dutch regulations (Philips 2006, p. 214).

The sheer size, importance and success of US capital markets, together with the prowess of US multinationals (which report under US GAAP) meant that the US regulatory

authorities often had the last word on how regulations should be formulated. While it could still be argued that US GAAP are not "high quality", the pre-eminence of US markets meant that the SEC and FASB could decide if other accounting standards were "high quality". Was there any likelihood that IAS would ever be classified "high quality"?

3.6 FASB reveals its vision for the future

In 1999, the US Financial Accounting Standards Board (FASB) published *International Accounting Standard Setting: A Vision for the Future* (FASB 1999). It spoke of a hypothetical, quality International Standard Setter (ISS) which would be able to lead in the development and improvement of standards, not just follow in the wake of others or codify the status quo. It would have to be at the forefront of advanced thinking and research on accounting issues; independent and accountable only to the public interest; have an adequate due process, supported by a group of qualified individuals whose time was devoted fully to the standard-setting process. Its funds would have to be raised independently and there would have to be independent oversight. FASB added that the Trustees of the Financial Accounting Foundation (FAF) "continue to provide independent oversight of the FASB in the United States" (p.30). The ISS would promulgate "high-quality accounting standards that contribute to high-quality financial reporting ... that provides decision-useful information for outside investors". In addition, there would be an International Interpretations Committee (IIC) – to deal with common problems as early as possible - and an International Professional Group (IPG) – to ensure dissemination, education in, and compliance with, the standards.

FASB added three "key considerations": (1) FASB should retain a worldwide leadership role in standard setting; (2) FASB should do all it could to participate in developing the "high quality standards"; (3) "worldwide acceptance of internationally recognized standards and a global standard-setting process is impossible without US acceptance and participation". The ISS would have to be independent and accountable only to the public interest, but the US would have to have the power of veto – the US was putting its hegemony card on the table.

3.7 The SEC asks: "Are IAS high quality"?

In a *Concept Release* issued on 16 February 2000, the SEC outlined its approach to upholding the "quality of financial reporting" domestically and to encouraging convergence towards a "high quality global financial framework internationally". It re-

iterated its commitment to its system of regulation – the pursuit of "investor protection by promoting informed investment decisions through full and fair disclosure" (SEC 2000a).

The Concept Release gave its view of the US financial reporting structure: high quality accounting and auditing standards, set by effective, independent and high quality standard setters, enforced by audit firms with effective quality controls, and profession-wide quality assurance carried out under active regulatory oversight, all contributed to the success of a high quality financial reporting framework. It sounded very similar to Ishikawa's (1985, p. 45) aim of controlling quality in its every manifestation. The SEC went on to affirm that a set of high quality accounting standards on its own would not achieve this. If a reporting company's management did not implement and properly apply generally accepted accounting standards, or if auditors did not actually test, and express their real opinion on whether the financial statements were fairly presented in accordance with those standards, regardless of the quality of the standards, the information was neither transparent, nor comparable nor consistent. This, at least, was the sound theory on which "high quality financial reporting" by companies in US capital markets was based. The large number of restatements which continue to be made by companies listed on US capital markets seem to tell a different story (Huron 2005, Pitt 2006). An observer could well ask whether there was any value in the audits of US listed companies (Sutton, M. 2002).

In 1988, the SEC had issued a policy statement to the effect "that all securities regulators should work diligently to create sound international regulatory frameworks that (would) enhance the vitality of capital markets" (SEC 2000a). As part of its "due process", the SEC was now seeking views on a number of issues related to the use of IAS and whether a sufficiently robust framework existed internationally so that foreign companies that chose to report under IAS could dispense with the 20-F requirement of reconciling their financial statements to US GAAP (SEC 2000a).

3.8 Respondents' views on the SEC Concept Release

102 responses were received from a wide variety of persons, of which 48 were posted on the SEC website (a count gives 49 but one response is included twice). A number of respondents took the opportunity to air their ideas on other matters. Only selected pertinent replies will be commented on below. Since all the responses were made in the year 2000, this is omitted from response references in this section. All the responses are available at the "comments on concept release" site (SEC 2000b).

3.8.1 Zeff asks "Is the best the enemy of the good?"

Zeff noted that the SEC was repeating its call for a comprehensive set of high quality accounting standards it had made four years previously, but with a twist: it was now arguing that high quality accounting standards were not enough without a global financial reporting framework of the US type. In Zeff's view, the SEC had "significantly raised the bar" for the acceptance and use of IAS in US securities markets; the SEC's elaborate programme of auditing and regulatory reform set out in the Concept Release would become a precondition for the acceptability and use of IAS by foreign registrants in US securities markets without the need to reconcile the figures to US GAAP. The IASC had agreed to restructure itself in accordance with the model laid down by the SEC, but the SEC had now indicated that it would evaluate each new IAS on a case-by-case basis. The SEC had pointed out that significant differences between IAS and US GAAP may still need to be accorded special treatment in the form of a reconciliation or footnote disclosure, which went towards confirming the suspicions of persons outside the US that the SEC's secret agenda all along was to accept IAS for foreign registrants only if they were so much like US GAAP as to virtually be US GAAP[2]. The SEC had moved the goalposts by insisting that a global financial reporting structure was needed before the SEC could judge the acceptability of IAS when used by foreign registrants in US markets.

3.8.2 IASC's response

IASC claimed that IAS were high quality standards suitable for cross-border listings in the US without reconciliation to US GAAP, or with reconciliation limited to certain items, where it could be shown that investors need additional information. IASC had eliminated most of the choices that used to exist in its standards; the fact that some remained was not an indicator of poor quality – some choices were to be found in US GAAP. IAS were based on a "Framework" similar in its aim (to assist investors and others to assess future cash flows) and principles to FASB's Concepts Statements. A difference between IAS and FASB standards did not in itself indicate differences in quality. Independent experts within one country, such as the US, would often disagree on accounting approaches. SEC staff had attended IASC Board meetings in which decisions were based on a careful analysis of comments on published drafts and detailed

[2] Tweedie is keen to point out that the FASB standards on share-based payment, on idle capacity and spoilage costs in the cost of inventory and on exchange of assets are based on or converge with IASB standards to show that movement is not only in one direction (IASCF 2005a, p.4).

consideration of comments from a wide variety of members, including SEC members, but different comments pulled in different directions. IAS were the result of tough and thorough debate among experts from around the world, and rarely incorporated provisions that had not been used at a national level in some administration with high quality accounting. IASC admitted that the SEC could not yet be confident about the standards of auditing in all the countries in which companies reporting under IAS may be domiciled, but that lack of confidence in auditing was equally a reason for doubting the reliability of statements prepared by foreign companies using US GAAP.

3.8.3 Are the IAS of sufficiently "high quality"?

In general, the majority of respondents had a vision of a single set of "high-quality" global accounting and financial reporting standards (e.g., Arthur Anderson -AA; AICPA; Deloitte and Touche – D&T; FASB; Mercer – the world's largest employer /employee consulting firm; PricewaterhouseCoopers – PWC; the Securities Industry Association - SIA). AA, PWC and SIA stated that the IASC was the best forum in which to create a comprehensive set of high quality global accounting standards quickly. Close cooperation between IOSCO and IASC had resulted in a "much needed tightening" of IAS (AA). AA and D&T believed that their worldwide use would increase user comprehension and reduce costs to financial statement users and to preparers. The AICPA believed that specialized industry topics and additional guidance would need to be developed to make IAS sufficiently comprehensive.

The Institutes of Chartered Accountants of Australia, England and Wales and Scotland and the Institute of Public Auditors in Germany (IDW), all agreed that IAS were high quality standards. The Forum of European Securities Commissions (FESCO), the assembly of 17 securities commissions in Europe, had the same view.

The EU found the Concept Release's discussion of whether IAS were of high quality to be "slightly troublesome". The Release compared IAS with US GAAP in a way that implied that "US GAAP has got it right and (was) the benchmark to which IAS should aspire. However, what troubles us is that many of the specific concerns raised by the SEC staff about IAS as listed in the Release appear to relate to areas in which US accounting standards are seemingly inconsistent with the concepts from which they are supposed to be derived". The UK Financial Reporting Council (FRC) noted that the position taken by the SEC "could suggest, with damaging consequences for reaching agreement on international

standards, that high quality was equated solely with American standards. Not surprisingly we would dispute this, especially in cases where the UK Accounting Standards' Board has, for conceptual reasons, disagreed with the FASB's approach". The FRC felt it was perfectly acceptable that jurisdictions may wish to ask for additional disclosure to ensure fairness between domestic and cross-border companies, but it believed that it was important for all international regulators to encourage a process whereby, as far as was practicable, "accounting standards for measurement used nationally and internationally should be identical so that profit, assets and liabilities appear as the same figure no matter in which jurisdiction the accounts were prepared".

The Global Financial Reporting Advocacy Committee (GFRAC) of AIMR (now the CFA Institute) pointed out that, by design, IAS were not as detailed or as comprehensive as US GAAP; rather than providing detailed rules, IAS focused on the principles that, when followed appropriately, would provide the same quality and quantity of information in financial statements. The Financial Accounting Standards Committee (FASC) of the American Accounting Association[3] stated that its responses were based on published or unpublished accounting research and on class-room teaching experience. It admitted that the comprehensiveness of frameworks had not been researched, but "it is generally agreed that IAS do not cover all the issues addressed by US GAAP which are themselves not comprehensive".

Individual respondents from outside the US had the view that IAS were sufficiently high quality to be adopted internationally, albeit with reservations on the extent of coverage of the IAS or enforcement (but pointing out that the SEC could ensure compliance by foreign registrants more easily if they all used a single accounting system), eg., Chisnall and Professor Macve (London), Ravlic (Australia), Professor Harris (Columbia Business School, NY: originally from South Africa).

Individual American respondents had the contrary view. McRitchie, the editor of "Corporate Governance", stated that IAS were not of sufficiently high quality; US GAAP were. Blair claimed that IASC standards were very vague and left a lot to be determined by corporate management, and lacked implementation guidance. Schwartz thought IAS did not demand full disclosure. Mladek, a Czech/American academic, practitioner and

[3] The members of the Committee were: James Wahlen, Chair; James Boatsman; Robert Herz; Gregory Jonas; Krishna Palepu; Stephen Ryan; Katherine Schipper; Catherine Schrand; Douglas Skinner. The principal author of the letter containing the responses was Katherine Schipper.

investor stated allowing IAS would "significantly reduce the quality of the information" provided to investors. Napolitano and Knutson (both US based financial analysts) stated that "a universally acceptable and agreeable definition of 'High Quality' is elusive"; accounting standards were high quality if they "have the characteristics of both reliability and relevance; also, able to be applied with equanimity and attested to with reasonable assurance". They added that globally comparable accounting standards needed to be of "high quality" – at least on a par with US GAAP, which were "increasingly being adopted by global enterprises outside the United States". IAS should not be endorsed in any way until: (a) listed companies that purport to follow IAS actually did so; (b) audit reports always identified any instances of non-compliance ("the quality of auditing, compliance, and enforcement in certain jurisdictions is either substandard or nonexistent ...these circumstances cannot be tolerated in the US "); (c) the integrity of the re-structured IASC, and the intellectual and independent character of the standard setters, had both been assessed. To ensure compliance, the SEC could regulate foreign registrants directly or have them audited by an "approved" auditor.

AA stated that several stock exchanges accepted IAS for foreign registrants and several countries had adopted IAS as their local GAAP or aligned their GAAP to IAS or used IAS when their own GAAP did not deal with a specific issue; the World Bank, the IMF and IFAD recommended IAS as a benchmark for countries striving to improve the quality of their financial reporting.

3.8.4 Experiences of actual users of IAS

Novartis had been using IAS for several years. Financial statements prepared under IAS were now fully transparent, reliable and useful to all stakeholders. Novartis preferred focusing on concepts and principles in IAS rather than on "thresholds" in US GAAP, even if IAS were more strict than US GAAP in a number of areas. IAS documentation was increasing but it was better structured than US GAAP. A costly reconciliation relating to business combinations increased neither transparency nor shareholders' ability to predict cash generating potential; Novartis proposed scrapping the reconciliation as soon as possible. ENI, the Italian energy group, expressed similar views.

3.8.5 Importance of "principles-based" rather than "rules-based" standards

PWC pointed out that the IASC's promulgating a comprehensive set of high quality global accounting standards would involve the convergence of different cultural

approaches to accounting, but harmonization would be best served by a concentration on principles rather than rules, together with reasonably detailed guidance to ensure consistent interpretation and application, and to enable appropriate compliance and enforcement. Both PWC and D&T stated that IAS, interpreted in the light of the conceptual framework, provided sufficient guidance to ensure consistent and comparable reporting; US standards contained significantly more detailed and extensive guidance, explanation and reasoning for requiring a particular approach, but this did not necessarily mean that the outcome was better. The outcome was influenced by the philosophical approach to standard-setting – prescribing a detailed set of rules or laying down principles. D&T added that the practical application of standards could possibly be questioned in the US.

The union of German Bankers (BdB) argued that IAS gave conceptual guidance to practitioners in the standards and also in the conceptual framework. The Confederation of British Industry joined D&T in noting that US GAAP contained so much detailed guidance that the underlying concepts could be circumvented by designing transactions to achieve the desired accounting results. The CBI continued that in the UK, companies had to account for the substance of transactions; the IAS were closer to this model. This enhanced the usefulness of financial information.

The Institute of Public Auditors in Germany (IDW) emphasized that IAS provided general principles that could be applied in addressing accounting issues which were not currently covered by IAS. The IAS were easier to understand and to apply (especially for foreign users) than "standards that do not have such a transparent structure and which contain a large number of detailed rules to cover various circumstances". For complex accounting issues, the risk of applying US GAAP wrongly was much higher that for IAS. The entire set of the current IAS had been issued over a shorter time period than that of US GAAP, and were therefore more consistent. IAS were discussed and approved on a world wide basis; hence, IAS could be applied in environments with different legal systems and "allow (for) the consideration of national circumstances in an appropriate and reasonable manner, which leads to sound financial statements". The fact that companies on the "Neuer Markt", which could apply either IAS or US GAAP, had chosen IAS and US GAAP in approximately equal numbers, and analysts and financial institutions were equally happy with accounts prepared under either set of standards, showed that one set of accounting standards was not better than another.

The group of 100 (G_{100}) pointed out that US GAAP have been developed over many years; compromises made in the process had resulted in a number of inconsistencies. The structure and drafting of IAS needed improvement to avoid a potential source of confusion.

3.8.6 Would IASC restructure itself successfully?

AICPA stated the restructured IASC would promulgate high quality IAS and would continue to improve existing IAS.

The French regulatory and business authorities (AMA) submitted a unified response. AMA thought that the IASC was already a high-quality standard setter and was the ideal body to set high-quality global accounting and financial reporting standards; IOSCO had approved the core IAS; AMA was confident of IOSCO's competence – whether AMA knew that the SEC had been steering IOSCO's technical committee all along was difficult to deduce. In relation to IASC's ability to restructure itself successfully, AMA pointed out that the SEC was in the nominating committee for the Trustees of the new IASCF; AMA was therefore confident of the ability of the future trustees and consequently the future board. AMA also queried the SEC's asking whether non-US auditors could ensure full compliance with IAS; world wide audit firms were able to audit US GAAP; there was no reason why they would not be able to audit IAS with the same quality.

The CBI stated that in evaluating IAS, the important issue was the quality of the standards, not the process by which they were produced. The CBI were of the view that audit approaches could validly vary from country to country; the US approach was not the only correct one to follow. Moreover, expertise in IAS was improving all the time, and would significantly increase once IAS were more generally used.

The Financial Accounting Standards Committee of the AAA stated that the SEC should approve IASC's processes, and not its standards piecemeal, provided IASC had been restructured. Mercer noted that IASC staff were helpful when available, and IASC had been willing to change some standards when difficulties had emerged in certain countries. The SIC took too long to deal with problems. IASC probably suffered from a lack of resources, but there was very significant support for IASC in Europe and this should ensure the restructuring was successful.

The G_{100}'s experience with the SIC was different. The SIC had dealt with a wide range of issues on a timely basis which proved its usefulness to the implementation of IAS.

Although the extant IASC structure did not give the assurance of a high quality standard-setter, this did not mean of itself that the quality of existing standards was impaired; but the new structure would give this assurance.

3.8.7 The need for a common conceptual framework

The G_{100} believed the IASC conceptual framework and core standards provided a sound basis for addressing fundamental accounting issues in a broad range of industries; the shortcomings were the lack of a conceptually consistent approach to measurement (use either cost or fair value) and a partial response to financial instruments. Until there were generally accepted international standards for insurance, extractive industries, etc, entities could use US GAAP but there should be a willingness to change to IASC standards when these were developed if the IASC standards were seen as providing more relevant and reliable information to users.

3.8.8 International harmonization

AICPA stated that the international standards-setting process would fall short of producing a comprehensive set of international standards mutually acceptable to all jurisdictions if those standards were required to conform to predominant national standards. An essential element of the convergence process was for national standard setters to incorporate promulgated international standards.

D&T believed that both IAS and US GAAP could be improved, by making greater reference to the underlying conceptual framework as a basis for conclusions and guidance. Global harmonization could progress if there was a common conceptual framework, as a basis for all standards and all guidance to standards.

AA believed that the SEC should promote harmonization to arrive at a single set of global accounting standards, which would be the IAS. D&T thought that the need for high quality should be pursued at the same pace as the need for harmonization: there was considerable debate about how best to achieve high quality and harmonization; did there need to be a trade off between the two? D&T claimed that some believed that harmonization could be achieved only by sacrificing quality, so that a uniform set of accounting standards would be accepted globally in the shortest possible time: others believed that convergence should be aimed at because it is often not possible to come to complete agreement as to what constitutes high quality: others believed that quality should never be sacrificed for the sake of convergence. If quality was compromised, standards

were watered down, leading to uncertainty in the capital markets and a lack of confidence in the financial reporting system. D&T agreed with FASB's approach of pursuing both goals simultaneously: D&T concluded that "high quality promotes confidence in capital markets, while harmonization eliminates the most fundamental global concerns – the lack of a level playing field and user comprehension".

PWC expressed its concern with FASB's continued focus on narrowly defined topics within US GAAP; FASB should focus on the fundamental issues associated with harmonization and the overall financial reporting model. The SEC should orient FASB towards this goal and set a target date for eliminating the major differences between US GAAP and IAS, a process which would involve amending both sets of standards. PWC added that US investors investing abroad "must be made a far greater priority ...US investors are increasingly at risk as a result of the investments they make, directly and indirectly, outside the US". Encouraging the development of a single set of high quality accounting standards that could be used globally would improve financial reporting in many countries in which Americans invest. 40 different accounting standards were used for filings with the SEC; many more were used by companies in which Americans invest but which did not file with the SEC.

3.8.9 Was an international financial infrastructure necessary?

AICPA viewed action by the SEC on IAS as independent of the broader infrastructure issues unrelated to the process of setting accounting standards; these infrastructure issues existed with or without acceptance of IAS. The Financial Executives Institute (FEI) wanted immediate attention to the quality of global audits, the rigor of auditing standards and regulatory oversight in jurisdictions outside the US irrespective of whether IAS were accepted in US capital markets.

The World Bank stated that establishing a sound regulatory framework and transmitting the professional knowledge that was a precondition to serious implementation of quality standards had been and would continue to be difficult at the international level. Many developing countries claimed that they had standards that were based on IAS but the financial statements of enterprises in those countries did not comply with those national standards, nor with IAS; the lack of efficient and effective enforcement mechanisms allowed widespread non-compliance. Progress could be slow in improving accounting, auditing and regulatory practices, and dealing with low skill levels and societies resistant to

change; but resources would be better used in adopting a single set of internationally recognized, high quality standards than have national variations; the Bank considered "the adoption of IASC standards to be highly desirable due to their wide international acceptance and flexibility in incorporating a wide range of international best practices".

Both FASC of the AAA and G_{100} stressed that a supra-national, strong, well-resourced and respected regulator would need to monitor and enforce compliance with standards on a consistent and transparent basis; this regulator should also examine whether auditors play an independent role in ensuring the credibility of the outputs of the accounting process and compliance with the standards. The G_{100} added that there should be a clearly specified and understood mechanism to periodically review the quality of IAS, their comprehensiveness and the way foreign companies complied.

IFAC left comment about accounting to IASC, but intended to monitor member institutes' compliance with IFAC's membership obligations. It would create a Public Oversight Board and require an independent, firm-wide review programme for multinational audit firms. It would introduce a programme for accreditation of individual accountants in International Accounting and Auditing Standards.

AMA suggested that IOSCO should require each of its members to implement quality control requisites similar to those in the US.

3.8.10 Financial reporting in the US

PWC stated that the SEC's mandate was to protect US investors in domestic markets. All companies which entered this market were required to report key data in accordance with US GAAP. US markets were "significantly focused on a single figure of earnings". Allowing an IAS measure of earnings would lead to confusion. PWC, AA, FASB and AICPA proposed to continue full Form 20-F reconciliation, which made IAS and US GAAP measurement differences clear to US investors. FASC argued that research showed that, although up to one third of some samples required no Form 20-F reconciliation because IAS yielded the same result as US GAAP, Form 20-F reconciliations were value relevant for investors (Pownall and Schipper 1999). The AICPA stated that, although individual IAS may be of high quality, the body of IAS was not sufficiently high quality to be used without reconciliation to US GAAP; as convergence progressed (a movement towards higher quality standards from all jurisdictions – not simply a movement towards only IAS or towards only US GAAP), the reconciliation would become unnecessary.

FEI believed that protection of US investors could not be achieved by focusing only on US capital markets. The reconciliation to US GAAP was not the panacea some believed it to be – investors often relied solely on the primary financial statements (confirming Philips' approach, section 3.5) – the quality of the underlying accounting was of paramount importance. FEI focused on global capital markets in which financial information is prepared under many GAAPs. US institutional investors had traded equities on a massive scale in foreign markets for the previous decade and this was continuing to grow; stock markets themselves were merging internationally; individual US investors would be attracted to trade equities in foreign markets. It would be in the best interests of the US to promote IAS, that rely on an investor oriented framework, and which are better than those of most other nations. If the SEC accepted IAS in US capital markets, IAS would be accepted in world markets. FEI therefore proposed that *all* registrants in the US choose either US GAAP or IAS for annual *and* interim reports (categorising registrants as foreign or domestic was nonsensical); the development of a single set of global accounting standards that would be used in all securities markets should be accelerated.

The G_{100} noted that, as a result of the Comparability/Improvements Project, IAS were sufficiently robust for the requirement of reconciliation to US GAAP to be dropped. If circumstances warranted a re-introduction of the reconciliation to US GAAP, this should then be required once again.

The Institutes of Chartered Accountants of Australia, England and Wales and Scotland and the Institute of Public Auditors in Germany (IDW), together with the majority of the members of GFRAC of AIMR, proposed that IAS financial statements were of sufficiently high quality to be accepted without reconciliation to US GAAP. The CBI and the AMA concurred. The CBI pointed out that removing the reconciliation requirement would remove the competitive disadvantage currently suffered by foreign companies which have to account on two different accounting bases to enter the US capital market. UK preparers found that they spent considerable time and effort in preparing reconciliations to US GAAP; but analysts and investors seldom asked questions on the reconciliations. The AMA noted that the cost of preparing the 20-F reconciliation outweighed the benefits from the reconciliation. The AMA saw no important differences between US GAAP and IAS. Foreign companies reporting under IAS would be at a disadvantage to US companies, as some IAS were more conservative than US GAAP.

D&T proposed that IAS be the only non-US GAAP standards for which full 20-F reconciliation was not required, in order to promote the use of IAS around the world. Important items which cause differences when treated by IAS rather than by US GAAP should be quantified, so that a partial reconciliation was prepared.

Cairns proposed that the SEC should accept "properly prepared" IAS financial statements from foreign companies without reconciliation – any continuing reconciliation requirements should be eliminated within five years. While IASs were of sufficiently high quality, the *International Accounting Standards Survey 1999* had revealed that some IAS financial statements were *not* properly prepared or audited.

3.8.11 Overall conclusion on the comments on the Concept Release

Generally regulators and accounting organizations from outside the US thought that IAS were "high quality" and often were superior to US GAAP because they were "principles based" (3.8.3, 3.8.5). Individual American respondents thought that IAS were not high quality (3.8.3). Submissions by the New York offices of the big 5 audit firms, by the AICPA, FEI and SIA were much more balanced (3.8.3-11). By and large, it was felt that IASC would restructure itself successfully; the new structure would ensure that it was a "high quality" standard setter (3.8.6). There was a need for a common conceptual framework as a basis for international harmonization to arrive at a single set of internationally accepted standards (3.8.7). An international regulatory framework was necessary to ensure compliance: IFAC was ready to step up to this task (3.8.10). The majority of overseas submissions thought that IAS were sufficiently "high quality" to obviate the Form 20-F reconciliation; some felt it was important so that US investors could make an easier comparison between US and foreign companies listed in the US (3.8.11). The FASC of AAA was not aware of any accounting research which directly assessed IAS-related expertise, or the consistency of interpretation and application of IAS, in various jurisdictions, which was strange since a number of studies of IAS compliance had been published at the time, including Street et al. (1999) and Tower et al. (1999).

3.9 The catalyst for change arrives

The SEC took no further action on the Concept Release, possibly because it realized that there was hostility to what many viewed as a superiority complex. The SEC may have convinced itself that regulation in the US was so superior to the rest of world markets, that this superiority would be acknowledged by all. It may have expected a large number of

responses in support of its views from US based organizations. Instead, the majority of responses listed on the SEC website came from foreign organizations which gave many reasons why the SEC should be more supportive of IAS. A number claimed IAS were "high quality standards". Even US based organizations, eg., AICPA, FEI, SIA and the Big 5 audit firms, supported IAS. FEI even proposed that US companies be allowed to report in the US using IAS.

On 31 July 2001, Jenkins, the Chairman of FASB, and Leisenring, a member of IASB, appeared before a subcommittee of the US Congress to explain issues then current to FASB. Congresswoman Harman, noting that FASB was a "proponent" of developing "high quality international accounting standards", stated that Congress also had a responsibility to ensure that FASB was "taking the proper steps to influence the policy and standards of IASB" (US Congress 2001, p.8). Congressman Dingell commended FASB and assured the committee that "the quality of information we receive from US companies exceeds that of almost any other nation" (US Congress 2001, p. 9)

The year 2001 was an eventful one in US capital markets. What happened to one company caused a financial revolution in the US. At the start of the year, Enron, rated the most innovative large company in Fortune magazine's survey of Most Admired Companies, had a market capitalisation of over $60 billion; its share price was $83.13; on 2 December 2001, its share price was $0.26 and it filed for bankruptcy (Healy and Palepu 2003).

It has been reported elsewhere that responsibility for ensuring that Enron complied with reporting standards lay with the SEC (ICANZ 2002, p. 47). Observers suggest that the SEC had constantly engaged with companies "over minutiae, which contributed to an excessive focus on short-term, reactive problem solving", at the expense of market development that would have ensured compliance with financial reporting standards in other ways; at the same time, Enron lobbied Congress to block SEC initiatives to curb Enron's aggressive business strategy, and offered political donations to members of Congress who supported the company (ibid., p. 48).

3.9.1 Reactions from the SEC

On 11 December 2001, before investigations into Enron's "meltdown" had started, Pitt, the Chairman of the SEC, cautioned that "mandated financial statements are often arcane and impenetrable. ...A private-sector standard setting that ...achieves its goals too

slowly, or not at all, ...paves a road to the wrong locale. ...we can and will improve our review of financial reports" (Pitt 2001).

When the accounting frauds behind Enron came to light, Sutton, the Chief Accountant of the SEC from June 1995 to January 1998, told the Banking, Housing, and Urban Affairs Committee of the US Senate, headed by Senator Sarbanes, on 26 February 2002:

> *"As we gather today, the institutions responsible for financial reporting in our capital markets are reeling from the fall-out of a financial reporting scandal of colossal proportions. Reports on the collapse of Enron to date have exposed massive manipulations of financial reporting by management, inexplicable breakdowns in the independent audit process, astonishing revelations of holes in our financial reporting standards and practices, and stunning lapses of corporate governance...Enron is a cataclysmic event that has changed the world's view of a system that we have often touted as 'the best in the world'....Can we any longer believe in and rely on the independent audit? Can we any longer believe that our accounting and disclosure standards provide the transparency that is essential to investors and the public? ...Pleas that the vast majority of financial reports are of high quality, that most audits are effective, and that financial reporting failures are few miss the point ... Debates about how many failures are tolerable are not only not productive, they are nonsense"* (Sutton, M. 2002).

Sutton went on to suggest that auditors have to meet high public expectations and uncover and report to the public financial improprieties. They should have zero tolerance of financial reporting failures. They would have to accept new regulations that give comfort to investors, which could best be achieved by setting up a new statutory regulatory organization (a Public Oversight Board) which would operate under the oversight of the SEC. This organization would conduct continuing inspections of the accounting and auditing practices of registered audit firms.

3.9.2 A new view of US GAAP?

Sutton stressed that strengthening the independent audit was only part of the reform needed. The processes by which accounting standards were developed required critical examination. FASB had studied consolidation issues for years, and had done little more than tinker around the edges; rules for accounting for special purpose entities were nonsensical. Accounting standards allowed company directors to manage earnings lawfully and to structure transactions to achieve desired accounting results. Auditors were pressured to accept these standards. Legislators lost sight of the importance of an independent standard setting process. The standard setters backed down from solutions they believed were best.

US standards had become increasingly detailed. Instead, they should be broader statements of principle, applied with good judgement and respect for the substance of underlying transactions and events. Those who had the greatest stake in transparent financial reporting, buy-side analysts, who invest for retirees and invest their funds, should take a more active role in standard setting. FASB should obtain independent funding. He also stated:

> *"We also should take immediate steps to establish an independent governance process to replace the current constituent-based foundation board. The leadership for implementing these changes should come from leaders of unquestioned objectivity and demonstrated commitment to the goals of high quality financial reporting and the public interest"*. (Sutton, M. 2002).

Sutton also proposed that corporate governance guidelines be revised to break the bonds between management and the independent auditor and to spell out the responsibilities of boards of directors and audit committees to investors.

Six weeks after Sutton appeared before the Senate Committee, the Financial Accounting Foundation (FAF), which oversees FASB, announced that it would "strengthen its commitment to a strong, transparent and rigorous system of financial accounting standards for America's capital markets". FASB needed to be more flexible in responding to change and to increase the efficiency of its standard setting process, to enhance financial reporting standards. FASB would be reduced from 7 to 5 members, a simple majority vote (3-2) would replace the 5-2 majority requirement and proposed standards would be exposed for shorter comment periods (FAF 2002).

3.9.3 FASB and IASB sign a Memorandum of Understanding.

It is tempting to attribute FASB's signing a Memorandum of Understanding with IASB on 18 September 2002, to Sutton's remarks to the Senate Subcommittee. It certainly helped the process along but the process was begun in 1997 when IASC appointed a Strategy Working Party (SWP) to develop IASC's strategy and structure, and included a member of FASB and a FAF trustee in the SWP (US Congress 2001). The process continued in January 2001 when the newly appointed IASC Trustees selected the initial members of the then new IASB. Two former members of FASB were appointed full-time members of IASB; an American, James Leisenring, who had been the vice-chairman of FASB for twelve years, and Anthony Cope, who was born in the UK but who had worked for many years in the US, and was a member of FASB from 1993 until his appointment to IASB (Deloitte and Touche 2005b).

In the Memorandum of Understanding, both FASB and IASB acknowledged each other's commitment to the development of "high-quality, compatible accounting standards that could be used for both domestic and cross border financial reporting". They pledged to make every effort to make their standards fully compatible as soon as was practicable and to co-ordinate their future work programmes to ensure that compatibility was maintained (IASB 2002b). But nowhere was it admitted that IAS were "high quality".

3.9.4 SEC roadmap to eliminate reconciliation for IFRS users

On 21 April 2005, the Chairman of the SEC met the EU Internal Market Commissioner to discuss a number of issues, which included expanding "the use of high quality global accounting standards". The SEC staff had developed a roadmap by which the requirement that foreign companies reporting under IFRS reconcile IFRS figures to US GAAP would be eliminated by 2009 at the latest. Progress would depend on a detailed analysis of the faithfulness and consistency of the application and interpretation of IFRS in financial statements across companies and jurisdictions, and continued progress on the IASB-FASB convergence project (SEC 2005a).

3.9.5 Conclusion on changes facilitated by Enron

A thorough search of SEC documents and speeches has not unearthed the SEC admitting categorically that IFRSs are "high quality". Nicolaisen (2005), the SEC Chief Accountant, admits they are "high quality" indirectly when he states:

> *"I believe that the IASB and FASB, while seeking convergence, have been able to do so while maintaining high quality accounting standards".*

Erhardt (2005), the SEC Deputy Chief Accountant, similarly declares:

> *"I believe the IASB and the FASB have demonstrated that they can set high quality standards under difficult and changing conditions, so that stakeholders in financial reporting can look to them to do their jobs well".*

But although she stressed the importance of progress towards a single set of high quality global accounting standards, one year later she cautioned that having financial statements prepared under IFRSs could lead to a number of weaknesses: how would the needs of many investors be dealt with by IFRSs, how would these investors become educated about IFRSs and would this be consistent: how could many preparers ensure that they complied with the "true" IFRSs: were there education opportunities for all these different preparers: were they changing and up to date: were these opportunities in English: did different regulators enforce the application of IFRSs in the same way? (Erhardt 2006).

As Enron becomes more distant, it would seem that the SEC retreats further into its Concept Release position. Nevertheless, it would seem that the SEC has been forced to admit, at least indirectly, that IFRS can be called "high-quality standards". It was now possible for the financial statements of a company prepared in compliance with IFRS, as opposed to US GAAP, to be rated as "high-quality". However, as pointed out in section 2.2.2, many other elements of the interim report and the annual report would also have to be "high quality" before the company could claim to have achieved "high quality financial reporting".

3.10 Conclusions

From this chapter, it can be concluded that a wide variety of organizations related to capital markets use the phrase "high quality financial reporting" (3.2.1, 3.2.2). The expression seems to have been used first by the Jenkins Report (3.3) and was than adopted by the SEC (3.4). A number of organizations agree that US GAAP are "high quality" (3.5). FASB has clarified that it will maintain its worldwide leadership role as a standard setter and that it will be involved in developing "high quality standards"; if any standards are developed without the US being involved, or even if the US is involved but does not accept the standards developed, those standards will be worthless (3.6). When the SEC sought views as to whether IAS were sufficiently "high quality" to dispense foreign companies listed on US markets from filing a 20-F reconciliation (3.7), a large number of important organizations involved directly or indirectly in accounting voiced their support for IAS; some explicitly claimed that IAS were "high quality" (3.8). Enron's demise shook the US accounting confraternity to its foundations (3.9.1, 3.9.2), but was fortuitous for IAS; it made accounting authorities in the US much more amenable to accepting IASB as an equal partner to FASB in developing "high quality accounting standards" (3.9.3, 3.9.4). It is difficult to find any direct statement by the US accounting gatekeepers, the SEC or FASB, that IAS are "high quality", but the SEC Chief Accountant and his Assistant have both admitted indirectly that IAS are "high quality" (3.9.5).

This chapter has outlined the more public side of the story leading to the SEC's indirect admission that IAS are "high quality accounting standards". From one point of view, this admission is of critical importance. US capital markets are the biggest and possibly the most important in the world. As capital markets become more global, entry to the US markets will probably be sought by increasing numbers of foreign companies.

Many of these companies will have been encouraged or instructed to adopt IAS; if IAS are accepted without a 20-F reconciliation when these companies obtain a listing on a US market, adopting IAS will have been worthwhile.

The other side of the story is that over this period, and behind the scenes, IAS have made real progress. For example, when the new IAS 1: *Presentation of Financial Statements* became operative on 1 July 1998, it required a complete Profit and Loss Account to be included in the financial statements. When Kenya adopted IAS, the requirement to disclose all the main numbers in the Profit and Loss Account was viewed by many analysts in Kenya as a major improvement in disclosure (section 9.7.2). Disputes will continue as to whether all the changes were for the better but overall, many will probably agree that a number of improvements to IAS were effected. These changes would not have occurred so quickly without the SEC's insistence on coming to "high quality" solutions. Hence, adopting IAS has become more worthwhile precisely because IAS are of a "higher quality". The SEC's insistence on "quality" has probably been worthwhile.

The accounting scandals in the US, of which Enron was an example, served another useful purpose in that they reminded everyone involved in financial reporting that accounting standards are only part of the process; "high quality financial reporting" is achieved, not by being quoted on the largest stock exchange in the world, not by having a superb website, not by being audited by a world famous auditing firm, but by ensuring that each and every aspect of the whole reporting process is "high quality".

This chapter contributes to the purpose of this study in that it shows that, in principle, by adopting IFRSs, Kenya has chosen a route that has the potential of achieving "high quality financial reporting". If the SEC and FASB had not acknowledged IFRSs as "high quality accounting standards", Kenya would certainly have gained by adopting them, but may have thought that it would have gained even more by adopting US GAAP instead.

CHAPTER 4
The accounting environment in Kenya

4.1 Introduction.

This chapter aims to show why Kenya has been chosen for this study. Kenya is a developing country; is there any possibility of accounting disclosure there being high quality? Emerging economies tend to have underdeveloped institutions (WB 2004a, p. 9). The resulting incapacity disables the systems necessary to permit the economy to function well (WB 2005, p. 2). One reason why an August 2004 IMF assessment mission to Kenya was postponed was the lack of Government institutional capacity in the country to manage donor funds (WB 2004a, p. 28). In prior research, Gray, S. (1988) has shown that the development of national systems of accounting tends to be a function of environmental factors. The environment in which research is undertaken provides a context within which to interpret the findings (Sarpong 1999).

The chapter is organized as follows. Sections 4.2 and 4.3 list factors that favour, and that make difficult, "high quality financial reporting disclosure" in Kenya. Section 4.4 gives some basic context on the location, the background, the population and the GDP of the country. Section 4.5 gives an overview of the economy and employment. Section 4.6 looks briefly at companies in Kenya and gives reasons why it is likely that financial reporting disclosure by companies should be superior to that of unincorporated businesses. Section 4.7 outlines the accounting disclosure requirements of the Companies Act and gives reasons why compliance with these requirements is probably higher for Nairobi Stock Exchange quoted companies then for other companies. Section 4.8 gives an outline of the Institute of Certified Public Accountants of Kenya (ICPAK), Section 4.9 the Professional Standards Committee of ICPAK, and Section 4.10 Kenyan Accounting Standards. Section 4.11 describes the "Best Presented Accounts of the Year" competition, which became "The Financial Reporting Excellence Award" in 2002. The Nairobi Stock Exchange (NSE) and the Capital Markets Authority and their disclosure regulations are covered by Sections 4.12 and 4.13. Section 4.14 outlines the Donde Act. The overall conclusions are presented on Section 4.15.

4.2 Factors for "high quality financial reporting disclosure"

Kenya is a very young country; Nairobi is a very young city. The Johannesburg and the Bulawayo Stock Exchanges (founded 1887 and 1896, see Okeahalam and Jefferis

1999) had been in existence for 12 and 3 years before the first building was erected in Nairobi, now the capital of Kenya and the situs of the country's Stock Exchange (Smart 1950). Mining drew people to Johannesburg and Bulawayo; a railway attracted people to Nairobi (Nangulu-Ayuku 2000). From some points of view, Kenya, and in particular Nairobi, have come a long way in a short time.

When Kenya gained independence in 1963 it was already one of the most developed countries in Sub-Saharan Africa (Bauer et al. 2002). Kenya's GDP grew at 7.9% per annum between 1965 and 1973, underpinned by good internal security, working infrastructure and capable public institutions (WB 2000, p. 55). Kenya's financial system is arguably one of the best developed in Sub-Saharan Africa in terms of breadth and diversity (Brownbridge and Harvey 1998). A well-functioning financial system makes a critical contribution to a country's economic performance by facilitating transactions, mobilizing savings and allocating capital across time and space (Herring and Santomero 1999). Nairobi has been chosen as a financial centre for a number of surrounding countries, as the headquarters of two United Nations Programmes (UNEP and Habitat, see UN 2006) and Shelter Afrique (Okonkwa 2003), and as a regional base for a large number of non-governmental organizations (including the regional headquarters of 23 UN agencies, see UN 2006), because Kenya has enjoyed relative political stability (Nshuti 2002).

The NSE is one of the best developed exchanges on the African continent (WB 2004a, p. 63). The privatization of Kenya Airways through the NSE in 1996 stimulated capital market development when 110,000 people became shareholders in the company: the privatization team was given the World Bank Award for Excellence for 1996 for being a model success in the divestiture of state-owned enterprises (NSE 2002a, p.165). Wagacha (2000) finds shareholders of NSE quoted companies to be mainly young (aged 28-37), well educated and well informed, seek dividend yield as much as capital growth, churn their portfolios in order to cash in on gains and seek little advice from brokers. Auditors in Kenya pay special attention to the audit of companies quoted on the NSE (interviews with auditors, chapter 9 of this thesis). Auditors in Kenya are ready to decline audits if the risk of their having to compromise their honesty is high (Wahome 2002). Kenya was one of the first countries in Africa to adopt IAS for all businesses in the country. One of the two members of the Board of IFAC from Africa is a Kenyan (Ndungu Gathinji) and is the Chairman of the "Developing Nations Permanent Task Force" (IFAC 2005a).

Kenya is regarded as one of the most corrupt countries in the world (TI 2004), and Ashraf and Ghani (2005) argue that the adoption of IAS by Pakistan, a country rated equally corrupt (TI 2004), has not led to an improvement in the quality of financial accounting in that country; but Ali et al. (2004) find that Pakistan has a higher level of overall disclosure compliance than India and Bangladesh.

The median Kenyan worker produces $3,457 of manufacturing value added, two-thirds more than the median Tanzanian worker and three times the Ugandan (WB 2004a, p. 36). The achievement of quality in any area of human activity implies a readiness to change, a willingness to study, a desire to expand horizons, an eagerness to learn from others, a commitment to adopt best practice in that activity (Ishikawa 1985, pp.20-22). This chapter shows that one part of the economy of Kenya has developed quite significantly, alongside a way of life that reflects the more traditional style of life in Africa. The "modern" sector of the economy of Kenya is small in terms of the number of people employed in it, but makes a significant contribution to the country's GDP.

4.3 Factors against "high quality financial reporting disclosure"

At the same time, a number of factors militate against accounting disclosure by companies quoted on the NSE being high quality.

In the year to 30th June 2002, 53% of electricity generated in Kenya was from hydro (KPLC 2002, p. 44) - in the year to 30th June 1997 this figure had been 78% (ibid.). In the year 2000 rainfall was poor and in 2001 the rains failed. This resulted in widespread crop shortages, depleting farmers' purchasing power. In addition, there was severe electricity rationing throughout the country, with only 32% of the total electricity generated being from hydro (ibid.). Industrial producers had to modify their production schedules drastically to use power only when it was obtainable and had to pay a higher price for what electricity was available - increased costs of thermally generating electricity were passed on to consumers. As a result, all sectors of the economy were adversely affected by the shortage of rain.

The majority of countries that surround Kenya have suffered from civil war in recent years; the possibility of war in Kenya is regarded as remote by Kenyans but is seen as a real possibility by investors from abroad (WB 2000, p. 54 -55).

Crime and theft are major impediments to business in Kenya; crime levels against businesses in Kenya are three times higher than in Uganda and Tanzania; one third of all

businesses in Kenya have been victims of crime (WB 2004a, pp. 17-18). Law enforcement is poor, due to weaknesses in the police and judicial systems. 80% of incidents of crime are reported to the police but only 20% are solved. Police officers themselves are often implicated in criminal activity with the result that a number of crimes go unreported (ibid., pp.77-78).

Kenya has had only three presidents since its independence in 1963. The idea of a leader being accountable to those beneath him is novel in Africa: once elected, they have tended to spend their time entrenching their power base rather than making sure that the machinery of government is working, is adapting to new competition from other emerging countries, is changing for the better (Edigheji 2005, p.19; Adar & Munyae 2001). Government jobs are rewards to the leader's ethnic group, sometimes irrespective of whether employees are suitably qualified (Oriang 2006). Government salaries are unable to be raised because of the bloated head count in the civil service, the general mismanagement of finances and the difficulty of raising tax revenue from a generally poor populace (IMF 2006, p.21). Well qualified technocrats avoid working in Government: outdated laws are difficult to change (WB 2004a, p. 95).

The World Bank claims that corruption is the most significant barrier to doing business in Kenya (Karanja 2005). Corruption adversely affects the court system (WB 2004a, p.77); in 2003, the anticorruption authority found credible evidence of corruption against 5 of the 9 Court of Appeal Judges and proof of misconduct against 18 of 36 High Court judges and 82 of 254 magistrates; in October 2003, one half of Kenya's senior judges were suspended over allegations of corruption (LoC 2005).

Kenyan business enterprises are 1.5 times as capital intensive as those in Tanzania and China, 4.8 times India and 7.9 times Uganda. In spite of the heavier investment in equipment, Kenya's labour productivity is only equal to that in India and less than that in China (WB 2004a, p. 37). Gerdin (1997, Ch.6) finds that productivity growth from 1964 to 1994 was minus 0.12% per annum. The World Bank (WB 2004a, p. 39) finds that between 1999/2000 and 2002/2003 almost no productivity improvement is seen in the average enterprise.

A relatively large number of qualified accountants working in the Big four audit firms in Nairobi have been recruited by the European, Australian and US offices of those firms after Europe and Australia adopted IFRSs and the US passed the Sarbanes Oxley Act

(ICPAK 2006b). This loss of well trained personnel could lead to a decline in the quality of financial reporting disclosure.

Finally, Street and Gray (2002) find that compliance with IAS measurement and presentation standards tends to be lower for companies domiciled in Africa.

4.4 Kenya: its location, background, population and GDP

Kenya is a country of 582, 646 square kilometres and straddles the equator on the eastern coast of Africa (EB 1979, Vol. 10, p.422 - **10**:422). For comparison the United Kingdom is 244,786 square kilometres (ibid., **18**:864), France 551,000 (ibid., **7**: 582) and Texas 692,379 (ibid., **18**:164). 80% of the land is either arid or semi-arid. These infertile areas support 20% of the population; the remaining 20% of the land is arable and supports the remaining 80% (Waithaka, Anyona & Koori 2003). Kenya is bordered on the north by Ethiopia and The Sudan, on the west by Uganda and Lake Victoria, on the south by Tanzania, and on the east by Somalia (EB 1979, **10**:422) and 536 kilometres of the Indian Ocean (LoC 2005). Its borders were fixed by the 1884/5 Conference of Berlin (EB 1979, **1**:205) and an Anglo-German Agreement in 1886 (ibid., **6**:99), but its present western and eastern borders were changed in 1920 (Trzebinski 1986) and 1925 (EB 1979, **6**:99)

The name Kenya (from the Akamba "Kee Nyaa" meaning "ostrich", see Trzebinski 1986: p.94, because of the snow covered peak of Mount Kenya, 17,058 feet or 5,199 metres above sea level, the second highest mountain in Africa, which sits in the middle of the country, almost exactly on the Equator, see EB 1979, **10**:423) was first used in 1920 to replace "the East African Protectorate".

The capital of the East African Protectorate was moved in 1907 from Mombasa, the main port on the hot and humid coast, to the more temperate Nairobi (Nicholls 2005, p. 105), derived from the Maasai name "Engore Nyarobe" meaning "the place of cold water"(Smart 1950), 480 kilometres to the northwest, situated 1,800 metres (5,400 feet) above sea level. Nairobi did not exist prior to 1899 – Maasai herdsmen would water their cattle at the river that ran through the spot (Nangulu-Ayuku 2000). The first building structure to be erected in what was to become Nairobi was a rail-store in 1899 when the construction of the Uganda railway through the Athi plains had been completed and the ascent into the highlands was to begin (Nangulu-Ayuku 2000). Nairobi became a city in 1950 (Smart 1950).

Kenya became a colony of Britain on 1 July 1895 and achieved its independence on 12 December 1963 (Kenya Government 2004 - KG). It became a republic within the Commonwealth on the same day one year later (KG). Jomo Kenyatta was the first President of independent Kenya from 12 December 1964 (he was the Prime Minister from 12 December 1963 to 12 December 1964) to his death on 22 August 1978 (KG). "Tribalism", corruption and smuggling had already become deeply entrenched in Kenya by the time of his death (Adar and Munyae 2001; Ndungu Report 2004). Daniel arap Moi, the then Vice President, succeeded Kenyatta and ruled until 30 December 2002, when Mwai Kibaki succeeded Moi (KG).

In Somalia, Ethiopia, Southern Sudan, Uganda, the Democratic Republic of the Congo (formerly Zaire), Rwanda and Burundi there have been wars or coups in the recent past (Edigheji 2005, p. 5). Tanzanian forces invaded Uganda in 1979 to overthrow Idi Amin (Tayeebwa 2004); the cost of this intervention took a very heavy toll on the Tanzanian economy (BBC 2006). The other country in the region which has had relative peace is Kenya; a coup was attempted by the Kenya Air Force on 1 August 1982, led largely by Luo officers, but was contained within a day by the Kenya army (Adar and Munyae 2001). "Tribal clashes" were instigated by some high ranking politicians from 1991 to 1994 and again from 1997 to 1998 (Adar and Munyae 2001). Although a number of people were killed and many fled to their ethnic homelands, civil war was avoided (Kanyongolo and Lunn 1998).

With a population of 31 million (WB 2003a), Kenya is one of the 48 countries of Sub-Saharan Africa (SSA – population 700 million), which is dealt with as a distinct group by the World Bank (WB 2000, p.132). Kenya has the seventh largest population and the fourth largest GDP ($14bn.) in SSA. In spite of having such a high rank in economic terms, the number of "poor" people in Kenya increased from 3.7 million in 1973 to 17 million (56% of the people) in 2002 (Waithaka et al. 2003).

Table 4-1: 7 most populous countries in Sub-Saharan Africa (2002)

	Country	Population: mn	GDP $bn
1	Nigeria	133	50
2	Ethiopia	67	7
3	Democratic Republic of the Congo	52	5.6
4	South Africa	45	160
5	Tanzania	35	10
6	Sudan	34	18
7	Kenya	31	14

Source: WB 2003a.

It can be seen that Kenya's emergence as a country occurred over an extremely short period of time. Many of the tensions between the different ethnic groups that suddenly found themselves making up the same country made political rule difficult, as it has in many other SSA countries (Mitullah 2002). Kenya could be considered a typical example of a developing country, especially in the African setting, but different from a number of countries in that major civil conflicts have been avoided.

If the financial accounting disclosure of companies quoted on the Nairobi Stock Exchange is found to be "high quality", then the Kenyan model can be put forward as one to be imitated in other developinging countries, especially in Africa.

4.5 An overview of the economy and employment in Kenya

4.5.1 Agriculture, manufacturing and extractive industries

Kenya is regarded as an agricultural country: 75% of its people are involved in agriculture (USAID 2003). In 2001, 26.5% of its gross domestic product (GDP) came from agriculture – higher than what it was (19.0%) in 1972 (IMF 2003). Kenya's principal export had been coffee, but with oversupply becoming more acute in the world market, and with problems of marketing the product and paying farmers, coffee has become less and less important in the country's economy; it dropped from 19% of total exports in 1990 to 4% of total exports in 2001 (IMF 2003). Tea and horticultural products have replaced coffee as the major agricultural export commodity, making up 29% and 8% of total exports in 1990; in 2001 the figures were 22% and 14%. 8 of the 47 companies quoted on the NSE in 2002 were agricultural companies. 7 produced and exported tea or coffee; 1 produced and exported sisal. Of the 7 companies that produced tea and coffee, one has subsequently ceased growing coffee to concentrate on tea, tropical fruit and horticulture.

"Other exports", made up mainly of manufactured goods, have grown from 25% of total exports in 1990 to 46% in 2001 (IMF 2003). However, manufacturing made up only 13.0% of GDP in 2001 (IMF 2003). Several manufacturing companies are quoted on the NSE but make up a miniscule proportion of manufacturers in Kenya.

49% of exports went to other African countries in 2001, 29% to Europe, 12% to Asia, 6% to the Middle East, 2.5% to the US and Canada and the remaining 1.5% to the rest of the world (IMF 2003). Whereas the North American market is crucial for a number of countries in East Asia, it is almost non-existent for Kenya. North Americans know Kenya better from its athletes and its tourism.

Kenya has few mineral resources. Soda Ash is produced from Lake Magadi, 80 kilometres south west of Nairobi, and made up 1.3% of the country's exports in 2001 (IMF 2003). Enough cement for the country and a small amount for export (0.8% of total exports in 2001) are produced in Mombasa, and at Athi River - 40 kilometres south east of Nairobi. 3 cement producing companies are quoted on the NSE.

4.5.2 Services

Services contributed 55% of GDP in 2001 (IMF 2003). Tourism has traditionally been a large foreign exchange earner. When "tribal clashes" occurred in Mombasa in August 1997, in the run-up to the general elections held in December that year, there were massive cancellations in hotel bookings all over the country, but more especially along the coast (Mbogo 1998). In August 1998, the American Embassy in downtown Nairobi was bombed. Americans were advised to avoid Kenya (Kenya Times 1998). The number of tourists visiting the country plummeted (Wachira 2004). After the NARC opposition was elected to power on 30 December 2002, tourism began to pick up again; in 2005, the number of tourists in SSA grew by over 10%, almost twice the world rate (5.5%), with Kenya's growth (26%) the second highest in the region (East African 2006). In 2001, trade, restaurants and hotels made up 13% of GDP (IMF 2003): 9 companies in this category are quoted on the NSE.

Finance, insurance, real estate and business services - with 12 quoted companies and all the 600 accounting firms in the country (ICPAK 2006b) - made up 10.6% of GDP but employed only 6.8% of the private sector, and 0.5% of the total, Kenya labour force in 2001(IMF 2003). This sector makes an important contribution to the economy as a whole, without considering the order and the information that accountants provide in other sectors. Transport, storage and communications contributed 6.2% of GDP (IMF 2003) with 2 companies quoted on the NSE.

4.5.3 Employment

Figures 4-1 and 4-2 show the distribution of the Kenyan labour force overall and also the distribution of the labour force among the distinct areas of the private sector. The majority of Kenyans live in the rural areas and work in farming or the informal sector of the economy. After the Kenyan economy was liberalized in the late 1980s and early 1990s (import licences and foreign exchange controls were abolished), a large number of

Figure 4-1: Kenya Labour Force 2001: Total 12.195m. (IMF 2003)

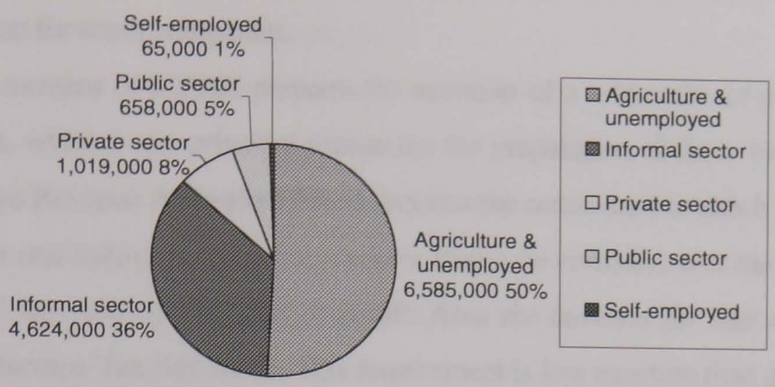
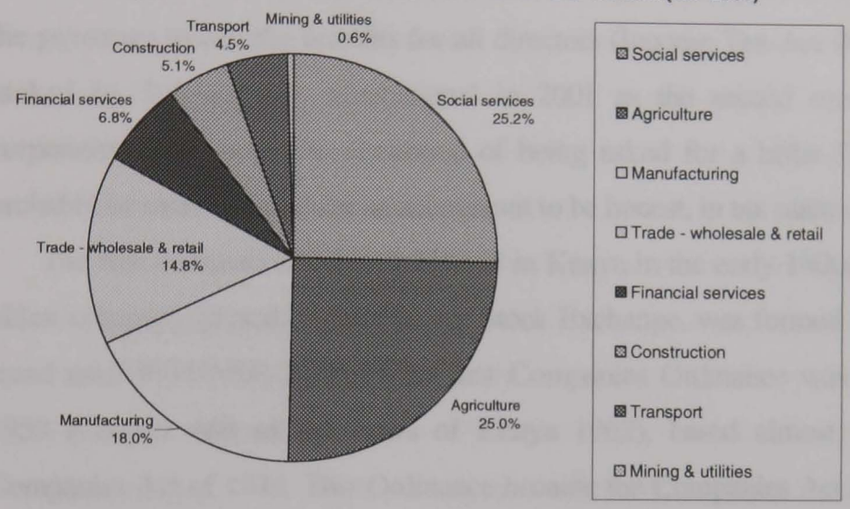


Figure 4-2: Private Sector Labour Force 2001:Total 1.019m. (IMF 2003)



companies in the country closed down. Kenyan manufacturers simply could not compete with imports in terms of quality (WB 2004a, p. 30).

The formal sector employs far fewer people but produces a disproportionately large part of the GDP of the country. This is typical of many SSA countries.

4.6 Companies in Kenya

The Nairobi Stock Exchange is one of the oldest in Africa (Kariithi 2001). One of the most important functions of a stock market is to promote a culture of saving by providing a way by which savers can earn a return on their investments (NSE 2002a, p.5). Stock markets also promote higher standards of accounting (NSE 2002a, p.5). But stock markets presuppose the existence of companies and a law to define the rights and duties of the parties involved in financing and running those companies (La Porta et al. 1999, pp. 1-15). High quality financial disclosure is more likely to occur in companies than in unincorporated business enterprises if the financial statements of companies have to be audited and if those of unincorporated businesses do not (La Porta et al. 1999, p. 23). In

Kenya, all companies must have their accounts audited each year; there is no audit exemption for small companies.

If a member of ICPAK prepares the accounts of a sole trader or a partnership for tax purposes, which is the principal reason for the preparation of these businesses' accounts, the Kenya Revenue Authority (KRA) requires the accountant to attach a certificate stating "*whether and subject to what reservations, if any, he considers that the accounts present a true and fair view of the gains or profits from the business for that accounting period*" (Kenya Income Tax Act 2002). This requirement is less exacting than an audit. In the case of a company's tax return, the accountant has to sign a different certificate which specifies the payments to and the benefits for all directors (Income Tax Act 2002). The KRA was ranked by Transparency International in 2001 as the second most bribe-prone state corporation, with a 63.7% likelihood of being asked for a bribe (TI 2001) - it would probably be more difficult for an accountant to be honest, in tax matters, than not to be.

The first companies were established in Kenya in the early 1900s. Unga Limited, the oldest company quoted on the Nairobi Stock Exchange, was formed in 1908 but was not listed until 1971(NSE 2002a). The first Companies Ordinance was not published until 1959 (Chapter 486 of the Laws of Kenya 1962), based almost wholly on the UK Companies Act of 1948. This Ordinance became the Companies Act after Kenya became independent, and has been amended in very minor ways with the passing of the years but the accounting provisions have not. At the time of Kenya's independence in December 1963, there were 4,714 local companies registered in the country and 624 branches of foreign companies. By the end of 1975, the numbers were 11,443 local companies and 868 branches of foreign companies (Pannell Bellhouse Mwangi 1977); approximately 7% of the local companies were public and 61 of these companies were quoted on the NSE. There were 264 firms of accountants auditing these companies (ibid.). The Registrar of Companies was unable to state the number of public companies in Kenya in 2002, since the register was kept manually and had not been kept up to date. The number of private companies in the country was 110,380, but it was not known how many of these were dormant. The Kenya Revenue Authority states that there were 64,543 companies chargeable to tax in 2002. The number of NSE quoted companies had dropped to 47.

4.7 The Kenya Companies Act

4.7.1 The accounting requirements

For many years in Kenya (from 1959 to 1983), the only regulations as to the content of financial statements of companies generally and, in particular, the companies quoted on the NSE, were contained in the Kenya Companies Act. These regulations were the precursors of IFRSs, but remain in force alongside IFRSs. They could be regarded as the foundation on which financial disclosure in Kenya was built, by creating a cultural environment in which compliance with a regulatory system became the norm. The accounting profession in Kenya was modelled on that in the UK, as has happened in many other countries around the world (Gernon and Meek 2001). Stamp (1972) points out that a Companies Act gives accountants the necessary "teeth" to deal with problems that arise with the audit of companies; because some US states have extremely lax corporation laws, the US SEC has to devote part of its energies to substituting for a Federal Companies Act.

The Kenya Companies Act 1962 (CA 1962) requires all companies incorporated in Kenya to keep books of accounts in the English language, not so much as to prevent owners from preparing accounts in Swahili or a language of one of the ethnic groups of Kenya, but more to prevent directors of Indian origin from keeping those accounts in one of the Indian scripts. The books are required to give "a true and fair view of the state of the company's affairs and to explain its transactions" (Section 147, CA 1962).

At least once in each calendar year, a Profit and Loss Account for the year (s.148), a Balance Sheet as at the end of the year (s.148), a Directors' Report (s. 157) and an auditors' report (s.156), must be laid before the members of the company in an annual general meeting (AGM). The Profit and Loss Account must give a true and fair view of the profit or loss for the year (s.149). The Balance Sheet must give a true and fair view of the financial position of the company as at the year end (s.149), and must be signed by two directors on behalf of the Board of Directors, or in the case of a bank, by the secretary or manager and three directors (s.155). The signing of the balance sheet signifies the board's approval of the accounts (s. 156.2).

Every company must hold an AGM in each calendar year; not more than 15 months can elapse between one AGM and the next; notice calling this meeting must specify that it is the AGM and be given in writing, together with (and free of charge), a copy of the accounts, the directors' report and the auditors' report (s. 158), at least 21 days before the

meeting, to every member and every debenture holder of the company (ss.131 & 133). The AGM must be held within 9 months of the company's year end (s. 148).

The profit and loss account and the balance sheet must comply with the requirements of the Sixth Schedule to the Companies Act (s. 149). A summary of these requirements is included in Appendix 4-1. The aggregate remuneration paid to directors each year, differentiating between emoluments paid to directors who are managers and fees paid to non-executive directors, must be shown in the Profit and Loss Account (s.197). Any loans given by the company to officers of the company (that is, directors and the company secretary), or by a third party and secured or guaranteed by the company, must be disclosed separately in the balance sheet of the company (s. 198). The details of Sections 197 and 198 are included in Appendix 4-1. In the case of a group, a consolidated balance sheet and a consolidated profit and loss account for the whole group must be prepared (s.151).The consolidated accounts must also comply with the requirements of the Sixth Schedule. Investee companies are members of a group if they are controlled by the holding company (s.154).

The Directors' report must deal with the company's state of affairs, must indicate any change in the nature of the business (under IAS 1 paragraph 102 (b) a description of the nature of the company's operations and its principal activities must be disclosed), must reveal the dividend proposed by the directors, and the amount which they propose to transfer to reserves (s.157).

The Companies Act was amended in 1978 to accommodate the newly passed Accountants Act: auditors of companies must now be members of ICPAK. The Auditors' report must state expressly whether the auditors have obtained all the information and explanations which to their knowledge and belief were necessary for the purposes of their audit; whether proper books of account have been kept; whether the company's profit and loss account and balance sheet are in agreement with the books; and whether the profit and loss account and the balance sheet give the information required by the Companies Act in the manner required by the Act, and give a true and fair view of the profit or loss for the year and the financial position as at the year end (Seventh Schedule). In addition to these requirements, all auditors are required by ICPAK to state whether, in their opinion, the financial statements of the company comply with IFRSs (ICPAK 1997). Every company (the members) must appoint an auditor at each AGM (s159). The auditor must be independent of the company, and every partner of the audit firm must be the holder of a

practising certificate (s. 161). If a new auditor is to be appointed in place of the present one, this must be done by special resolution; the outgoing auditor has the right to make written representations which must be sent to all the members (s.160).

Section 404 of the Kenya Companies Act empowers the Minister of Finance to make regulations to alter or to add to the requirements of the Act, or the Sixth Schedule, in relation to the matters to be stated in a company's or group's balance sheet and profit and loss account. However, this power has not been used to date.

4.7.2 Possible improvements in the Kenya Companies Act

The Kenya Law Reform Commission has been working on revising the Kenya Companies Act since 1989 (ICPAK 1989) but has not produced the legislation yet.

Although there are numerous complaints about the fact that the Companies Act is out of date, from both accountants working in Kenya and from "experts" who visit the country from various organizations abroad, the legislation is robust. The World Bank's ROSC (WB 2001) claims that the Companies Act "*was not amended to reflect the requirements set by the Accountants Act*" which is an error of fact: the World Bank goes on "*consequently, there is lack of clarity concerning the statutory requirements on disclosures in the financial statements of limited liability companies*", which is equally fallacious: the World Bank concludes "*This is an important gap in the legal and regulatory framework that needs to be addressed*": this conclusion is debateable. It is clear that the Companies Act could be fine tuned extensively. A more pressing problem in the country is to have a well functioning Registrar of Companies which ensures that all companies on the register file annual returns, and all public companies file yearly audited accounts. One of the largest audit firms in Kenya sought clarification from the Registrar of Companies as to the meaning of some of the requirements of the Sixth Schedule; no reply was ever received: it is difficult to obtain the number of companies that operate in Kenya from the Registrar of Companies: companies' files go "missing" when it is convenient for this to occur (interview with partner of firm E). Some of the wording of the Sixth Schedule is difficult and some of it is out of date. If these areas are ring-fenced, the remainder of the legislation is a first step towards a sound basis for "high quality disclosure".

Disclosure is only one aspect of "high quality financial reporting". An equally important aspect is the "quality of measurement". Kenya's accounting follows the UK system which historically left measurement up to the individual accountant who followed his chosen method

according to basic principles. Nobes (1998) suggests that a series of technical rules, such as the French "*plan comptable général*", which contains a detailed chart of accounts and which specifies classification, valuation and costing procedures and prescribes the content and form of financial statements (Oldham 1981, as quoted in Mwarania 1983), may be a more suitable framework in emerging countries than IAS. But IFRSs have brought greater uniformity and comparability than was the case before their introduction (ICPAK 2001).

4.7.3 Quoted companies have a higher likelihood of compliance

This thesis examines financial reporting by NSE companies. These form an extremely small proportion of the total number of companies in Kenya. Accounting firms that audit quoted companies are especially careful in carrying out this work (chapter 9 of this thesis). Wagacha (2001) finds that one third of respondents in unlisted organizations give the "many strict regulations" and "heavy taxation" as major reasons for not listing on the NSE. The corporation tax rate for listed companies is exactly the same as for non-listed ones, and equal to the top rate of income tax at 30%; a quoted company is more in the public eye and may be unable to "toa kitu kidogo" ("give something small") to staff of the taxation authority to reduce "slightly" the amount of tax charged (Szlapak 2002, p. 54); the risk of discovery for a quoted company would likely prevent a departure from the requirements of the law. It follows that there is a higher likelihood for the accounts of NSE companies to comply with the Companies Act. The fact that the Act has been constant for so long should mean that practitioners can become very familiar with the details of its accounting requirements. However, there is also a tendency for practitioners to think that they are familiar with these requirements, when in fact they are not.

In 2001, the directors of the main coffee marketing company in Kenya, the Kenya Planters Co-operative Union Limited (KPCU), a non-quoted company, decided to approach a Big 4 audit firm to replace the company's auditors. One firm turned down its being proposed as new auditors at the AGM. Another Big 4 firm accepted, was voted in and then corrected the previous year's figures by making a provision for taxation of KShs. 45 million (approx. Sterling £0.4 million) whereas the previous set of accounts had made no provision. Although this news became public, a satisfactory explanation was never given by either the company's directors, the auditors involved or ICPAK, although ICPAK had promised a full investigation as it suspended another firm for the poor quality of its audit of a non-quoted client company (Wahome 2002; Kisero 2002).

4.7.4 Additional disclosure required by ICPAK from 2002

The Institute of Certified Public Accountants of Kenya (ICPAK) has required, since early 2002, the inclusion of a "Statement of Directors' Responsibilities" (the heart of which reads as follows: *"The directors accept responsibility for the annual financial statements, which have been prepared using appropriate accounting policies supported by reasonable and prudent judgements and estimates, in conformity with IFRSs and the requirements of the Companies Act"*), signed by the two directors who sign the financial statements, to be attached to the financial statements of *all* companies in Kenya (ICPAK 2002a). Many quoted companies had adopted this statement prior to 2002.

4.8 The Institute of Certified Public Accountants of Kenya

The first piece of legislation controlling accountants in Kenya was "The Accountants (Designations) Ordinance" (Chapter 524 of the Laws of Kenya) which took effect from 30 December 1950. An accountant could not be appointed the auditor of a company in Kenya unless he or she was a member of one of the designated bodies included in this ordinance. These were the Institutes of Chartered Accountants of Scotland, England and Wales, Ireland and India, the Association of Certified and Corporate Accountants and the Societies of Chartered Accountants in South Africa and in Southern Rhodesia.

In 1969, the Kenya Government established the Kenya Accountants and Secretaries National Examinations Board (KASNEB) to provide professional examinations leading to the Certified Public Accountant of Kenya qualification. Prior to this date, a number of Kenyans trained in the UK to become members of one of the UK Chartered Institutes. A second alternative was to sit the examinations of the Association of Chartered Certified Accountants (ACCA) and to train in Kenya. After the number doing this fell to a very small figure in the mid 1990s, the number has increased and continues to increase each year. The reason for the popularity of this UK based examination is that it is perceived to increase the chances of employment abroad, especially in the UK, the US, South Africa, Canada and Australia, in spite of this not necessarily being the case.

The Accountants Act (Chapter 531 of the Laws of Kenya) received Presidential Assent on 1 March 1977 and came into operation on 1 July 1977, by notice in the Gazette. It superseded the Accountants (Designations) Act. It established a Registration of Accountants Board (RAB) and the Institute of Certified Public Accountants of Kenya, and gave legal recognition to KASNEB. Mr. S. K. Mbugua was the first Chairman of the

Registration of Accountants Board, and over 500 accountants had been registered by 17 November 1978, when the then Vice-President of Kenya, Mwai Kibaki, inaugurated ICPAK. Immediately following the inauguration ceremony, the first AGM of the new Institute took place. 350 registered accountants attended the inauguration and this meeting at the Kenyatta Conference Centre. Mr. S. K. Mbugua was elected the first Chairman at the meeting. By this date, over 5,000 Kenyans had registered with KASNEB and 70 persons had completed the CPA examinations. Vice-President Kibaki stressed that ICPAK would be expected to promote "*a high standard of professional competence and practice amongst its members . . . acceptable both in Kenya and internationally*" (ICPAK 1978).

By 30 September 1979, RAB had registered 686 accountants: 322 had obtained practising certificates and the total who had paid their subscription fees was 534 (ICPAK 1979). One of the principal reasons for the de-registration of accountants by RAB remains the non-payment of annual subscriptions to ICPAK. At 31 December 2002 there were 2,295 paid up members of ICPAK, 848 of whom had practising certificates (ICPAK 2006b). ICPAK estimates that there are at least a further 500 qualified accountants in Kenya who are not registered with the Institute (WB 2001, p.2). Accountants who pass the ACCA examinations have to pass two examinations (one in Kenya Company Law; another in Kenya Taxation) in the KASNEB system in order to register with ICPAK.

4.9 The Professional Standards Committee

The new Institute set to work immediately. It joined the International Federation of Accountants (IFAC) and the International Accounting Standards Committee (IASC). In 1982, IFAC and IASC made mutual commitments to each other. The sponsoring professional accountancy bodies agreed "to maintain IFAC with the objectives, powers, membership and obligations of membership set out in the IFAC Constitution" and to maintain the IASC. The bodies acknowledged that IFAC and IASC are sponsored by and report to the same professional accountancy bodies; they recognised that IASC had "full and complete autonomy in the setting of international accounting standards" and recognized "the necessity of involving other interested parties in the accounting setting process to widen input and encourage acceptance and adoption of such standards". All members of IFAC were ipso facto members of IASC (IFAC 1982).

ICPAK established a Professional Standards Committee which had the task of considering whether mandatory accounting standards should be imposed on members. A

questionnaire was sent out to members in 1980. It explained that Standards would be mandatory on all members; since "*all auditors of limited companies in Kenya must by law be members of ICPAK, this will ensure that all company accounts would comply with the provisions of all standards*" (ICPAK 1980). If any standard conflicted with Kenya law, representations would be made to the Government to change the law. The syllabus of the CPA (Kenya) examinations would include the standards and in fact did so.

The required wording of the auditors' report would be changed so as to incorporate the fact that the auditors were of the opinion that the accounts were in compliance with Kenyan Accounting Standards.

4.10 Kenyan Accounting Standards

4.10.1 The standards are promulgated

An Explanatory Foreword to Kenyan Accounting Standards (KAS) was published. This document explained that, in discharging ICPAK's obligations as a member of IASC, it would incorporate International Accounting Standards (IAS) into KAS. When an IAS was issued, it would be published by ICPAK for the information of members. It would be compared with Kenyan practice (whether or not covered by a KAS) to determine if there were significant differences between the two. Kenyan practice would prevail until ICPAK issued a new KAS. Kenyan Exposure Drafts (KED) would be issued by ICPAK and comments would be invited by the Professional Standards Committee within a stipulated period which would not be less than three months. KAS would be published after due regard had been given to representations received.

The first Kenyan Accounting Standard (KAS 1), on Disclosure of Accounting Policies, was published in 1982 and became operative for financial statements relating to accounting periods beginning on or after 1 January 1983. KAS 1 indicated that compliance with its requirements would ensure compliance with IAS 1; this model was followed in subsequent KAS. 18 Kenyan Accounting Standards were promulgated between 1982 and 1995. A Kenyan Accounting Guideline on *Accounting and Reporting Practices of Short Term Insurers* was published in August 1997. A full list of the Kenyan Accounting Standards is included in Appendix 4-2(a).

In spite of the 18 Kenyan Accounting Standards having been promulgated, the profit and loss account of all companies other than banks and insurance companies remained no more than an appropriation account (Morris 1984, p. 67), with the addition of the "turnover"

figure in the case of quoted companies. When IAS were adopted in Kenya, the "full" profit and loss account (or income statement) was introduced for the first time. Analysts (in particular) saw this as a great improvement in financial reporting disclosure in Kenya.

4.10.2 Problems encountered in the process

At the AGM of the Institute held on 26 May 1989, the newly elected Chairman James Muguiyi, noted that ICPAK had now been in existence for just over ten years. He pointed out that 14 Kenyan Accounting Standards and several Exposure Drafts had been issued. "*One thing that has been glaringly lacking is the input by both the public and private sectors to whom these standards are supposed to apply. It is my view that these matters are too important to be left solely to the profession to decide*" he added (ICPAK 1989). All attempts to obtain comments on Kenyan Exposure Drafts failed to come to fruition, except from the Nairobi offices of the large international audit firms. The comments from these offices were strikingly similar to those made by their UK offices when similar exposure drafts were circulated in the UK. Mwarania (1983) points out that "*the response is so pathetic that one wonders whether there is any need ... of circulating Kenyan Exposure Drafts... evening lectures are arranged to explain to members why the standard is being proposed and what its contents are. (The audience is composed of) mainly the members of the Professional Standards Committee*".

The explanation for this seemingly uninterested attitude amongst the members of the Institute was that qualified accountants were busy producing accounts in their various places of work; they had little time to devote to the theoretical matters of developing accounting standards. Moreover, they had received IASs from the Institute when these had been promulgated and "*Kenya is simply rewriting International Accounting Standards and christening them 'Kenyan Accounting Standards'*" (Mwarania 1983, p.31).

It was inevitable that at some point the Council of the Institute would accept the reality of the situation and decide to adopt IAS in their entirety. This did not occur until 8 years later. In 1997 the Council made the decision to do so, which has been noted in section 1.2.1 of this thesis. IAS became mandatory for all accounts produced in Kenya with effect from 1 January 1999. Could adopting IAS be viewed as a weakness on the part of ICPAK?

4.10.3 Even The Netherlands considers this option

ICPAK's admission that it had not kept KAS up to date with IAS was similar to the position of the accounting profession in a country as advanced as The Netherlands, which acknowledged in late 1991 that "*the current output of CAR (the Council for Annual*

Reporting – the Raad voor de Jaarverslaggeving) is a problem and a certain backlog exists. More staff does not seem to be the problem. More international co-operation and using IASC standards as an input to the process seem to be more realistic ways of decreasing the backlog. International accounting standard setting is a very important ingredient of current national accounting standard setting. International comparability does not seem to be important only for the multinational companies" (Hoogendoorn 1992). Cooke (1989a) points out that The Netherlands was ranked in the top 5 countries (along with the UK, the US, Canada and Sweden) in a survey of 17 countries' annual reports studied by Cairns et al. (1984): annual reports in the top 5 countries were described as "good" in this study. But Camfferman and Cooke (2002, p. 19) also reveal that regulation in The Netherlands is much less rigorous than in the US and the UK. So Kenya can point to a much more economically developed country which also decided to leave the standard setting process to professional standard setters. A few years later, all the countries in the European Union adopted IFRSs for the 7,000 quoted companies in the EU.

4.11 The Best Presented Accounts Award

The idea of running a competition for the best presented accounts in Kenya was discussed in the January 1984 meeting of the Professional Standards Committee of ICPAK. In 1986, the Council of ICPAK decided to award an annual prize for the best presented accounts. Initially the award was limited to companies quoted on the Nairobi Stock Exchange (ICPAK 1986). The aim of the award was to stimulate interest in the presentation of accounts for the benefit of these quoted companies, their shareholders and the public (ICPAK 1986). The first panel of judges was made up of two accountants in academia, one from Strathmore College and one from the University of Nairobi, and a retired accountant, Irvine McLean. The accounts examined in the first competition were the latest accounts for the year ended on or before 31 December 1985, and were judged on a number of criteria, decided upon by the Professional Standards Committee: (1) compliance with the Kenya Companies Act; (2) compliance with Kenyan and International Accounting Standards in effect at the time when the accounts were prepared; (3) the clarity of presentation of the information contained in the accounts; and (4) the quality of the format adopted for the various financial statements.

A scoring system was devised by the panel of judges and is shown in Table 4-2. Scores were awarded on the following bases. It was assumed that the accounts were fully

Table 4-2: Scoring System for Best Presented Accounts Award: 1985 -1988

1	Compliance with the Kenya Companies Act	30
2	Compliance with Kenyan Accounting Standards	30
3	Compliance with International Accounting Standards	20
4	Clarity of presentation of the information	10
5	Quality of the format adopted for the financial statements	10
	TOTAL	100

in compliance with the Kenya Companies Act and Kenyan Accounting Standards, since the auditors of each company stated that this was the case. If any departure from compliance with Kenya company law or Kenyan Accounting Standards was detected, a deduction would be made from the appropriate number 30 (as shown in the last column of Table 4-2), the size of the deduction being dependent on the seriousness of the departure. IAS did not apply in Kenya; but where there was no conflict between Kenyan practice and an IAS, the same scoring system was used to deduct marks when a lack of compliance was found. The final two criteria (numbers 4 and 5 in Table 4-2) were subjective; each judge scored the accounts according to his best judgement.

30 companies quoted on the Nairobi Stock Exchange took part in the first year. Each judge examined the annual report of each of the 30 companies and allocated a score to the accounts. The scores arrived at by each judge for each company were summed for the three judges. The company with the highest total overall was declared the winner. This method of scoring was followed in competitions from then on.

In the first competition, overall scores expressed as percentages varied between the highest at 96% (Kakuzi Limited) and the lowest at 67%. The winners of the competition, from the first year to the Financial Reporting (FiRe) Award for Excellence 2003, are listed in Appendix 4-2 (b). The scores for the 2003 competition were used in this thesis.

In the 1988 version of the competition (the third year in which the competition was held), non-quoted companies and parastatal companies were invited to take part. 8 non-quoted companies and 2 parastatals (Industrial & Commercial Development Corporation and Kenya Railways Corporation) submitted their accounts.

In the 1990 version of the award, the scoring system was changed after Professor Joseph Kimura, from the University of Nairobi, replaced Professor David Nzele Nzomo on the panel of judges. The scoring system was modified again for the 1997, 1998, 1999, 2001 and 2003 competitions.

The name of the competition was changed in 2002 (in respect of the reporting year 2001) from the Best Presented Accounts Competition to the Financial Reporting (FiRe)

Award for Excellence, and was entitled the "FiRe Award 2001". The Nairobi Stock Exchange and the Capital Markets Authority agreed to partner ICPAK in running the competition. The following year the competition adopted the year in which the Award was decided rather than the year for which the participating companies' accounts were prepared (since this now covered the period from 30 June in one year to 31 March in the following year). The second competition in the new format was called the "FiRe Award 2003" and was advertised as recognizing excellence in financial reporting. The scoring system used in the "FiRe Award 2003" version of the competition is detailed in section 5.4.3.

The "FiRe Award 2003" competition was the 18th time this annual award was contested. Although interest waned in the late 1990s, and especially in 1998, enthusiasm was generated again by ICPAK's introducing a new format into the competition for the year 1999 and again for the year 2001. The competition has been another element in ICPAK's attempts to raise the quality of financial reporting disclosure in Kenya. It can be seen from above that the scoring system was changed frequently in later years. This was always a time consuming exercise that would entail an extended discussion among the members of the technical panel and the members of the Professional Standards Committee. These changes indicate the desire of ICPAK to arrive at a more reliable measure of the "quality of accounting disclosure". Each year, a summary of the findings of the evaluation process was sent to the competing companies. With the inauguration of the FiRe Award, a report was published to coincide with the ceremony to award prizes to the Chief Financial Officers of the winning companies. The report details weaknesses of disclosure in all the various areas examined (ICPAK 2003b). In January 2006, ICPAK organized a "Financial Statements Disclosure Workshop" to educate members on the disclosure requirements of IFRSs. A team selected from the Institute's Professional Standards Committee drew heavily from the findings of the 2005 FiRe evaluation exercise. 7 hours of structured continuing professional education (CPE) were awarded to those members who participated in this workshop (ICPAK 2006a). All members of ICPAK are required to obtain in each calendar year 20 hours of structured CPE and 10 hours of unstructured CPE, which is monitored by ICPAK (ICPAK 2002c).

It is necessary for practising accountants to be constantly reminded of their need to ensure "high quality disclosure". One way of doing this is to have a high-profile competition. Although an examination of the list of winners shows that those who tend to

win, tend to win repeatedly, a challenge is given to all who participate to try to enhance the level and quality of disclosure of their annual reports.

4.12 The Nairobi Stock Exchange

4.12.1 Brief History

Trading in shares in Kenya started in the 1920's as a sideline business conducted by accountants, auctioneers, estate agents and lawyers (NSE 1998, p.4). In 1951, an estate agent, Francis Drummond, established the first stock-broking firm in Kenya. With the assistance of the Minister of Finance at the time, Sir Ernest Vasey, he approached the London Stock Exchange in July 1953 and obtained authorization to set up the Nairobi Stock Exchange (NSE). The NSE was set up in 1954 as a voluntary association of stockbrokers registered under the Societies Act. Immediately prior to independence, activity on the market slumped due to the uncertainty of trading conditions in a future independent Kenya. After independence, with Kenya achieving sustained economic growth, the market did well and there were a number of highly oversubscribed public issues of shares. Inflation produced as a result of the oil crisis in 1972 depressed share prices. This was compounded by the introduction of a 35% capital gains tax between 1975 and 1985, which was imposed at the insistence of the IMF. In 1988, the first privatization through the NSE occurred when the Kenya Government sold 20% of the shares of Kenya Commercial Bank Limited (NSE 1998, pp. 4-5). The Capital Markets Authority, a regulatory body, was established in 1989. In 1991, floor based trading was introduced to replace the "call over" system.

4.12.2 Accounting regulations of the Nairobi Stock Exchange

The "Rules and Regulations of the Nairobi Stock Exchange" were published in 1954, reprinted with amendments in 1981 and revised in 1989. Appendix V contained the "requirements for quotation" (NSE 1989, Rule 104, page 22). Every company which wished "to go public" was required to provide a certificate from its auditors stating that it had been properly registered under the Companies Act (ibid., paragraph - p. - 1), to have a paid up share capital of K.Shs. 2 million (p.2 – at that time Sterling £100,000) and to offer for sale at least 20% of its authorized share capital, which had to be maintained during the continuance of its quotation (ibid., p.3). Before a company offered shares to the public, details with regard to all directors, the secretary, the auditors and legal advisers of the company, the date of the company year end and any subsidiaries or associated companies together with their profit and loss accounts, had to be shown in the accounts (ibid., p.4). Any subsequent changes had to be notified immediately to the NSE (ibid., p.4). The wording of this paragraph was poor,

in that it placed no continuing requirement to display these items in the accounts (although most companies actually did so); also, the emphasis was to "notify the Stock Exchange", not the members of the company. There was no onus on the stock exchange to notify the members of the company, who would be most affected by any change in the directors.

A quoted company was required to present a half yearly interim statement and the Chairman's Annual Report and Accounts to "the Nairobi Stock Exchange" immediately after these have been approved by the Directors (p.11a); to "notify the announcement of dividends, rights issues and bonus issues at least three weeks before the closing of the register" (p.11b) and to "notify any sale or purchase of assets which could materially alter the company's business or capital structure" (p.11c). Again the needs of shareholders were assumed to be catered for by the Companies Act. No details as to the content of the interim statement nor of the Chairman's Annual Report were specified.

A "Listing Manual" was published by the Exchange in 2002. The "Continuing Listing Obligations applicable to all Market Segments" (Part IV, Chapter 10, page 34) is a reproduction of the Fifth Schedule of "The Capital Markets (Securities)(Public Offers, Listing and Disclosures) Regulations 2002", drawn up by the Capital Markets Authority, and is stated as such. These are stated in section 4.13.3 below.

ICPAK has followed up complaints against quoted companies for non-compliance with Kenyan Accounting Standards or IAS. These have normally been resolved as cases where different views have led to different accounting treatments which have had little effect on reported profits or assets. When Kenya Finance Bank, a quoted company, became insolvent in 1996 and closed down, the partners of the audit firm (a non-Big 4 firm) which had given the bank an unqualified audit report just a few months previously appeared in the High Court to answer charges brought by the Central Bank of Kenya. However, the case was never proceeded with and ICPAK never took any action either.

4.13 The Capital Markets Authority

4.13.1 Outline of changes achieved

In 1984, the Central Bank of Kenya and the International Finance Corporation completed a study entitled "Development of Money and Capital Markets in Kenya" which became a blueprint for structural reforms in the financial markets of the country. The Kenya Government's "1986 Sessional Paper on Economic Management for Renewed Growth" proposed the creation

of a regulatory body for capital markets. An Act of Parliament was passed in 1989 and the Capital Markets Authority (CMA) was inaugurated on 7 March 1990 (CMA 2002c, pp. 2 – 3).

In 1991, CMA persuaded the NSE to change from a members' society to a company registered under the Companies Act. With assistance from USAID and with the help of a USAID funded advisor, a trading floor was established and the previous "call over" trading system was phased out (USAID 1994). In 1994 CMA proposed to the Government that foreigners be allowed to invest on the NSE. This was effected in January 1995.

4.13.2 The Nairobi Stock Exchange is reorganized into 4 markets

In February 2001, CMA reorganized the NSE into 4 independent market segments: the Main Investments Market Segment (MIMS), the Alternative Investments Market Segment (AIMS), the Fixed Income Securities Market Segment (FISMS) and the Futures and Options Market Segment (FOMS) – the last to cater for the trading of these derivative instruments in the future, if and when they come into existence. The only differences between MIMS and AIMS are that the minimum paid up share capital and net assets for a company to qualify for MIMS immediately before a public offer of shares are Kenya (K) Shillings (Shs.) 50 million and KShs.100 million respectively, while for AIMS they are KShs.20 million and KShs.20 million respectively; if a company which is already listed failed to meet the minimum of KShs.20 million in February 2001, it was given 3 years to bring the paid up share capital to the required minimum level (and supposedly the net assets too), but it was required to ensure that the minimum paid up share capital was KShs.10 million immediately (CMA 2002a and NSE 2002a, p. 166). There are a number of other differences when a company which is issuing shares for the first time is to join AIMS rather than MIMS but the reporting requirements are identical for both segments.

4.13.3 Capital Markets Authority disclosure regulations

The first set of regulations from CMA relating to disclosure in the financial statements of companies quoted on the Nairobi Stock Exchange was contained in the Fifth Schedule to "The Capital Markets (Securities)(Public Offers, Listing and Disclosures) Regulations 2002". The regulations became operational on 7 January 2002. These are explained below.

4.13.3.1 Interim Financial Reports

Every quoted company must prepare and publish an interim financial report in accordance with *IAS 34: Interim Financial Reporting*, for the first half of its operating year. The report must be published within 60 days of the end of the first half year. At a meeting which this

researcher had with representatives of the Institute of Certified Public Accountants of Kenya, the Capital Markets Authority and the Nairobi Stock Exchange in September 2003, it became clear that the word "publish" which is used in *IAS 34: Interim Financial Reporting* means something different to each organization. The relevant part of paragraph 1 of the standard reads "this standard applies if an enterprise is required . . .to 'publish' an interim financial report in accordance with IAS". ICPAK understands "publish" to mean that a copy of the Interim Financial Statements should be sent to all the shareholders of the company; in 2002, only three companies on the NSE did this. CMA understands "publish" to mean publishing the Interim Financial Statements in a national newspaper, even though the CMA Corporate Governance Guidelines for quoted companies state that "all shareholders should receive information on the company's performance through (the) distribution of ... half-yearly results" (CMA 2002a). CMA assumes that all shareholders of all the quoted companies read the main English language newspapers. The NSE understands "publish" to mean the company sends a copy of the Interim Financial Statements to the NSE, which is a hangover from its earlier practice as detailed in section 4.12.2 above. The representatives from the CMA and the NSE were not ready to change their understanding of the word at the meeting but stated that this divergence of opinion would be reported to higher authority.

4.13.3.2 Annual Financial Reports

Every quoted company must "**prepare** an annual report containing audited annual financial statements within four months of the financial year" (emphasis added). The financial statements must "comply with all the requirements of each applicable IAS and interpretation of the Standing Interpretations Committee of IASC" (CMA 2002a, Fifth Schedule, paragraph B.21). For a transaction not covered by an IAS, the directors should ensure "that the financial statements provide information that is (a) relevant to the decision making needs of users; and(b) reliable . . ." (ibid.)

It is unfortunate that this part of the regulations uses imprecise terminology. IAS 1, paragraph 52 states quite clearly that "an enterprise should be in a position to **issue** its financial statements within six months of the balance sheet date" (emphasis added). The directors of a company that does not meet the four month deadline imposed by the CMA Regulations could argue that it had **prepared** its financial statements within the 4 month period but had simply not **issued** them, which they are not required to do under the CMA regulations. In addition, some of the accounting requirements of the IAS are reproduced in

the CMA Regulations. This again is unfortunate. When changes occur in the IFRSs, as they will do inevitably, the CMA Regulations will be at variance with the IFRSs, which causes problems for preparers, auditors and users of the financial statements in the future.

The CMA has a "Market Supervision Department" which reviews the financial reporting of companies quoted on the Nairobi Stock Exchange but no instances of non-compliance with IASs or with the Kenya Companies Act had been raised prior to 2002. A person from this department has been a member of the panel of judges of the Best Presented Accounts competition since 1997; two persons were judges for the FiRe Award 2003. This provides a check on the work of this department.

4.13.3.3 Corporate Governance Disclosure

The Capital Markets Authority issued corporate governance guidelines, which came into effect on 14th January 2002, requiring listed companies to disclose in their annual reports whether they complied with the guidelines (CMA 2002b). If the company did not comply, the directors should have indicated the steps the company would take to achieve compliance. Many companies referred to this legislation in great detail in their 2002 Annual Reports but it was clear that few financial controllers or directors had actually read the document; or if they had, they chose to ignore the disclosure requirements. The disclosure requirements are contained in Appendix 4-3. The wording of some of the guidelines is imprecise. Some contents of Appendix 4-3 are interpretations. If compliance with this document had been widespread, scores achieved on S&P's Transparency & Disclosure Survey would have been substantially higher. The purpose of these disclosure items is not to score highly on the S&P Survey but a higher score on the survey shows that disclosure on the NSE is more in line with what analysts around the world desire.

4.13.3.4 Conclusions on the NSE and CMA

It can be concluded firstly that the Nairobi Stock Exchange is a functioning exchange; sometimes stock exchanges are established merely as status symbols – Central Africa's first Stock Exchange, the Douala Stock Exchange in Cameroon, was established on 28 April 2003, but no companies were quoted on the exchange, although officials were enthusiastic that this would change in the near future: in October 2006, there were still none.

Secondly, there are regulatory systems in place which should pick up any non-compliance with IASs. These systems could and should be strengthened. One way by

which this could be done is for a report to be prepared each year once the checking process has been completed. The report should be a public document and should be sent by CMA to all the companies quoted on the Nairobi Stock Exchange.

4.14 The Donde Act

A consideration of accounting disclosure in Kenya would not be complete without one being aware of the "Donde Act" which became law in Kenya in 2001. It illustrates how political costs arise in Kenya and how they are mitigated.

Even "small" banks in Kenya are large companies in respect of share capital, assets, turnover and profit. On 31 December 2002, the minimum core capital for a bank in Kenya was KShs. 250 million - approximately Sterling £2 million (The Banking Act 2002, s.20A): the minimum share capital for a company to be quoted on the NSE was KShs.20 million (NSE 2002b). On 6 August 2001, the Central Bank of Kenya (Amendment) Act 2000 (which local "vox populi" named the "Donde Act", after the member of Parliament who proposed it) received reluctant and delayed Presidential Assent. The style of Government in Kenya at the time was to be all things to all people: on the one hand it wanted to be seen as looking after the interests of the "wananchi" – the people in the street; on the other, it wanted to ingratiate itself with the business community, of which the President, a number of Ministers, Members of Parliament and senior civil servants formed a part. The Donde Act came into effect on 1 January 2001. Banks in Kenya were perceived to have been making unduly high profits, and this Act sought "to regulate interest being paid/charged by commercial banks" (CFC Bank 2001, p.4). However, on 24 January 2002, the Act, which had been framed by the Attorney General's chambers, was ruled by the Constitutional Court to be inconsistent with the Constitution of the country – because it was retrospective. Various conflicting legal interpretations were published. Acting on legal advice which confirmed that the Act was ineffective, banks prepared their 2001 accounts with apprehension, not knowing whether the Act would indeed take effect, to reduce income reported and create liabilities not provided for. This apprehension was still present when the banks prepared their 2002 accounts. But with the passing of time, other more newsworthy events dulled memories. Banks took the line that the less mention they made of the Act, the more its existence would fade away. They tended to increase the size of their other disclosures (see section 9.4.1), and omitted any reference to potential problems caused by the Donde Act.

4.15 Overall conclusions

This chapter has shown that while accounting was introduced into Kenya much more recently than in many other countries around the world, the country had the advantage of having a number of firms of chartered accountants which formed the foundation on which the Institute of Certified Public Accountants of Kenya (ICPAK) could be built. These firms built up a tradition of ensuring that financial statements complied with the Kenya Companies Act, and continued that tradition by ensuring compliance with Kenyan Accounting Standards (KAS), when these were promulgated by ICPAK. The Companies Act establishes clearly the rights and duties of directors and members of companies, especially in relation to the publishing and auditing of annual financial statements. ICPAK has been active in promulgating accounting standards but has been realistic in admitting that this process is best left to professional standard setters. ICPAK has emphasized the importance of compliance with KAS and now with IFRSs. The change over to IAS was a relatively easy one, since KAS had been based on IAS, although KAS had not always been kept up to date. Since 1986, ICPAK has run an annual competition to promote high quality disclosure in Kenya. The Nairobi Stock Exchange has been slow in laying down accounting regulations and the Capital Markets Authority could have dealt with this earlier, but did publish legally binding requirements in early 2002. While the court system in Kenya works poorly, reliance on it has not been necessary for accounting regulators in Kenya so far. ICPAK has been active in dealing with complaints against the accounting of quoted companies but has not always been as keen to resolve problems for unquoted companies. All the companies quoted on the NSE, except for one, are audited by the Nairobi offices of Big 4 firms. These firms pay particular attention to the audits of quoted companies and are conscious of the need to maintain their reputations. The result is that compliance of the audited annual financial statements with the disclosure requirements of IFRSs should be expected to be high. Conversely, the confusion surrounding the publishing of interim financial statements, combined with the fact that they are not audited, leads to the expectation that disclosure compliance for interim reports may not be high.

However, conflicting tensions exist: corruption and crime are rampant (4.3); the brightest young accountants are attracted abroad (4.3); the office of the Registrar of Companies is disorganized (4.6); the tax authority is bribe-prone (4.6). Chapter 7 provides the answer to whether disclosure can be "high quality" with these tensions present in society.

Chapter 5
Research Methodology and Methods

5.1 Introduction

The purpose of this chapter is to present, explain and critically evaluate the research methods used in this study. The chapter is organized as follows. Section 5.2 explains the philosophical underpinning of the methodology used in this thesis and the choice of the method to measure high quality financial disclosure by Nairobi Stock Exchange (NSE) companies. Section 5.3 describes the data sources and lays out the main procedures used to obtain the half-year and annual reports of companies listed on the NSE. It also examines the reasons why the opinions of those interviewed were sought as data for analysis. Section 5.4 explains the main research instruments and deals with the construction of the IFRS disclosure checklist, the measuring processes employed for the IFRS, the S&P and the FiRe Award checklists and the structure and process of the interviews. Section 5.5 presents the econometrics employed in testing the hypotheses that were formulated. The conclusions are summarised in Section 5.6.

5.2 Approach adopted in this study

5.2.1 The philosophical aspect of the approach

An empiricist approach has been taken in this study following the definition put forward by Miller, P. and Wilson (1983, p.27) that empiricism denotes "observations and propositions based on sense experience and/or derived from such experience by methods of inductive logic, including mathematics and statistics". The empiricist attempts to describe, explain, and make predictions based on observation, as opposed to the rationalist who believes that reason is the primary source of knowledge. Procedures mentioned below are designed to collect factual information about hypothesized relationships that can be used to decide if a particular view of a problem is correct.

Laughlin (1995, p.65) notes that "**all** empirical research will be partial, despite any truth claims to the contrary, and thus it would be better to be clear about the biases and exclusions before launching into the empirical detail". This "inevitable truth" is accepted. Another factor to consider is whether theories which have been developed for sophisticated markets should simply be accepted as being applicable to the Nairobi Stock Exchange or whether new theories need to be developed to explain the findings in this market. If the theories are accepted, then this study can be viewed as a questioning of whether the observations confirm

these well developed theories which are accepted prior to its commencement. The alternative view is that the empirical detail is not data that confirms or refutes some prior theory, but becomes theory in its own right. Laughlin (1995, p.67) states that "this detail **becomes the** theory for this particular phenomena (sic) but cannot be transferred to another study for the reasons that other theories could not be used in the context of this study – both are separate and distinct and should be approached as such".

Smith, M. (2003, pp. 2-3) points out that "two major processes of reasoning, 'deductive' (theory to observation) and 'inductive' (observation to theory), are important for theory construction and observation testing". Deductive reasoning starts with a theory; specific predictions are made; observations verify the predictions or refute them. Inductive reasoning generates theories from observations or data; these theories are tested against further observations to confirm or refute the validity of the theories; Hawking (1998) notes that these theories can never be regarded as certain since one contrary instance can cause them to be refuted.

Howard (1985, p. 7) notes that "current scientific methods wed the best aspects of the logic of the rational approach with the observational aspects of the empirical orientation into a cohesive, systematic perspective". Cooper and Emory (1995, p.25) state that the essential tenets of the scientific method are: (1) "direct observation of phenomena, (2) clearly defined variables, methods, and procedures, (3) empirically testable hypotheses, (4) the ability to rule out rival hypotheses, (5) the statistical rather than linguistic justification of conclusions, and (6) the self-correcting process". However they go on to state that there is no single best perspective from which to view reality or to do science, only preferred ones.

House (1970) explains the positivist approach as one where a priori hypotheses are formulated on the basis of theory and literature; criteria to measure the acceptability of the hypotheses are laid down; the dependent and independent variables are investigated directly or by proxy; and conclusions are arrived at. Smith, M. (2003, p.19) cautions that where people are involved and where multiple variables are beyond the control of the researcher, positivistic approaches are of questionable validity.

Baker, M. (2002, p.178) notes that a method of teasing out and defining underlying relationships through an inductive and intuitive interpretation of the data is the grounded theory approach. Grounded theory seeks to derive structure through the analysis of non-standardized data while surveys define a structure and then collect data to enable the

testing of hypotheses on which the structure is founded. Baker goes on to point out that few researchers who claim to use grounded theory do so in the highly structured and systematic way described by Glaser and Strauss' seminal book *The Discovery of Grounded Theory: Strategies for Qualitative Research* (Glaser and Strauss 1967). Many researchers approach a set of data with at least some preconceived problem in which they are interested. Where time is a limiting factor in a study, it would be a high risk strategy to use a grounded theory approach, but Baker had encountered many dissertations in which a grounded theory methodology was used in the early, exploratory phases of their studies.

A completely inductive approach cannot be followed in this study because the population of companies quoted on the Nairobi Stock Exchange is too small to select a random sample, gather data from this sample, generate theories on the basis of the observations and then test the theories by gathering data from other random samples to check whether compliance with the theories is found. Time is a limiting factor in this study. This precludes the possibility of the fully grounded theory approach as explained by Glasser and Strauss (1967).

Cooper and Emory (1995, p.121) suggest a two-stage design as a useful approach. Exploration becomes a separate first stage with limited objectives: (1) to clarify the definition of the research question; (2) to develop the research design: once this has been clarified, a more formal approach can be taken – clearly stated hypotheses can be formulated and associations among different variables can be sought.

5.2.2 An exploratory study

Chapters 2 and 3 are exploratory, as suggested by Baker (2002) above. Since the researcher has approximately thirty years experience of working on accounting by companies quoted on the Nairobi Stock Exchange, it could be argued that an experience survey had been completed at the commencement of the study, for certain aspects of the study. In an experience survey, information is sought from persons experienced in the field of study. Their ideas about important issues or aspects of the area of study are sought. In so far as the researcher has been exposed to the views of a variety of persons connected with the Nairobi Stock Exchange, this information has been collected. However, this collection process has not been documented, and with the passage of time, some views will have been forgotten, some will have been tinted with views expressed by others, and some will have become distorted. Views in agreement with his own would be remembered more easily, and would come to mind more quickly, than those contrary to his own. It is

admitted that this position of supposedly "knowing" can be dangerous in arriving at objective views on the subject. Biases can creep in almost unwittingly. The researcher may have views which differ, sometimes radically, from those of others working in the field of study. The researcher must be completely honest in putting the views of others across without colouring these views with his own opinion about the area of study. For example, in interview research, he has to ensure that he does not put his words into the mouths of those being interviewed. When his outlook on some matter is different from that of others working in the field, he must take great care to ensure that the reasoning of those who hold the contrary view is put across with the same degree of clarity and precision as he would use to get his own view accepted. Particular care was exercised to avoid this source of bias, to enable the reader to make logical decisions on her/his own.

Marshall and Rossman (1989) suggest several approaches which can be adopted for exploratory investigations. Those considered for this study are: (1) document analysis; (2) elite and indepth interviewing – information is sought from influential or well-informed people in the site studied, usually conversational rather than structured; (3) case studies – for an indepth contextual analysis of a few events or conditions.

Cooper and Emory (1995, p.117) reveal that an exploratory study is particularly useful when the researcher lacks a clear picture of the problems s/he will meet in her/his study, and to be sure that it is practical to do a study in the area. The exploration helps the researcher develop concepts more clearly. The area of investigation may be so vague that the researcher needs to do an exploration just to learn something about the problem. Important variables may not be known or thoroughly defined. Hypotheses for the research may be needed - exploratory research assists in formulating these.

5.2.3 A case study?

From certain points of view, this investigation can be regarded as a case study. Smith, M. (2003, p. 134) reveals that the "case study" usually refers to research confined to a single unit of analysis, "which might be a single department, company, industry or even country". The scope of the study could be broad but the "single unit" studied means that the research is narrower that would be embraced by the expression "fieldwork" which would encompass more general studies of activity in the field.

While the investigation into "high quality financial accounting" does not fit into this taxonomy, the second part of the study could; the second research question asks which

disclosure theories could be applied to a developing country capital market to form expectations about "high quality disclosure" practices by quoted companies.

Ryan et al. (1992, p.114) distinguish five categories of case study in accounting: (1) descriptive: current practice is described in terms of the procedures followed. Studies of this sort seek to portray particular departments or companies as "best practice" or "successful" (e.g., Peters and Waterman 1982); (2) illustrative: the researchers explore the implementation and the outcomes associated with innovative practices (e.g., Kaplan 1984; Kaplan and Norton 1992); (3) experimental: the research studies an experiment being carried out in the field. A new method is followed in a particular setting. Research into this type of case study is rarely found in the accounting literature. In management studies, the most famous were the Hawthorne experiments (Mayo 1933). (4) exploratory: the researcher conducts a preliminary investigation about how and why particular practices are adopted, with the aim of making a contribution to theory or method. (5) explanatory: the research seeks to provide convincing explanations which justify choices made in practice and which facilitate the development of theory.

As has been stated above, this study is partly exploratory (chapters 2 and 3) and partly explanatory (chapters 7, 8 and 9). It is also a case study in so far as it examines financial reporting in a single site, which is the capital market in Kenya.

5.2.4 Validity of conclusions

Kidder and Judd (1986, pp. 26-29) reveal four tests that are commonly used to establish the quality of research:

(1) there must be construct validity: correct operational measures must be established for the concepts being studied. To increase construct validity, Yin (1994, p.34) suggests three approaches: (a) use multiple sources of evidence in a manner encouraging convergent lines of inquiry. In this study, annual and interim reports of companies quoted on the Nairobi Stock Exchange are used as primary data. These documents are available to all the members of these companies. The sample of interim and annual reports made up the total population, because the number of companies is so limited. The views of preparers, auditors, regulators and analysts were also sought in face to face interviews because of the difficulty of obtaining responses to surveys in Kenya. (b) establish a chain of evidence. In this study, the interim and annual reports of all the companies were collected. They were examined in a methodical way. Disclosure was acknowledged only if the item was

expressed in a clear and easily understood way. The outcome of the examination process was a computer spreadsheet which tabulated all the results. These results were checked before final scores were arrived at. Open-ended interviews were recorded and tapes were carefully labelled to ensure that the name and function of the persons interviewed was evident from the label. Interview analysis was likewise made on a spreadsheet: conclusions were drawn from this spreadsheet backed by quotes available on the tapes. (c) have the case study report reviewed by key informants. This will be difficult to achieve in this study. But many of the persons interviewed would like to read the final completed study. This acts as a check to ensure that quotes are reproduced correctly.

(2) there must be internal validity: a causal relationship, whereby certain conditions are shown to lead to other conditions, is established, as opposed to a spurious relationship. Yin (1994, p.33) states that this is not necessary for an exploratory study, but clearly internal validity is of utmost importance in all studies. Causal relationships are difficult to prove in accounting but regression analysis can show an association between one variable and another. If the investigator is trying to determine whether there is an association between independent variable x and dependent variable y, and states that there is one without being aware of the presence of another factor z – which may have actually caused y – the research design has not dealt with some threat to internal validity.

(3) external validity: the domain to which a study's findings can be generalized is established. As has been pointed out in section 1.2.3 earlier in this study, Sarpong (1999) cautioned researchers as to the generalizability of the findings on any emerging capital market. Forces for and against achieving high quality disclosure are very different in each emerging market – for example, there are very few family owned companies quoted on the Nairobi Stock Exchange. But even if the findings are applicable only to companies quoted on the Nairobi Stock Exchange, those companies which do not achieve high quality disclosure, and those companies which will have their shares floated on this market in the future, can learn from companies that achieve high quality disclosure and from those that do not. The domain may be restricted to this capital market; further research into accounting in other developing country capital markets may confirm that the findings can indeed be generalized. In the light of Sarpong's comment, it would be unwise to make this claim without having proof from empirical studies of other markets.

(4) reliability: if the study was repeated by a different researcher, the same results would be achieved. The study has to be as objective as possible; the researcher has to avoid allowing his or her preconceived ideas to influence the study in any way. In other words, the truth has to be told in so far as this "truth" exists.

5.2.5 Methods of determining if disclosure is high quality

This section examines five methods of measuring high quality disclosure in financial reporting, together with the relative advantages and limitations of using them.

5.2.5.1 Do the financial statements feel right?

Figure 2-1 in chapter 2 of this thesis shows that users of accounting information have varied expectations of the quality of that information, and form perceptions as to whether the information provided by the company is high quality or not.

A first method of evaluating whether financial reporting disclosure is high quality or not, mentioned by Copeland and Fredericks (1968, p.109 – C&F), is completely by "feel"; that is, does it look "right"? However they go on to point out that the classification of disclosure as high quality (they use the word "excellent"), average or poor would depend wholly on the opinion of the viewer, which would be completely subjective. Two informed investors may well agree on the classification, but again they may not. It would be difficult to argue for one position or the other without well defined criteria being laid down first. But C&F point out that when items are selected by a researcher to be checked to see whether they are disclosed in financial statements, to arrive at some valid measure of disclosure, the researcher chooses those items s/he considers to be of importance to users of the statements; others may disagree that the items selected are important. So subjectivity is difficult to eradicate in all cases.

This method of judging quality by "feel" has to be ruled out because of its subjectivity, although it is likely that a number of investors probably judge the quality of disclosure in this way. In one audit firm that this researcher visited in Nairobi, when a set of accounts has been finalized by one partner and the team with whom s/he worked, another partner who was completely unconnected with the audit reads the annual report to check that it "feels" right. This method of judging was proposed by Irvine McLean to score the 1985 annual reports of NSE companies in the first year of the Best Presented Accounts competition run by ICPAK (see section 4.11).

5.2.5.2 Obtain the views of users

A second method of evaluating whether financial reporting disclosure is high quality or not is to develop a description to assess how users analyse financial statements, to evaluate the assumptions underlying their analysis, and to assess the implications of the disclosure issues which arise (Dyckman et al., 1978, p. 51). This method does not measure disclosure directly, but is more concerned with the perceptions of users, which is the outcome of disclosure. From one point of view, this would be a robust method, since the concept of "quality" is a customer driven one. However, results are likely to depend on the persons chosen to represent users. One possibility is to obtain the views of a broad spectrum of users; in practice it is difficult to ensure that any group is representative of users generally and it is difficult to obtain the views of a large number of people. In addition, a large number of individual "users" of financial statements may not use them for decision purposes at all. Mirshekary and Saudagaran (2005) manage to obtain responses from 245 individuals from a wide range of user groups: this would be difficult to achieve in Kenya, due to poor responses from companies to any form of written communication (TI 2001, p.1). Bradish (1965) and Ecton (1969), both cited in Dyckman et al. (1978), restrict their studies to specific groups to determine the direct impact of disclosure policies on these groups. However, accessibility of data, high costs, excessive use of time, the absence of a composite score and the difficulties of measuring perceptions of disclosure are some of the deficiencies in this type of study (McBurney and Collins, 1984).

5.2.5.3 Determine the frequency with which items appear

A third method is to determine the frequency with which information items are distributed in the annual reports or interim financial statements, on the assumption that a greater frequency of a number of items increases the quality of information provided. Botosan (1997, p.324) reveals that researchers tend to assume that disclosure quantity and disclosure quality are positively related. Morris (1984) prepared a frequency distribution of the number of items disclosed in the balance sheets and profit and loss accounts of a sample of companies in New South Wales, Australia, at ten year intervals between 1860 and 1890 inclusive. In addition, Morris constructed tables to show the items disclosed and the number of times those items were disclosed by the companies in the four different types of industries in which they operated, at each ten year interval. Although this method could be developed to show the percentage of companies that disclose individual items, all

the items may not be applicable to all the companies in the sample. This method may give unreliable results when applied to measuring quality.

5.2.5.4 Determine the number of words

A fourth method is to count the number of words used in the financial statements to disclose the information required, as proposed by Copeland and Fredericks (1968), again assuming that a greater number of words denotes a higher quality (Botosan 1997, p. 324). Marston and Shrives (1991 – M&S) and Cooke (1989c) have criticised this method as being unsatisfactory, since repetitions of certain words and numbers can distort the results obtained. M&S also point out that more complex businesses would score more highly under this system, simply because they are more complex and thus require a greater number of words and numbers to explain their performance and position.

5.2.5.5 Use a disclosure index

A fifth method is to use a disclosure index. Marston and Shrives (1991, p.195) refer to disclosure indices as "extensive lists of selected items which may be disclosed in company reports". The word index has several meanings in English, and M&S use it here in one sense. Another sense is that defined by Cooke (1989a, p.183; 1989b, p.4) as a measure of the relative level of disclosure by a company being the "ratio of the actual scores awarded to a company to the scores which that company is expected to earn". M&S (p.196) refer to this ratio as the "index score" but also as a "disclosure index" (p.197). Coy, Tower and Dixon (1993, p.122) define a disclosure index as a "qualitative based instrument designed to measure a series of items which, when aggregated, gives a surrogate score indicative of the level of disclosure in the specific context for which the index was devised". But Coy and Dixon (2004) state that "an index comprises numbers that encapsulate, in single figures, objects in the set that one wants to measure and that are capable of measurement".

Cerf (1961) was a pioneer of the use of a disclosure index. It has been used to measure compliance with mandatory disclosure items (e.g. Malone et al. 1993; Abayo et al. 1993; Cairns 1999; Street and Gray 2002; Camfferman and Cooke 2002; Glaum and Street 2003; Ali et al. 2004), voluntary disclosure items (eg Chow and Wong-Boren 1987; Eng and Mak 2003) and mixed mandatory/ voluntary items (Al-Razeen and Karbhari 2004).

This method is to score items listed in a disclosure index according to whether they are disclosed or not. M&S point out that the usefulness of the disclosure index as a measure of disclosure depends critically on the selection of the items for inclusion. Different

information items can be viewed as having different importance. Hence, weights can be assigned to the items in the disclosure index. Rules are laid down to determine whether disclosure is achieved or not (see below for the rule in this study); different scores can be awarded for various levels of the detail of disclosure.

Wallace (1987) and Owusu-Ansah (1998) use large numbers of items in their disclosure lists. Owusu-Ansah (1998) argues that the intensity of items mandated by regulations in Zimbabwe is captured by disaggregating the items into a large number of sub-items. Cairns (2002) reiterates that the limited scope of the checklist of IAS-required disclosure practices used by Street and Gray (2002) "is cause for a much greater concern" than other problems in their study; he goes on to point out that their checklist covers fewer than half of the IAS that applied at the time of their study. He states that the limited content of the checklist severely restricts the value of the conclusions.

It was decided to measure financial disclosure by using a disclosure index covering all items that should be disclosed by IFRSs to gauge IFRS compliance in both the annual and interim reports of NSE companies. However, a score was awarded for the item disclosed only if the wording was intelligible to a layperson. M&S reveal that the use of the disclosure index has persisted over time and has been used by many different researchers. It would not continue to be used if it gave poor results. It is direct and it is replicable. Companies can be ranked and explanatory variables can be tested. Frequency distributions of information items can be reported with ease. The results can be compared with other studies. The method is cost and time effective.

However, measuring disclosure in this way is not without its drawbacks. It was stated above that financial disclosure is an abstract concept that cannot be measured directly. Subjectivity cannot be eliminated entirely in the measurement process, since disclosure is acknowledged only if it is lucid; information disclosure by companies cannot be measured with scientific precision (M&S, p. 207-208). Attaching weights to indicate the relative importance of information items can add further subjectivity (Cooke 1989b, p. 115; M&S. p.201).

It has been noted in section 2.4.1 previously, that a number of researchers have used a disclosure index as a measure of quality disclosure; a number of regulators and standard setters would argue that compliance with IFRSs would in itself be "high quality disclosure" (EU 2003). However, M&S (p.195) point out that "an index score for a

particular company can give a measure of the extent of disclosure but not necessarily the quality of the disclosure". While this is true, the method adopted by this study ensures that the quality of disclosure is captured to some extent by the disclosure index: it is admitted that it falls short of capturing the totality of quality: it is recognised that this is only a fist step in measuring the quality of disclosure of these companies. But quality is such a rich construct that, in reality, any quantitative method of measuring it falls short of doing so.

Frost, Gordon and Pownall (2005) find that companies in their sample use IFRSs (or US GAAP) only rarely and conclude that financial reporting and disclosure quality is low; they find that there is a strong association between emerging market companies' access to global equity capital and the companies' use of IFRSs or US GAAP. Street, Gray and Bryant (1999, p. 46) speak of "the international investment status that comes with the adoption of IASs", pointing out that many companies are anxious to seek this status but do not always fulfil the requirements and obligations that bind them if they claim that they adhere to these standards. Cairns (2002) states that many companies have adopted IAS over the past few years and these companies ought to be the focus of researchers in disclosure studies. Since compliance with IFRSs has not been measured comprehensively for the companies quoted on the NSE, a necessary first step in assessing the quality of disclosure by these companies is to measure this compliance: using the method adopted by this study captures the additional element of quality. If the level of compliance is found to be poor, it can be concluded immediately that disclosure is not high quality. Unless the level of mandatory disclosure is 100%, no regulatory authority in the world would agree that disclosure even approaches high quality. If it is found to be 100%, the other indices that will be used in this study (the S&P Survey and the FiRe Award) cab be used to check other aspects of disclosure and a decision can be reached as to whether the company's disclosure is high quality.

5.2.6 Choosing financial reports

The purpose of this section is to show that when the quality of disclosure of financial information by a company is examined, it is sufficient to measure the quality of disclosure in the company's interim and annual reports.

Marston and Shrives (1991) state that information is disclosed by companies in a variety of ways. Figure 2-1 in chapter 2 shows that the disclosure of financial information to persons interested in the company is made by means of interim and annual reports, announcements,

press briefings (in more "developed" countries, conference calls), and via the World Wide Web.

Some of the larger companies in Kenya use the opportunity of the announcement of their results or the holding of their annual general meeting to publish a one or two page supplement in one or more of the English language newspapers. These often disclose financial information about the company. However, these newspaper articles do not appear before the annual report is published and journalists in Kenya report financial information quite poorly[4].

Marston and Polei (2004) conclude, from reviewing the literature, that a significant number of companies in all countries use the Internet for communicating financial information to their shareholders; the Internet offers companies opportunities not only to supplement and enhance traditional communication with shareholders, but to replace it. With an inefficient postal system in Kenya, this would offer ways to Kenya companies of communicating in a cost efficient manner with shareholders. But at the present time, a number of companies quoted on the Nairobi Stock Exchange do not have websites and those that do, often do not have their annual reports available electronically.

Marston and Shrives (1991) state that the main disclosure vehicle is the annual report and accounts. Anderson (1981) indicates that annual reports are seen as an important source of information for institutional investors in Australia. Hines (1982) finds that annual reports may be an important input to investors' long-term investment decision-making. Courtis (1979) reveals that annual reports are comprehensive data bases of past corporate achievements, and facilitate the confirmation, revision and formation of readers' expectations about companies in which they have an interest. Bartlett and Jones (1997) find that the annual report of Bulmers plc is an important means of communicating by means of a common document to both employees and shareholders the corporate philosophy of the company being "a team working together to fulfil agreed objectives, employees and

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[4] As an example of this, on 20 December 2005, it was reported in "*The Nation*" that a shareholder of Uchumi Supermarkets Limited had stated, in relation to the company's auditors, at the Annual General Meeting of the company the previous day that "When the company's profit declined to Sh113 million they told us all was well; the loss increased to Sh98 million, they also said all was okay; today the company has made Sh1.2 billion loss and all they are saying is that the results are okay. We cannot reappoint them; they ought to have told us what was going on". "*The Nation's*" Editorial on 22 December 2005 argued that "some shareholders . . . thought the auditors should have discovered the depth of the problems much earlier. The implication is that the auditor (*sic*) should have evaluated all the risks. This is a matter that merits serious debate . . . otherwise, it seems, the auditing business will become more expensive" (Daily Nation 2005a &b).

shareholders being considered of equal importance". Day (1986) finds that although very few investment analysts in the UK possess accounting qualifications, they scrutinize accounting policy notes very carefully and pay particular attention to controversial areas; they are extremely keen that companies follow best practice. Frownfelter-Lohrke and Fulkerson (2001) reveal that a survey conducted by the Yanelovich Consulting Group (American Demographics 1996) found that two-thirds of the portfolio managers and 54% of the security analysts in the sample in the US stated that the annual report is the most important document prepared and disseminated outside the corporation; Ho and Wong (2004) find that investment analysts in Hong Kong rate annual reports of much higher value as sources of information about companies that other media. Botosan (1997) states that the annual report serves as a good proxy for disclosure across all communication channels, based on the finding of Lang and Lundholm (1993) that annual report disclosure levels are positively correlated with the amount of disclosure in other media.

Abu-Nassar and Rutherford (1996), studying accounting in Jordan, find that users of annual reports use them in much the same way as those in developed markets.

For these reasons, it can be argued that annual and interim reports of companies quoted on the Nairobi Stock Exchange are valid proxies for company disclosure.

5.2.7 Conclusion

This study is exploratory from three points of view.

Firstly, it explores the meaning of the phrase "high quality financial reporting".

Secondly, it explores to see whether it is practical to do a study of "high quality financial reporting"; the clarification of the meaning of the phrase "high quality financial reporting" reveals that, principally due to time constraints, only one aspect of the concept can in fact be studied. The aspect chosen is disclosure.

Thirdly, it explores for possible factors that could explain the presence or absence of "high quality disclosure" in the interim and annual financial statements of companies quoted on the Nairobi Stock Exchange. A wide range of independent company variables were tested against the dependent variables representing "high quality disclosure". Once relationships between these dependent variables and the independent variables had been found, a positivistic approach was then adopted to test hypotheses developed.

5.3 Data Sources

The data for this study were obtained partly as primary and partly as secondary.

To answer **EQ_1** (What is the extent of high quality disclosure among companies quoted on the NSE?) and **EQ_2** (Is there a significant association between high quality disclosure and company characteristics on the basis of expectations derived from prior research and theoretical models?), primary and secondary data were used. Smith, M. (2003, p. 142) reveals that a company annual report may be regarded as a primary or a secondary source of data depending on the identity of the user. The data produced by each company and studied by this researcher are regarded as primary data for the purposes of the study. Hence, the primary data examined were contained in the annual reports of companies listed on the Nairobi Stock Exchange (NSE). An examination was also made of the interim financial reports of the companies listed on the NSE in order to measure these companies' compliance with IAS 34: *Interim Financial Reporting*.

Secondary data were the scores awarded by the adjudicators of the Financial Reporting (FiRe) Award for Excellence 2003 to the 35 companies listed on the NSE whose annual reports were submitted to the Institute of Certified Public Accountants of Kenya for the competition. Scores awarded by the staff of Standard and Poor's in their Transparency and Disclosure Survey 2003 for companies listed on stock exchanges in a number of countries around the world, based on financial statements for the year 2002, were used for comparison with scores arrived at by this researcher using the S&P's checklist for all the companies listed on the NSE in Kenya.

Primary data are used to answer **EQ_3** (What are the perceptions of preparers, auditors, regulators and analysts of "high quality disclosure" and how do these observations help the interpretation of the quantitative results of this study?). The primary data are the opinions of persons who had first-hand knowledge of the preparation, audit, regulation and use of the financial statements of these companies in Kenya.

5.3.1 Primary sources: Financial Statements

The population I studied was the corporate half-year and annual reports of companies listed on the NSE. There were 47 companies, as shown in Table 5-1:

Table 5-1: Number of companies studied

Number of companies as stated in NSE Handbook 2002 Edition (p.162)	53
Number eliminated by actual count of companies in the Handbook	(3)
Number de-listed (details in Appendix 5-1)	(3)
Number of companies studied	47

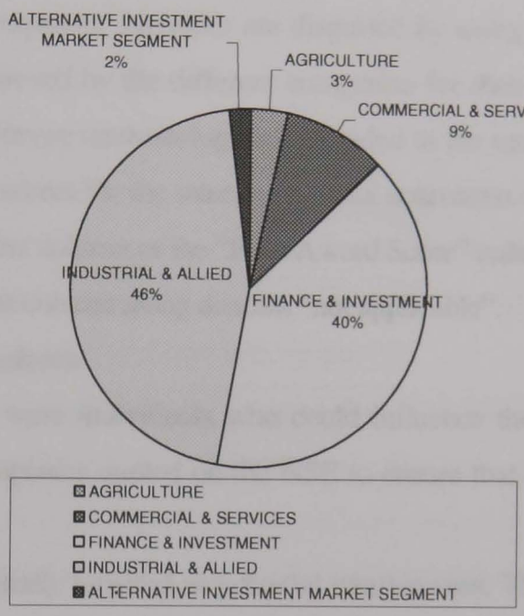
One of the 47 companies, Mumias Sugar Company Limited, was listed on the exchange for the first time on 14 November 2001. It prepared its first set of accounts as a listed company for the year to 30 June 2002. Both Owusu-Ansah (1998, p.617) and Leventis (2001, p.135) exclude companies which become listed for the first time in the year being examined. Owusu-Ansah does so on the basis that the full impact of the disclosure requirements of the stock exchange on the financial reporting practices of listed companies can be assessed only if they have been listed on the market for more than one year. Leventis argues that the listing process may have a significant effect on management decisions over disclosure strategies and newly listed companies may not have developed their disclosure policy. The annual report of Mumias Sugar Company Limited for the year ended 30 June 1999 (prepared in accordance with Kenyan Accounting Standards) was compared to that for 2002. Except for the additional disclosures required by IFRSs, there were few other changes. The financial statements of this company have been available to members of the public for a number of years because the company was a parastatal – a company run for commercial purposes but owned by the Government of Kenya. This company had taken part in the Best Presented Accounts Competition run by ICPAK over an extended period of time. In addition, the 30 June 2002 annual report of the company was included in the Financial Reporting (FiRe) Award for Excellence 2003 Competition. It was decided to include this annual report, since this company had a considerable time to develop its financial reporting to the public at large before it became listed. A point to note is that the NSE classifies this company as an "industrial and allied" company because it "manufactures" sugar, rather than as an agricultural company.

Figure 5-1 indicates the relative proportions of the market capitalization as at 31 December 2002, by industry as determined by the Nairobi Stock Exchange, of the companies on the exchange. 8 banks (defined by the Kenya Banking Act; in reality, one of these "banks" is a mortgage lending institution) and 2 insurance companies are included in the 47 companies listed on the NSE. These together with an investment trust make up the Finance and Investment sector of the market. If the annual reports of the banks and insurance companies are excluded from this study, almost 40% of the companies listed on the exchange by market capitalization, and 3 of the 10 largest companies by market capitalization as at 31 December 2002, would be excluded. It was decided to include the

annual reports of the banks and the insurance companies quoted on the exchange in order that any results arrived at could be generalized to the whole population. A number of researchers examining voluntary disclosure exclude financial companies because they are more highly regulated or because their operations are highly specialized (e.g. McNally et al. 1982; Cooke 1989a; Hossain et al. 1995; Meek et al. 1995).

Figure 5-1:

NAIROBI STOCK EXCHANGE MARKET CAPITALISATION AS AT 31 DECEMBER 2002



In order to obtain the annual reports of the companies listed on the Nairobi Stock exchange, a letter was sent to all the companies in February 2003. 17 responded. I decided not to send a second letter. Two assistants visited the larger companies which did not respond; they obtained the annual reports of a further 23 companies. I visited the Nairobi Stock Exchange in June 2003 and photocopied the annual reports of the remaining 7 companies.

The interim reports were obtained in a different way. I obtained the interim reports of 3 companies that actually sent out an interim report to their shareholders from the financial controllers of the companies when I visited their offices to interview them. The interim reports of the remaining companies were obtained by searching the main newspapers published in English in Kenya, *The Daily Nation*, *The East African Standard* and *The Kenya Times* around the dates that these interim reports should have been published. When these had been obtained, they were compared with the interim statements which had been

sent to the Nairobi Stock Exchange (see section 4.12.2) to ensure that they were identical, which they were, in all cases.

5.3.2 Secondary sources: FiRe Award & S&P's scores

35 of the 47 companies quoted on the NSE entered the Financial Reporting (FiRe) Award for Excellence 2003 organized jointly by the Institute of Certified Public Accountants of Kenya (ICPAK), the Nairobi Stock Exchange (NSE) and the Kenya Capital Markets Authority (CMA). The scores awarded to these companies are listed in appendix 7-1, in which companies' identities are disguised by using numbers to identify companies. The scores achieved by the different companies for their annual report IFRS compliance and the S&P Survey methodology are included in the same table for the sake of compactness, as are the scores for the interim financial statements of the companies. In appendix 7-1 DNE in the first column of the "FiRe Award Score" column denotes "did not enter" and "N/A" in the next column along denotes "not applicable".

5.3.3 Interview Respondents

Interview respondents were individuals who could influence the preparation of the financial statements of companies quoted on the NSE to ensure that disclosure was high quality.

68 individuals were initially targeted as potential interviewees. They were regulators, external auditors, buy-side analysts and the financial controllers of all the companies quoted on the NSE. 53 of them were actually interviewed, as shown in Table 5-2. The overall response rate was 82%. Of the 47 companies listed on the NSE, preparers of the accounts of 39 companies were interviewed. The financial controller of the Kenyan subsidiary of a French multinational agreed to be interviewed but later declined when his expatriate supervisor informed him that he should not do so. The Financial Controller of Company 45 agreed to be interviewed but called the meeting off due to pressure of time. In two of the interviews with buy side analysts, they mentioned that this company had problems with its Enterprise Resource Program (ERP), which the company was trying to make operational. The interview with this Financial Controller may have revealed interesting insights into disclosure in the context of a company which had pressing problems with another aspect of its accounting and the possible detrimental effects on disclosure in its annual report. This is a possible area of future research.

A number of other possible respondents were too pressed for time and were unable to

Table 5-2: Interview Respondents

Persons	No. Tar-geted	No. Inter-viewed	Response Rate
Financial Controllers of all NSE companies	47	39	83%
Regulators: NSE	1	1	
CMA	1	1	
Central Bank	2	2	
Commissioner of insurance	1	0	
ICPAK	1	0	
Total	6	4	
External Auditors: Firm A	1	1	
Firm B	1	0	
Firm C	1	0	
Firm D	1	1	
Firm E	1	1	
Total	5	3	
Analysts: buy side	10	10	
Overall total	68	56	82%

agree to be interviewed. The fact that only 83% of the intended number were able to be interviewed could bias the conclusions of the interviews.

Bankers could have been included in the sample of persons interviewed but since the chief financial officers of 6 banks were interviewed as preparers, and since many bank loan officers examine the financial statements of unlisted companies rather than listed ones, it was decided that it would be better to avoid interviewing this latter group.

Sell-side analysts could also have been interviewed. There were 18 stock-broking firms which dealt with shares and bonds on the Nairobi Stock Exchange at the time the interviews were being conducted (NSE 2002a, pp. 174-175). They are all fairly small in size and often did not have a designated research department with specific analysts carrying out research on an ongoing basis. Wagacha (2000) finds that although shareholders normally buy and sell shares through brokers, they rely to a very limited degree on brokers' advice as to which shares to buy. Brokers do little to get their advice to clients. Often analysts working in stock broking firms advise clients on the basis of earnings, price/earnings ratios and a somewhat basic understanding of the financial position of companies. Moreover, they tend to be quite busy when they were not actually on the floor of the exchange. It was decided not to try to interview any sell side analysts.

5.4 Research Instruments and Procedures

The main research instruments used in this study are reported in this section. The construction of the IFRS compliance checklist is explained (5.4.1). The application of the S&P survey is described (5.4.2). The FiRe Award checklist used by independent

adjudicators in Kenya is explained (5.4.3). Weights are discussed (5.4.4). The interview structure and approach followed by the thesis are also explained (5.4.5).

5.4.1 The IFRS disclosure checklist

The IFRS disclosure checklist was constructed using the IASB publication "*International Financial Reporting Standards 2003, incorporating International Accounting Standards and Interpretations*: *The full text of all International Reporting Standards extant at 1 January 2003*". Although "IAS 41: *Agriculture*" was included in this publication, it was effective for financial statements covering periods which began on or after 1 January 2003, which is later than the accounting periods I examined. No quoted agricultural company in Kenya adopted IAS 41 early.

A check was made to ensure that *all* the other IASs and the SIC Interpretations (up to and including Interpretation SIC – 33: *Consolidation and Equity Method - Potential Voting Rights and Allocation of Ownership Interests*") in the publication were effective for accounting periods that began between 1 July 2001 and 31 March 2002. It was found that the IFRS disclosure requirements remained static over this entire period – that is, no new disclosure requirement came into force during this period - so that the single checklist was applicable to all the interim and annual financial statements of all the companies quoted on the Nairobi Stock Exchange.

In many IASs, a number of paragraphs towards the end of the IAS appear under the heading "disclosure". However, for each IAS, the whole IAS was perused to see if disclosure was required by any other part of the document. If it was, the item was added to the spreadsheet in the appropriate place.

After perusing the financial statements of the companies quoted on the Nairobi Stock Exchange, it was decided that none of the following IASs (or in one case a part of an IAS) applied to any company, and they were omitted from the checklist: (1) IAS 11: *Construction Contracts*; (2) IAS 20: *Government Grants*; (3) IAS 22 paragraph 94: *Uniting of Interests*; (4) IAS 26: *Reporting by Retirement Benefit Plans*; (5) IAS 29: *Financial Reporting in Hyperinflationary Economies*; (6) IAS 31: *Financial Reporting of Interests in Joint Ventures*.

5.4.1.1 Reliability of the IFRS disclosure checklist

Marston & Shrives (1991) stress the importance of the reliability of index scores – would the results be reproduced by another researcher?

The first step to ensure that this would be achieved was to ascertain whether the IFRS disclosure checklist was as objective as possible. A detailed reconciliation was made of the items on this researcher's list with a printed copy of the PricewaterhouseCoopers (PWC) International Accounting Standards Disclosure Checklist 2002 (PWC 2002), omitting reference to the IASs omitted as per section 5.4.1 above. This checklist included all IFRSs which were in force for periods beginning on or after 1 January 2002. According to what is stated in section 5.4.1 above, these IFRSs were those in force for the period of this study.

There were two advantages of having prepared my own disclosure list. The first was that it enabled the researcher to familiarize himself with any small changes that may have been made to the IFRSs since the time he had previously been dealing with them in detail. The second was that a complete spreadsheet electronic listing of the disclosure requirements of the IFRS extant as at 1 January 2003 was available in a form which made the following much easier: (1) checking and recording whether relevant disclosures had been made by each company; (2) counting the disclosure items both (across) for individual items and (down) for each company; (3) checking that for each company and for each item there was a **1** if the item applied and was disclosed, **0** if the item applied but was not disclosed with quality, and **n** if the disclosure item was not applicable; (4) correcting items whenever an error was discovered.

The reconciliation between my checklist and PWC's was performed by writing the number of the line of the spreadsheet in which a disclosure item was contained against the corresponding item in the PWC checklist, starting with the first item on my checklist and working systematically through it to the end. If there were any items in the PWC checklist against which nothing was written, reference would be made to the IASB full text of the IFRSs and the item would be added in. This occurred very few times. For the annual financial statements, 1,049 items appear on this researcher's disclosure list as opposed to 1,053 items in the PWC checklist – the difference of 4 items is explained below; for the interim financial reports, 32 items appear on both checklists.

The reasons for the differences in the annual report checklists are as follows: (1) PWC includes "present the notes to the financial statements in a systematic manner" (IAS1 p94) which I omitted, since the wording of the IAS is "notes are normally presented in the following order" (all the companies on the NSE did actually follow this order but it was not a mandatory item); (2) PWC includes "IAS 1 does not prescribe the order or format for

presenting balance sheet items" as an item which I omitted; (3) PWC includes "IAS 24 p19 contains examples of situations which may require disclosure" as an item which I omitted; (4) I omitted the requirement to disclose whether any standards had been adopted early; this could apply only to IAS 41 and no company in Kenya adopted it early.

In counting "items" in the PWC checklist, when an item is described as "the nature and the purpose of . .(Eg. the nature and the purpose of each reserve within shareholders' equity, IAS1 p.74.b)" or "the nature and the amount of . .(Eg. the nature and amount of any impairment loss, IAS 39 p.170.f)", the "items" are counted as two rather than as one single item. The spreadsheet checklist showed these items as two separate items.

The usual controls were incorporated into the spreadsheet so that a high degree of accuracy was maintained when scores were recorded; any omissions or entries in wrong rows were picked up by these controls.

5.4.1.2 The World Bank Disclosure List

The World Bank used a 43 page disclosure checklist or index to examine the annual reports of the companies quoted on the Nairobi Stock Exchange (WB 2003b). I wanted to use the same checklist on the basis that it had been used in ten studies of countries other than Kenya and in the study of Kenya itself. It was found that this index of disclosure items was unsuitable for three main reasons.

The first was that the check-list was not comprehensive enough. An examination of the check-list produced by the World Bank indicated that it would not be adequate for an examination of whether companies disclose all the details required by IFRSs.

The second reason was that it had been prepared in October 2000 and therefore would not be suitable for examining financial statements with year ends between 30 June 2002 and 31 March 2003; changes to the International Accounting Standards had been made in the intervening period and new Interpretations of the Standing Interpretations Committee had been promulgated.

The third reason was that the World Bank checklist (WBC) was extremely user unfriendly – this could introduce errors in evaluating the different annual reports being examined. The WBC tended to deal with IASs one at a time so that a user would have to go back and forth from the income statement to the balance sheet to the cash flow statement, etc. This would have been an extremely time consuming method of checking for the items that had to be disclosed.

It was decided to prepare a checklist on a spreadsheet in which all the items dealing with the income statement, in the order in which those items usually appeared in the income statement in Kenya, would appear, and so on for the remaining financial statements and the notes. In this way, the amount of time and effort required to check in detail items from the checklist to the particular part of the financial statements where that item may appear was reduced. However, there is a disadvantage to this system. A number of researchers have measured compliance with individual IAS. The system chosen for this study makes this very much more time consuming. It was decided to forgo measuring compliance in this way in this study and leave it for further research.

5.4.2 Standard & Poor's checklist

In order to compare high quality disclosure by companies quoted on the Nairobi Stock Exchange with that of companies on other stock exchanges around the world, it was necessary to use a check-list or disclosure index that could be employed regardless of whether companies used IFRSs or national accounting standards. Frost, Gordon and Pownall (2005) use the Financial and Operational component (Block 2, items 29 to 63, in Appendix 7-2) of the Standard and Poor's Transparency and Disclosure index (S&P 2003) as a proxy for "*financial reporting and disclosure quality*". Khanna, Palepu and Srinivasan (2004) state that nearly all the disclosure items on the complete list correspond to either US mandatory or US best practice disclosures, and that some items classified under the "ownership" category can be regarded as financial reporting items. They point out that an advantage of scoring financial reports is that the scores are an objective assessment of disclosures, as opposed to an analyst's subjective assessment.

S&P in its "Transparency and Disclosure Study: Europe" (S&P 2003) presents "Transparency and Disclosure" scores as percentages, based on only the annual report and also on the annual report and other regulatory filings for more than 30 countries (ibid., p. 2). The disclosure list is independent of the accounting standards used. Permission to publish these tables was obtained from Standard and Poor's under the usual condition that the source is acknowledged.

S&P's Transparency and Disclosure checklist incorporates disclosure items based on the criteria that S&P's Governance Services uses in its interactive corporate governance scoring service (S&P 2003, p. 4), but does not address aspects of social and environmental reporting (ibid., p.5). The study focuses on annual reports as the primary source of

corporate disclosure. However, in the US, Canada and Japan, the annual report is more discretionary; as a result, a second analysis is made of the annual report and required regulatory filings (in the US, the company's annual 10K report and its proxy statement; in France, the "Document de Reference") (ibid., p. 6). For European companies which have issued American Depositary Receipts (ADRs) in the US, S&P also looked at the 20-F reconciliations of the financial results and position from the Accounting Standards of the domiciles of the European companies' to US GAAP. However, S&P point out that many 20-F forms were omitted from the survey because they were not available on the SEC EDGAR system (ibid., p.6). It was decided to use this disclosure list, but acknowledging disclosure only when it is done lucidly (when applicable), to evaluate the disclosure of the 47 companies quoted on the NSE against those of the other countries listed by S&P. A spreadsheet is again employed, using the same controls mentioned in section 5.4.1.1.

5.4.3 FiRe Award 2003 checklist

The "evaluation grid/scoring scheme" used in the Financial Reporting (FiRe) Award 2003 is contained in Appendix 5-2. Scores for the different aspects of disclosure are awarded as follows. For the first two "criteria" in Table 5-3, compliance with IFRS and the Kenya Companies Act, the method mentioned in section 4.11 of this thesis is employed. That is, it is assumed that compliance is complete since the auditors of each company have stated that this is the case in their audit report (see section 4.7.1).

Any departure from disclosure compliance is penalized as follows: (1) 1 to 2 points for any minor item required by the Kenya Companies Act or IFRSs; (2) 3 to 5 points for any major item required by IFRSs. For the remaining items in the "evaluation grid", scores are reduced from the maximum possible as follows: (1) 2 points for each accounting policy note or note to the accounts deemed to be unclear; (2) 1 point for poor layout, poor typeface or poor paper quality; (3) 1 point if any of the following are omitted: trends in turnover; numbers and charts for earnings and dividend per share; market performance of the share over the year; (4) 1 to 3 points if the business strategy is not articulated, or key business issues and their effects on different business segments (if applicable) and profiles of directors are not identified. Scores can never end up being negative. In practice, all the teams of scorers rarely give zero for a whole class of items, but this could happen if, for example, there is no disclosure of the "principal shareholding" as required by item 10 in Table 5-3.

Table 5-3: Scoring System for Financial Reporting (FiRe) Award 2003

1	Compliance with IFRSs	75
2	Compliance with the Kenya Companies Act accounting requirements	15
3	Clarity of the statement of accounting policies	10
4	Clarity of the other notes to the financial statements	20
5	Design, lay-out & appearance of the annual report	5
6	Board & management reports (details appendix 5-2)	20
7	Presentation of performance data including graphs, bar & pie charts, ratios & trends (details appendix 5-2)	10
8	Corporate governance (details appendix 5-2)	20
9	Social responsibility & environmental reporting (details app. 5-2)	20
10	Disclosure of principal shareholders	5
	TOTAL	200

From even a cursory examination of this scoring system, it is clear that it is subjective.

In the 2003 competition, different teams of two scorers were appointed for each of the following groups: banking institutions; insurance companies; listed non-financial companies; and non-quoted entities. All scorers and an overall moderator met before scoring commenced to lay down the criteria for the scoring process. Each scorer produced scores for his/her group of companies A meeting was held between the overall moderator and the teams of scorers to ensure that all the teams awarded scores on the same basis. The scores of the two members of the team in each category were added and the annual reports of the top 6 companies in each category were awarded scores by the overall moderator independently of the scores already awarded. The three scores now arrived at were totalled to work out the winners. These scores are detailed by a coding system, to preserve the anonymity of the companies, in Appendix 7-1.

5.4.4 Un-weighted disclosure index

A number of researchers have used weights for the different items in the disclosure lists; weights were allocated to disclosure items based on their relative importance according to (mainly) financial analysts (Cerf 1961; Singhvi & Desai 1971; Buzby 1975; Stanga 1976; Firth 1979; Malone et al. 1993). Buzby (1975) argues that companies have limited amounts of money which can be spent in providing information; therefore companies should concentrate on providing the most important items before the least important. Coy and Dixon (2004) use a weighting system so that not only is the absence (0) or presence (1) of the item measured, but a higher number measures whether the actual disclosure is presented satisfactorily (2) or excellently (3), and a further weighting denotes the importance of the item (1 for low, 2 for medium or 3 for high).

It is evident that a weighted system is used in the Financial Reporting (FiRe) Award for Excellence 2003. Scores are reduced according to the importance the scorer attaches to the item which is not disclosed.

However, there are possible weaknesses with using a weighting system. Buzby (1975) needed to test for non-response (of 71.2%) bias that could be present in arriving at weights based on responses from analysts, using the method suggested by Oppenheim (1966), where the 13 last respondents were taken as a proxy for non-respondents; there was no statistical difference between mean response scores of these 13 respondents and those of 13 randomly chosen respondents received on the first, second and third days. In Kenya, there are few financial analysts and non-response would be a major problem. Research has indicated that even experts have poor insights into the relative importance of items in their judgement process (Ashton 1974). On the other hand, previous research has indicated that linear models can be used to extract the judgement process of individuals (Slovic et al. 1972). Dhaliwal (1980) reveals that investment decision makers do not have a high degree of insight into the weights they give different items. In addition, he points out that the significance of any single disclosure item is related to the absence or presence of other items of information, and concludes that redundant items should not be included in disclosure lists, since they do not add to the quality of financial disclosure. He argues a third point, that the relative importance of disclosure items is dependent upon economic conditions and changes over time: Collins (1975) found segmental data useful for predicting share price changes at one time but not another. Coy and Dixon's (2004) system too has its drawbacks, in that a single metric cannot convey the dual concepts of extent of disclosure and the quality of disclosure: a low score may indicate that a small number of items were disclosed exceptionally well, or that complete compliance was achieved, but the adjudicator thought they were presented poorly.

Spero (1979), Chow and Wong-Boren (1987) and Zarzeski (1996) use both weighted and un-weighted indices. Their results identified no deviation between the two methods.

Many researchers have used an un-weighted index (Cooke 1989a & 1989b; Owusu-Ansah 1998; Haniffa and Cooke 2002; Ali, Ahmed & Henry 2004). They use

a dichotomous method of scoring one if an item is disclosed or zero if the item is not disclosed. However, in some cases, for example banks, the number of items that have to be disclosed may be greater than for non-banks. Non-banks should not be penalized for not disclosing information items that do not apply to them. To correct for this, a judgement has to be made as to whether an item was relevant or not for a company. The allocation of zero or one is made only to relevant items. There is a certain subjectivity and possible inaccuracy as a result of this; for example, a company may make no mention of contingent liabilities: one company claims it has no contingent liabilities because it wants to hide them and the auditor is convinced by the CFO's arguments; a second acknowledges that it has contingent liabilities but claims that the possibility of a cash outflow in settlement is remote; a third has overlooked contingent liabilities and the auditor may have overlooked them too. All three companies would obtain the same score. However, where any possible omissions of this nature did occur, the matter was brought up in the interview with the financial controller. The number of such items was extremely small.

In addition to the above arguments, IASB requires financial statements to comply with all applicable IASs and SICs. In order to arrive at an idea of the degree of compliance of any particular annual or interim report, an un-weighted approach would be preferable. It is also the method adopted by the S&P's Transparency and Disclosure Survey 2003.

This study adopts the un-weighted method to measure compliance with IFRSs for the reasons enumerated above.

5.4.5 Scoring method

A dichotomous procedure is adopted. If a disclosure item is applicable to the company, the item scores one if it is disclosed and zero if it is not disclosed.
The maximum disclosure score (MDS) a company can score is additive and varies with the number of items in the disclosure checklist applicable to the company:

$$MDS = n = \sum_{i=1}^{m} \mathbf{d_i}$$

where $\mathbf{d_i} = 1$ if the item should be disclosed or 0 if it need not be disclosed;

m = 1,049 in the case of the annual report,

m = 32 in the case of the interim report.

The actual disclosure score (ADS) a company scores is additive and depends on the number of items it discloses which are applicable to the company.

$$ADS = \sum_{i=1}^{n} d_i$$

where $\mathbf{d_i} = 1$ if the item is disclosed lucidly or 0 if it not disclosed lucidly;

n = the number of items the company should disclose.

The disclosure index (**DI**) for each company is then (**ADS/MDS**).

5.4.6 Interview Structure & Process

A decision had to be made as to how to obtain information about "high quality financial reporting" from the individuals involved in its production and use on the NSE. Smith, M. (2003, p. 118) reveals that the difficulty of achieving adequate levels of response to mail surveys is a key factor in the decline of mail survey methods. Chadderton, Hoque and Hopper (1992) point out that their experience with research in Third World countries indicated that residents of these countries are often opposed to completing written questionnaires. They go on to state that personal interviews have proven to be more successful in obtaining information. It was decided that the best way to obtain this information was by interviewing.

There are many ways of interviewing individuals to obtain their opinions on the matter under review (Sekaran 2000, p. 264). The structured interview was contemplated; the same closed questions, in the same order, with the same cues and prompts as required would make the coding of answers and the subsequent analysis easier, and reduce the possibilities for error associated with open questions; but they would restrict the comparative advantage of the interview method by excluding the flexibility and richness of response that open questions would permit (Smith, M. 2003, p. 128). It was decided to use the semi-structured interview method. By using this method of interview, more emphasis was placed on the "why" of issues rather than the mere "what" and "how" (Saunders et al. 2000, p. 245), and the potential for discovering issues that had not been considered previously was created. Semi-structured interviews also allowed the questions to vary from one interview to another and permitted further inquiry into matters which came to light as a result of some interviewees having their own insights (Yin 1994, p. 84).

The questions that were asked of the interviewees by the researcher were developed on the basis of the review of the literature (chapter 2) but modified suitably to take account of

the institutional and cultural characteristics of Kenya, and the aims of this study. The questionnaire was sent by electronic mail to three persons to test whether the questions would be understood by interviewees. All three have experience of preparing and analysing financial statements in a professional capacity in Kenya. Only one person answered the questionnaire; he is now resident in the US; in 2000, he had retired as the company secretary (in which post he was also in charge of the preparation of the annual report) of a company quoted on the Nairobi Stock Exchange; he had previously been in the same position in another company quoted on the Nairobi Stock Exchange. A number of reminders were sent to the two persons currently working in Kenya, but no response was obtained. This reinforced the need to persuade respondents to agree to a face to face interview which would be recorded on an audio tape. The replies received from the single person who had tested the questionnaire did not lead to any changes in the questions. All the interviews were conducted in English, which is the working language in the formal sector in Kenya. The interview questions are set out in Appendix 5-3.

A letter requesting an interview with the financial controller of each of the companies quoted on the NSE was sent in advance. This letter explained the purpose of the study. The questionnaire was attached to the letter.

5.5 Econometric Methods Used

The purpose of this section is to outline the univariate and multivatiate analyses used to test the hypotheses developed in chapter 6.

5.5.1 Examination of Data

Cooke (1998) stipulates that researchers should pay attention to the structure of the data being examined. Problems of skewness, kurtosis, outliers and non-linearity have to be addressed. He suggests that the histogram, the stem-and-leaf plot and the boxplot be used to establish the skewness and kurtosis of the distribution and identify outliers.

In this study, variables for one year from the total population of companies quoted on the Nairobi Stock Exchange are being considered. The problem of generalizing the results for the population as a whole therefore does not arise. The results for one year can serve only as a guide for other years. But inferences about the population as a whole will be arrived at only after the rigour of statistical tests have been applied to establish whether these inferences can be stated validly, as if the

population was merely a sample. Although inferences made about populations based on data from samples are always a little risky (Tabachnick & Fiddell 2001, p.31), this will not be the case when inferences are made in relation to IFRS and S&P's Survey scores. Many inferential methods require the population, and samples chosen from it, to be normally distributed and samples from the population to have equal standard deviations (Weiss and Hassett 1991, p.747). Cooke (1998) points out that the error term in regression analysis is assumed to be normally distributed.

Examination of the data gives insights to choices about econometric techniques used to test the hypotheses developed. Data has been examined using box-plots, Q-Q plots, histograms, stem-and-leaf plots and the Kolmogorov-Smirnov test with Lilliefors significance and the Shapiro-Wilk's test.

5.5.2 Econometric Methods Used in Testing Hypothesis

5.5.2.1 Univariate Analysis

Correlational coefficients (e.g., the Pearson product-moment correlation) provide a numerical summary of the strength and direction of the linear relationship between two variables. The relationship between variables can be inspected visually by generating a scatterplot. The correlation coefficient (e.g. the Pearson r) provides an indication of the linear relationship between variables; if the two variables are related in a non-linear way (e.g., curvilinear), the Pearson r will seriously underestimate the strength of the relationship.

S&P's Survey scores and FiRe Award scores meet the conditions for parametric tests listed below. As a result the Pearson product-moment correlation coefficient was used to test their associations with company and market variables.

Data relating to annual report IFRS compliance and interim report IAS 34 compliance in this study do not satisfy the conditions for parametric tests, which are: (1) that data are measured at the interval or ratio level, that is, using a continuous scale rather then discrete categories; (2) scores are obtained using a random sample from the population; (3) observations must be independent of one another; (4) scores for each variable should be normally distributed; the distributions of scores are checked using histograms and the Kolmogorov-Smirnov statistic and the Shapiro-Wilk's test; (5) the relationship between the two variables should be linear; (6)

homoscedasticity: the variability in scores for the independent variable should be similar at all values of the dependent variable.

Since this is the case, the non-parametric Kendall rank correlation coefficient (tau) is used to calculate the strength of the relationship between IFRS compliance scores and continuous independent variables. The Kendall, rather than the Spearman, test is used since claims have been made that it is superior (Griffiths 1980; Noether 1981) and has been used in many studies of accounting disclosure (e.g., Buzby 1975; Belkaoui and Kahl 1978; Firth 1979; Suwaidan 1997).

Categorical or dummy variables are tested using the non-parametric Mann-Whitney U, since the number of data items is often small and since compliance scores are not normally distributed.

5.5.2.2 Multivariate Analysis

The traditional ordinary least squares (OLS) method is the most commonly used estimation process in accounting disclosure literature, mainly for the simplicity of the approach and for the modest demands on the data required (Koutsoyiannis 1977). Since S&P Survey and FiRe Award scores meet the conditions for parametric tests, the OLS regression model will be used to test associations between disclosure scores and independent variables. Annual report IFRS, and interim report IAS 34, compliance scores do not meet the conditions for parametric tests.

Cooke (1998) points out that the theoretically correct form of the relation between the dependent and the independent variable in empirical accounting studies is sometimes not known. Furthermore, the disclosure scores and independent variables are proxies for underlying constructs; theory may suggest a functional form for the theoretical constructs but the same may not apply to the empirical proxies. Cooke suggests that the data be transformed and that Rank Regression be used in place of the conventional OLS. The advantages of Rank Regression are: (1) they are distribution-free (McCabe 1989) and they reduce the impact of measurement errors, outliers and heteroscedasticity (Cheng et al. 1992); (2) there is no loss of information that would lead to a loss of power (McCabe 1989) and conversely to other transformations (logs, powers, roots, etc.) - this corrects for both kurtosis and skewness (Cooke 1998); and (3) sufficient theoretical and empirical evidence exists to demonstrate the efficacy of this technique (e.g., Draper 1988).

However, there are disadvantages in using rank regression: (1) it is difficult to interpret β_i : if $\beta_i = 0$ there is no association; if $\beta_i = \pm 1$ the increase in the rank of the right-hand side variable increases or decreases the rank of the left-hand side variable by 1; but outside these three numbers, interpretation is indefinite; (2) in multiple regression, to undertake statistical tests of a hypothesis, if the form of the joint distribution of the dependent variable and the independent variables is not known, the correct significance levels cannot be determined: if the dependent variable is normally distributed, the **F** statistic tests the null hypothesis that all the coefficients except the constant term are zero; i.e. $\beta_1 = \beta_2 = \ldots = \beta_n = 0$; since ranks are distribution-free, testing for significance using the **F** and t-tests are not appropriate; (3) the error structure cannot be normal; (4) the mapping of individual observations to ranks is a somewhat arbitrary transformation; and (5) the data after transformation are ordinal instead of interval; the tests are effectively non-parametric and as such are weaker than parametric tests (Cooke 1998, p.213)

Siegel and Castellan (1988) note that parametric tests are better than non-parametric tests when the assumptions for the data are met. This is so because the power-efficiency of the parametric test is much greater than for the non-parametric test; that is, the test correctly identifies what it is used to test.

An alternative to rank regression is to use the van der Waerden approach suggested by Cooke (1998, p. 214). Actual observations are transformed to the normal distribution, by dividing the normal distribution into the number of observations plus one segments, on the basis that each segment has equal probability. The ranks are substituted by scores on the normal distribution. The regression analysis proceeds using the normal scores as the dependent variable.

In addition to the advantages of rank regression, the additional advantages of replacing ranks by normal scores are: (1) the resulting tests have exact statistical properties because: (a) significance levels can be determined; (b) the **F** and t-tests are meaningful; and (c) the power of the **F** and t-tests can be used; (2) the regression coefficients derived using normal scores are meaningful; and (3) the non-normal dependent variable is transformed into a normal one; hence the errors are also normally distributed.

In this research, for the annual report IFRS, and the interim report IAS 34, compliance score distributions, the log transformation is applied in addition to rank regression, to check the robustness of the results.

5.5.2.3 Criteria to assess the regression model

Achen (1982) points out that "...the selection of a suitable regression is an art, not a science...". Cooke (1998) reveals that the regression that should be chosen is the one that gives the best fit. Schroeder et al. (1986) argue that the maximization of the coefficient of determination, the adjusted R square ($_{adj}R^2$), is not the purpose of regression analysis; Cooke (1998) states that in assessing measures of best fit, it can be argued that the $_{adj}R^2$ is a possibility, but points out that it is not invariant to changes in the parameterizations of the left-hand side variables. Gujarati (2003) states that the aim of regression is to obtain dependable estimates of the true population regression and draw statistical inferences about them. The minimization of the Mean Square Error (MSE) is viewed as a valid criterion by a number of statisticians (e.g., Koutsoyiannis 1977, Achen 1982) and is suggested by Cooke (1998) .This criterion is also used in this study.

5.5.2.4 Multicollinearity

Multicollinearity or collinearity is the undesirable position where one independent variable is a linear function of another or other independent variables. When variables are multicollinear, they contain redundant information and they are not all needed in the same analysis; because they inflate the size of error terms, they weaken the analysis (Tabachnick and Fidell 2001, pp. 82-85).

Multicollinearity tends to be a serious problem when the regression is aimed at assessing the relative influence of independent variables (Mendenhall et al. 1986), which is the aim of $\mathbf{EQ_2}$: "Is there a significant association between high quality disclosure and company characteristics on the basis of expectations derived from prior research and theoretical models"?

Gujarati (2003, pp. 359-375) states that there are a number of ways to detect critical levels of multicollinearity. This study applies three different tests to detect these: (1) the matrix of bivariate correlations, where the correlations between all the pairs of independent variables are given, is examined; Berry and Feldman (1985) state that multicollinearity is not harmful if coefficients for correlation between the independent variables are as high as 0.8; Tabachnick and Fidell (2001, p.84) state that careful thought be given before including

two variables with a bivariate correlation of 0.7 or more; Judge et al. (1988) point out that these cut-off points could be arbitrary because pair-wise correlations could mask more complex relationships; in this study, it was decided to use a cut-off figure of 0.7; this test for collinearity is the one most commonly used in prior studies; (2) Gujarati (2003, p.360) states that multicollinearity may exist even when simple correlations are comparatively low (r = 0.5). It was decided to run two additional tests; the first examines tolerances and variance inflation factors (VIF); tolerance is calculated as $(1 - R^2)$ where R is arrived at by regressing each independent variable against all the other independent variables; if R^2 exceeds 0.90, that variable is highly collinear with the other independent variables; the tolerance would be less than 0.10 and hence, the variance inflation factor (VIF) for the independent variable (the inverse of the tolerance of this variable), would be greater than 10; (3) Belsley, Kuh and Welsch (1980, p. 96) state that none of the above approaches is fully successful at diagnosing the presence of collinearity; they propose that if the condition index (CI) is > 30 (ibid., p.157), there is severe collinearity – choosing this threshold is akin to choosing a test size (α) in standard statistical hypothesis testing; CI = √(Max. eigenvalue / Min. eigenvalue) =√(k), where the eigenvalues are of the scaled and uncentered cross-products matrix; Gujarati (2003, p. 362) indicates that if k is between 100 and 1000 there is moderate to strong collinearity and if k is greater than 1000, there is severe collinearity.

5.6 Summary and conclusion

This chapter describes and evaluates the research methods employed in this study. It deals with the underlying philosophy and methodology and the choice of the method to measure high quality disclosure by Nairobi Stock Exchange companies: it explains that an empiricist approach has been taken in this study: the importance of construct validity, internal validity and external validity and of the reliability of the study were noted (5.2). It outlined the main techniques and procedures to collect data (5.3). These data were analysed using the research instruments developed by this study; the development of the IFRS disclosure checklist was explained and justified; controls to ensure accuracy and enhance objectivity and replication were noted; the measurement process was examined and the reason for selecting an un-weighted procedure were explained; the reasons for selecting annual and interim reports were defended; the interview structure and process were also explicated (5.4). Finally the

main methods of testing data to answer the second empirical question were examined (5.5). Both parametric and non-parametric tests are used. Univariate and multivariate analyses are briefly described. These will be demonstrated empirically in chapter 8.

The overall framework of the study is made of two parts. The first part is an exploratory study to investigate the use and the meaning of the phrase "high quality financial reporting" – "use" comes before "meaning" although logically it should be the other way round: but it is found that the phrase was used for a number of years without its being clearly defined: and when it was defined, few people seem to have paid much attention to the definition: the phrase continues to be used in its "undefined" state – it would seem that some regulators prefer this undefined status, possibility so as to increase their bargaining power. In addition, a tentative definition of high quality disclosure was developed. The exploratory part of the study was covered in chapters two and three. The second part of this study is explanatory: high quality disclosure by companies on a capital market in a developing country is measured empirically; associations between high quality disclosure and company and market variables are tested; interview research is used to complement the quantitative findings. The explanatory part of the study is covered in chapters six to nine. This part of the study also has an exploratory aspect: can a better definition of "high quality disclosure" be proposed after the empirical investigations have been carried out and after the tentative definition has been tested? Insights will be obtained from experts who prepare, audit, regulate and analyze financial reports. These insights should provide a basis for an improved definition of "high quality disclosure", so as to meet the main objective of this research **GO**: "to make a contribution to understanding how preparers of financial statements that will be used in capital markets in developing economies can be assisted in achieving high quality financial reporting, and how regulators and other intermediaries can help them do so" (1.3). It is clear that the approach has strong empiricist leanings (Miller, P. and Wilson 1983) but tries to achieve a union of observations with the logic of the rational approach (Howard 1985) to achieve a valid conclusion.

CHAPTER 6
Development and Formulation of Testable Hypotheses

6.1 Introduction

The second empirical research question (**EQ_2,** section 1.5.2) asks whether "there is a significant association between high quality disclosure and company characteristics on the expectations derived from prior research and theoretical models?" To investigate this question, independent variables are identified, based on theories in prior literature, in order to formulate testable hypotheses.

These variables are specific corporate characteristics whose relationships with high quality disclosure in annual reports are investigated for financial years which ended between 30 June 2002 and 31 March 2003, in the case of IFRS compliance and S&P Survey scores, for the entire population of companies quoted on the NSE, and in the case of FiRe Award scores, for a sample of 35 companies. The sample of 35 companies is not randomly chosen; it comprises those NSE listed companies which entered the FiRe Award competition run jointly by ICPAK, the Kenya Capital Markets Authority and the Nairobi Stock Exchange. Relationships between specific corporate characteristics and high quality disclosure in interim financial reports for all 47 companies, measured by IAS 34: *Interim Financial Reporting* compliance, are also investigated.

Section 6.2 outlines the criteria used to select independent variables and the formulation of a general hypothesis. Sections 6.3 and 6.4 provide analytical grounds for the formulation of the testable hypotheses for high quality disclosure in annual and interim reports. Section 6.5 introduces control variables. A summary and conclusions are provided in section 6.6.

6.2 Criteria to select independent variables and general hypothesis

It may be possible to observe associations between a variety of variables and high quality disclosure in interim and annual reports. Where there is an association, the variables could explain the variation in high quality disclosure by the companies listed on the NSE. Criteria used to select these variables are:

(a) The variables are able to be measured reliably. They can be obtained from a reliable source and can be used for statistical tests.

(b) They have theoretical backing and/or are supported by empirical studies.

(c) They have been used a number of times in prior academic research; sometimes this is not the case.

(d) They have a degree of importance in themselves for Kenya.

(e) They can be found relatively easily so that costs incurred in finding them are not prohibitive.

(f) They meet the objectives of this research (Leventis 2001).

6.2.1 General Hypothesis: Company Characteristics & High Quality Disclosure

On the basis of the second empirical research question mentioned above, a general research hypothesis is formulated as follows:

H_0: *There is no significant association between high quality disclosure in interim and annual reports and company characteristics.*

The alternative hypothesis to this would be:

H_A: *There is a significant association between high quality disclosure in interim and annual reports and company characteristics.*

Based on theory and prior empirical findings, an association between high quality disclosure and company characteristics is expected.

6.3 Setting up Testable Hypotheses: annual reports

This section deals with the formulation of hypotheses which are developed to test associations of high quality disclosure in annual reports with company variables.

6.3.1 Hypothesis 1: Corporate Size

Marston (2003) points out that agency theory, signalling theory and cost-benefit analysis can all be used to show that a positive association between size and disclosure can be expected. She argues that larger companies, having an increased need for external funds, try to minimize agency costs which arise because of the conflicting interests of shareholders, managers and debt holders (Jensen and Meckling 1976); increased disclosure (which implies a higher quality of disclosure) reduces agency costs and information asymmetries. Also, larger companies have a greater incentive to signal their quality by means of higher quality disclosures. Larger companies tend to be more complex in that they have different business lines and operate in several different geographical locations; they need efficient management information systems that disclose an extensive array of information (Buzby 1972; Cooke 1989a). Also, higher quality disclosure is required to ensure that they can be understood to the same extent as less complex

companies (Marston 2003). Larger companies incur higher political costs, since they tend to make greater profits in absolute terms and therefore could be targets for nationalization or control (Stigler 1971, Peltzman 1976 and Jensen and Meckling 1976). Marston (2003) argues that political costs can be reduced by improved disclosures. Larger companies are able to meet the costs of increased disclosure and pay higher salaries to attract more highly skilled staff than smaller companies (Lang and Lundholm 1993). Larger companies have larger numbers of customers and suppliers, who are interested in their financial health (Camfferman and Cooke 2002); they also have a bigger following amongst analysts and the public in general (Lang and Lundholm 1993; McKinnon and Dalimunthe 1993). Smaller companies might see increased disclosure as a way of giving away competitive advantage (Stanga 1976, Cooke 1989a).

In prior studies, size has been identified as a significant explanatory factor on numerous occasions, commencing with Cerf (1961) and repeated for both mandatory and voluntary disclosure in both developed and emerging capital markets.

On the basis of what is reported above, there is a strong argument for there to be a positive relation between size and the quality of disclosure. The null hypothesis is:

$\mathbf{H_{O1}}$: *There is no significant association between annual report high quality disclosure and company size.*

The alternative hypothesis is:

$\mathbf{H_{A1}}$: *There is a significant positive association between annual report high quality disclosure and company size.*

6.3.2 Hypothesis 2: Number of shareholders.

Fama and Jensen (1983) point out that agency conflicts are likely to be greater where shares are widely held than when they are held by a small number of shareholders. Agency theory suggests that directors of companies whose ownership is diffuse have an incentive to engage in bonding activities to reassure shareholders that they are acting in a way which is consistent with shareholders' interests; they disclose more information to assist shareholders to monitor their behaviour (Raffournier 1995). McKinnon and Dalimunthe (1993) explain that the marginal cost to management of providing information is much lower than the cost to individual equity holders of ascertaining the same information; higher quality information serves to reduce agency costs.

Companies with a greater number of shareholders will have greater political costs. Cerf (1961) points out that companies with large numbers of shareholders are more in the public eye and are under more pressure from the market for better disclosure. Cooke (1989b) notes that the larger is the number of shareholders, the greater will be the demand for heterogeneous information. Realizing that they had a larger number of potential customers, analysts would also demand additional information. Companies with larger numbers of shareholders would realize that there were demands for more information and would attempt to ensure that this information is well packaged.

Cooke (1989b) argues that the number of shareholders of a company is a measure of the size of the company. For the 90 Swedish companies that make up the sample he studies, the correlation coefficients between "the number of share-holders" and "the size of total assets", and "sales", are 0.907 and 0.903. For companies on the NSE, the correlation coefficients between independent variables representing size and those representing the number of shareholders vary between 0.646 and 0.862 for all companies and between 0.640 and 0.850 (all significant at the 1% level of significance) for the 35 companies which participated in the FiRe Award 2003 competition. Hence, although variables representing the size of the companies and the number of shareholders are significantly correlated, the correlation is not sufficiently high to conclude that the size of the company and the number of shareholders are synonymous. Raffournier (1995) also argues that "the number of shareholders" is more a surrogate for size than a measure of ownership diffusion; he defines "ownership diffusion" as the percentage of shares not held by "known shareholders". Marston and Polei (2004), like Leuz and Verrecchia (2000), measure the dispersion of share ownership using "free float", which they define as "the percentage of shares that are freely traded on the stock exchange and are not in permanent ownership".

In Kenya, there is a requirement for NSE companies to publish the identities of the 10 largest shareholders (Appendix 4-3, e), but many omit this information. The number of shareholders is available from company returns submitted to the NSE; it was decided to use this number as a proxy for shareholding diffusion.

Although Wallace (1987) finds no significant association between his disclosure index and the number of shareholders, Cerf (1961), Singhvi and Desai (1971), Cooke (1989a, 1989b and 1992) find a positive association between the number of shareholders and disclosure. McKinnon and Dalimunthe (1993) find a positive association (significant at the

5% level) between disclosure of segment information and ownership diffusion. Raffournier (1995) finds no significant relationship between the extent of voluntary disclosure and ownership dispersion. Marston and Polei (2004) find their measure of ownership dispersion, free float, positively associated with voluntary disclosure, but significant only for the earlier period of their study. Haniffa and Cooke (2002) find a positive relationship between more concentrated share ownership (i.e., less diffused ownership) and voluntary disclosure levels, which contradicts the finding by Hossain et al. (1994); both studies examine Malaysian listed companies. Chau and Gray (2002) find, for listed companies in Hong Kong and Singapore, a positive association between wider ownership and the extent of voluntary disclosure. Barako et al. (2006) find a negative relationship, for the years 1992 to 2001, between "concentrated share ownership" (i.e., the opposite of diffusion) and the extent of voluntary disclosure for companies quoted on the Nairobi Stock Exchange.

On this basis, there is an argument for there to be a positive relation between the number of shareholders and high quality disclosure. The null hypothesis is:

$\mathbf{H_{O2}}$: *There is no significant association between annual report high quality disclosure and the number of shareholders in the company.*

The alternative hypothesis is:

$\mathbf{H_{A2}}$: *There is a significant positive association between annual report high quality disclosure and the number of shareholders in the company.*

6.3.3 Hypothesis 3: The shareholding owned by the holding or investing company

It would seem to follow logically from the previous hypothesis that if a holding or investing company owns more shares in its subsidiary or associated company, the shareholding tends to be more concentrated and hence the disclosure would be less, implying lower quality. Many companies quoted on the Nairobi Stock Exchange, including companies which are owned mainly by Kenyans, are majority or significantly owned by holding or investing companies. Raffournier (1995, p.264) argues that companies controlled by large shareholders are expected to disclose less information. Owusu-Ansah (1998) notes that where equity ownership is highly concentrated, there is generally little or no physical separation between those who own and those who manage the capital; however, this is not the case when the "owner" is a holding or investing

company. But it could still be argued that the holding or investing company has access to internal information of the company and may not need to rely on public disclosure to monitor its investment; demand for adequate disclosure would seem to be low in such situations. Bushee and Noe (2000) find that dedicated institutions, characterized by large, stable holdings in a small number of companies, are not sensitive to disclosure levels or changes, suggesting that corporate disclosure practices are not a significant factor affecting these institutions' investment decisions.

However, when a holding or investing company owns more shares in a subsidiary or associated company, political costs tend to increase; minority shareholders could raise an outcry that so few shares are available for free float (eg., Ngotho 2005). Agency and political cost theory assume that managers, out of self-interest, act opportunistically (Deegan and Unerman 2006, p. 207). Managers will attempt to minimize political costs, and, from agency theory, have incentives to show that they are working to benefit owners (Deegan and Unerman 2006, p.216), by ensuring that disclosure in the annual report is as high quality as possible. Stakeholder theory suggests that managers would exert more effort to manage the relationship with more important stakeholder groups, in this case the investing company; managers would want to prepare financial reports of higher quality. Barako et al. (2006) argue that due to their large ownership stake, institutional investors have strong incentives to monitor disclosure practices; they go on to find that the extent of voluntary disclosure in Kenya is positively associated with a higher percentage of shares owned by institutional shareholders.

On this basis, there is an argument for there to be a positive relation between a higher shareholding owned by the holding or investing company and high quality disclosure. The null hypothesis is:

H_{O3}: *There is no significant association between a relatively higher shareholding owned by a holding or investing company and annual report high quality disclosure.*

The alternative hypothesis is:

H_{A3}: *There is a significant positive association between a relatively higher shareholding owned by a holding or investing company and annual report high quality disclosure.*

6.3.4 Hypothesis 4: Age of the Company

One of the stakeholders in the accounting reporting process in Kenya is the Institute of Certified Public Accountants of Kenya (ICPAK). ICPAK decided that IAS would be used

in Kenya. It has investigated a number of claimed departures from IAS (Kisero 2002). Younger companies may view ICPAK as a more important stakeholder than an older company and may take more seriously requirements promulgated by ICPAK. Also, younger companies may be more versatile; since they have been established more recently, they may find it easier to deal with coercive isomorphism and may view mimetic isomorphism as an important way of improving their reporting. At the same time, since change is costly, a younger company with fewer resources may engage in a greater degree of decoupling that an older company. Owusu-Ansah (1998) argues that younger companies might consider they give away competitive advantage by increased disclosure, whereas older, more established ones would not; the cost of gathering, processing and disseminating the information stipulated in regulations would be more onerous for younger companies; and younger companies have less experience in dealing with problems and communicating their resolution to users of their annual reports (see Camfferman and Cooke 2002, p.20).

Barton and Waymire (2004) find that younger companies have higher reporting quality on US markets in 1929. Alsaeed (2005) finds no association between company age and disclosure in Saudi Arabia but Owusu-Ansah (1998) finds a significant positive association between company age and the level of mandatory disclosure of listed companies in Zimbabwe.

On the basis of Owusu-Ansah's arguments and findings, there is an argument for there to be a positive relation between the age of the company and high quality disclosure. The null hypothesis is:

$\mathbf{H_{O4}}$: *There is no significant association between annual report high quality disclosure and the age of the company.*

The alternative hypothesis is:

$\mathbf{H_{A4}}$: *There is a significant positive association between annual report high quality disclosure and the age of the company.*

6.3.5 Hypothesis 5: Leverage of the Company.

Jensen and Meckling (1976) argue that more highly levered companies incur more monitoring costs and they seek to reduce these costs by disclosing higher quality information in annual reports. Interest rates in Kenya in the years immediately prior to

2002 were very high[5]; this would tend to make leverage undesirable to shareholders. In addition, leverage increases financial risk for shareholders. Higher quality disclosure would tend to reduce investor uncertainty, and thus reduce the company's cost of capital (Watson, Shrives and Marston 2002, p. 290). Dumontier and Raffournier (1998) claim that increased disclosure through compliance with IAS improves the monitoring role of financial statements, in turn reducing agency conflicts and the scope for earnings manipulations.

Signalling theory can also be invoked to explain the link between leverage and disclosure. Ross (1977) notes that an increase in financial leverage is a positive signal since managers express confidence when they leverage the company; however, Myers, S., and Majluf (1984) claim that an unexpected increase in leverage signals to shareholders a smaller than expected cash flow – a negative signal. Leventis (2001) argues that lowly levered companies may wish to screen their financial structure by giving more disclosure. Hossain (1999) suggests that companies with higher debt ratios might disclose less information in their annual report to disguise the level of the company's risk.

Stakeholder theory predicts that managers would pay attention to reporting to both debenture holders and shareholders, since each group is an important stakeholder: disclosure to two important groups is likely to be better than to only one.

Belkaoui and Kahl (1978) and Zarzeski (1996) find a negative relationship between leverage and disclosure. Several studies find insignificant results (Chow and Wong-Boren 1987; Craswell and Taylor 1992; McKinnon and Dalimunthe 1993; Ahmed and Nicholls 1994: Wallace et al. 1994; Raffournier 1995; Dumontier and Raffournier 1998; Watson, Shrives and Marston 2002; and Ali et al. 2004). Hossain et al. (1995) find a positive relationship between voluntary disclosure and leverage but significant only at the 10% level. Wallace and Naser (1995) find a significant positive association between the ranks of mandatory disclosure and leverage using univariate analysis but not using multivariate analysis. Ahmed and Courtis (1999) find that voluntary and aggregate disclosure indices are significantly positively associated but that the mandatory disclosure index is not. However, Courtis (1979), Bradbury (1992), Malone et al. (1993) and Hossain et al. (1994) find a significant positive association between leverage and company disclosure. Also,

[5] The 91 day Treasury Bill interest rate per annum on 31 December: 1999 - 20.5%; 2000 – 13.5 %; 2001 – 10.9 %; 2002 – 8.4%. Commercial bank loans: 1999 – 25.2%; 2000 – 19.6%; 2001 – 19.5%; 2002 – 18.3% (CBK 2004, p. 52).

Barako et al. (2006) find that leverage is positively associated with voluntary disclosure for companies quoted on the Nairobi Stock Exchange between the years 1992 and 2001.

Hence, it is likely that a positive relation between the leverage of the company and high quality disclosure exists. The null hypothesis is:

H_{05}: *There is no significant association between annual report high quality disclosure and the leverage of the company.*

The alternative hypothesis is:

H_{A5}: *There is a significant positive association between annual report high quality disclosure and the leverage of the company.*

6.3.6 Hypothesis 6: Dividend Pay-Out Ratio

When companies in Kenya paid dividends to shareholders in the period covered by this study, they were required to deduct withholding tax of 5% when the shareholder was a resident individual (who had no further tax liability on this income), 7½% for foreign individuals and companies, and 0% if the shareholder was a company incorporated in Kenya which owned 12½% or more of the shares of the company (Kenya Income Tax Act 2002). For the period covered by this study, there was no capital gains tax in Kenya (ibid.).

Miller and Modigliani (1958, 1961 - MM) claim that in frictionless markets with investment policy fixed (and ignoring taxes), all feasible capital structure and dividend policies are optimal because all imply identical shareholder wealth; hence the choice among them is irrelevant and investment policy alone determines shareholder wealth. DeAngelo and DeAngelo (2006 - DD) argue that irrelevance requires a one-to-one correspondence between feasible policies and optimal policies; MM's (1961) assumptions reduce the feasible set of policies to the optimal set by forcing a 100% distribution of free cash flow in every period; MM thus assume away the value-relevant payout/retention decision. DD point out that the optimal payout policy entails distributions that are large in present value terms; equity is valuable only to the extent that it offers a legitimate expectation of future payouts. DD argue that agency costs create pressure for accelerated payouts because retention of profits increases managers' opportunities to expropriate shareholders' funds. Companies' investment opportunities generally outstrip their ability to generate internal capital in their early lives; hence they raise outside equity and pay no dividends. At some point later, the position switches, and agency problems become uppermost; companies pay dividends to reduce opportunities for cash flow wastage; in

Kenya, the Companies Act prohibits companies from buying back shares. Managers have to balance flotation cost savings and other advantages of internal capital against agency problems that arise as retained profits accumulate and investment opportunities decline. In Kenya, in the four years prior to 31 March 2003, the economy stagnated[6]; agricultural companies had little incentive to invest to supply saturated overseas markets (Brooke Bond 2002, p. 14; Kakuzi 2002, p. 4; Rea Vipingo 2002, p. 5; Sasini 2002, p. 6). To minimize agency costs, higher quality companies would have had higher dividend payout ratios. However, higher dividend payout ratios increase political costs, especially since 24 (i.e., over half the) companies quoted on the NSE are majority or significantly foreign owned, mainly by UK, but also by Dutch and French, listed companies (Ngotho 2005). As a result, the Kenyan companies would try to make better disclosure.

Inchausti (1997) suggests that companies with higher dividend pay-out ratios disclose less information, using contracting theory and signalling theory. She claims that if dividends are retained in the company, leverage is reduced and the company becomes less risky, thus benefiting creditors at the expense of shareholders; managers would disclose more to explain to owners why the restrictive payout policy has been adopted. She finds no association between disclosure and the dividend payout ratio. Easterbook (1984) views dividend payments as a potential solution to agency conflicts. Short, Zhang and Keasey (2002), using UK panel data, find a positive association between the dividend payout ratio and institutional ownership. Chay and Suh (2005) hypothesize that dividend payout ratios will be higher for companies with higher agency conflicts but find little empirical international evidence to support the hypothesis; they also find little support for the theory that companies with good investment opportunities have a low payout ratio because they have high cash needs; they find strong support for companies facing high levels of cash-flow uncertainty having low payout ratios, fearing cash shortfalls in the future. Desai, Foley and Hines (2006) find that larger dividend repatriations from foreign affiliates of US multinationals are associated with larger dividend payouts by parent companies. UK companies have consistently higher payout levels than US companies (Megginson 1997). In addition, Wagacha (2000) finds that individual shareholders of companies quoted on the NSE seek dividend yield (section 4.2). Hence, there are arguments for a positive association between the dividend pay out ratio and high quality disclosure. The null hypothesis is:

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[6] Real Gross Domestic Product growth in Kenya to 31 December: 1999: 1.42%; 2000: minus 0.24%; 2001: 1.23%; 2002: 1.16% (CBK 2004, p. 79)

H_{O6}: *There is no significant association between annual report high quality disclosure and the dividend pay out ratio of the company.* The alternative hypothesis is:

H_{A6}: *There is a significant positive association between annual report high quality disclosure and the dividend pay out ratio of the company.*

6.3.7 Hypothesis 7: Identity of Auditor being firm B

All the companies quoted on the NSE in the period under review, except one, are audited by Big 4 audit firms (Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers). As a result, the Big 4/Non Big 4 dichotomy that has been the subject of other studies (Haniffa and Cooke 2002), is not examined beyond noting that the score achieved for annual report IFRS compliance by the one company on the Alternative Investment Market sector audited by a Non Big 4 firm is joint highest (contradicting one of the claims of the World Bank's ROSC - WB 2001). This case is too particular to make generalizations: however, it is worth noting that in countries in which professional standards are high, the influence of audit firm size on disclosure is mixed (Firth 1979 in the UK; Malone et al. 1993 in the US). An additional point noted is that this company did not enter the FiRe Award 2003, with the result that all the quoted companies in this competition had their financial statements audited by Big 4 firms.

Dunn and Mayhew (2004) find an association between audit firm industry specialization and disclosure quality for companies in unregulated industries but not in regulated ones. In Table 6-1 below, amongst the Big 4 audit firms, firm E audits 3 out of 4 agriculture and 5 out of 7 commercial sector companies: firm A audits 9 out of 16 industrial sector companies. Of the 11 companies in the highly regulated financial sector, no Big 4 firm dominates. Firm D audits 3 of the 9 alternative market companies. Firm B audits one company in four different industry sectors in the Main Market. Firm B is not an industry specialist in any sector.

Table 6-1: Audit Firms of Nairobi Stock Exchange companies

Audit firms	Agri-culture	Comm-ercial	Fin-ancial	Indus-trial	Total main market	Alternative market	Overall total
A	0	1	4	9	14	4	18
B	1	1	1	1	4	0	4
C	0	0	0	0	0	1	1
D	0	0	2	2	4	3	7
E	3	5	4	4	16	1	17
Totals	4	7	11	16	38	9	47

Firms A and E are much more active in the Professional Standards Committee of ICPAK, run a number of courses for clients on IFRSs and meet their clients to make them aware of changes in IFRSs (interview with the CFO of company 40). Graduates from universities in Kenya choose as employers firms in the order E, D, A and only then B (interview with auditor from firm D). Employees from firms A, D and E obtain employment with Big 4 firms abroad while those from firm B have difficulty in doing so (ICPAK 2006b).

On this basis, there is an argument for there to be a negative relation between the company's auditor being firm B and high quality disclosure. The null hypothesis is:

H_{O7}: *There is no significant association between annual report high quality disclosure and the identity of the auditor of the company being Firm B.*

The alternative hypothesis is:

H_{A7}: *There is a significant negative association between annual report high quality disclosure and the identity of the auditor of the company being Firm B.*

6.3.8 Hypothesis 8: Association with a Multinational Company.

Multinational subsidiaries, viewed as sources of exploitation (eg., Ngotho 2005) and working under the constant threat of government control or expropriation, have higher political costs than their local counterparts in emerging countries (Ali et al. 2004). The result is that they disclose better (Dunning 1993) and are likely to have full compliance with all statutory and regulatory requirements (Owusu-Ansah 1998). Karamanou and Vafeas (2005) point out that large institutional stockholders are likely to be well suited to monitor management because they usually have better information about the company and can thus deter management from behaving opportunistically; in addition, larger investors in companies have a stronger incentive to monitor management, unlike small investors who are frequently free-riders because of insufficient information and incentives. Saudagaran and Biddle (1995) observe that multinationals are usually multiple listed and need to meet the informational requirements of a diverse group of investors with different cultural backgrounds. Jaggi and Low (2000) argue that if foreign investors demand detailed information whereas local investors are content with less, there will be a positive association between multinationality and better quality disclosure. Craig and Diga (1998) argue similarly. Owusu-Ansah (1998) adds that multinationals often transfer technology, including latest accounting practices, to foreign affiliates; he goes on to find a positive association between multinationality and disclosure.

The World Bank, in its Report on the Observance of Standards and Codes (ROSC) for Kenya, claims that "*except for local subsidiaries of multinational enterprises, the corporate sector in general does not have access to adequately trained accountants*" (WB 2001). Barako et al. (2006) find, for the period 1992-2001, a positive association between voluntary disclosure by Kenyan quoted companies and foreign ownership. On this basis, there is an argument for there being a positive relation between the company being an affiliate of a multinational and high quality disclosure. The null hypothesis is:

H_{O8}: *There is no significant association between annual report high quality disclosure and whether the company is a subsidiary or associate of a multinational.*

The alternative hypothesis is:

H_{A8}: *There is a significant positive association between annual report high quality disclosure and whether the company is a subsidiary or associate of an multinational.*

6.3.9 Hypothesis 9: Type of industry

Watson, Shrives and Marston (2002 -WSM) argue that companies in industries that are highly regulated are motivated to disclose information in an attempt to reduce agency costs (i.e., the costs of complying with the legislation). Companies in certain industries may be more vulnerable politically (Watts and Zimmerman 1986, p.239), eg., banks in Kenya after the Donde Act. Signalling theory predicts that companies want to show that they comply with industry best practice by making certain disclosures (WSM). If a company does not disclose with the same quality as others in the same industry, it could be interpreted as a signal of bad news (Inchausti 1997). Legitimacy theory predicts that companies under greater public scrutiny would improve disclosure to show their legitimacy (WSM).

Cooke (1989a) states that there may be a dominant company in a sector of the economy with a high level of disclosure, which may have a "bandwagon" effect on other companies in the same industry; he also suggests that there may be historical reasons for better disclosure in a particular industry, eg., Kenyan agricultural companies normally reveal more data on their physical output than other companies. Inchausti (1997) claims that companies in the same industry will disclose similar information. Stanga (1976) hypothesizes that the fear of giving away competitive advantage through increased disclosure may vary from one industry to another. Agricultural companies quoted on the NSE supply mainly export markets. So there is possibly less competition between them than companies supplying the local market, for example, motor vehicle dealers.

WSM state that, ex ante, there does not seem to be a clear relationship between industry and disclosure. Stanga (1976), Cooke (1989a), Meek et al.(1995), Wallace and Naser (1995), Suwaidan (1997) and WSM find empirically that industry type is significant in determining disclosure levels. McNally et al. (1982), Inchausti (1997), Owusu-Ansah (1998), Craven and Marston (1999) and Marston (2003) find no significant association between industry type and disclosure.

As a result, it is not clear whether high quality disclosure is more prevalent in one industry than another. The null hypothesis is:

H_{O9}: *There is no significant association between annual report high quality disclosure and the type of industry of the company.*

The alternative hypothesis is:

H_{A9}: *There is a significant association between annual report high quality disclosure and the type of industry of the company.*

6.4 Setting up Testable Hypotheses: interim financial reports

This section deals with the formulation of hypotheses which are developed to test associations of high quality disclosure in interim reports with company variables.

6.4.1 Hypothesis 10: Corporate Size

Tan and Tower (1999) find no statistically significant relation between interim report disclosure and company size in Australia and Singapore. But Schadewitz and Blevins (1998) find Finnish interim disclosure to be positively associated with company size. On the basis of the latter finding and the reasoning contained in section 6.3.1 above, there is an argument for a positive relation between company size and the quality of disclosure in interim financial reports. The null hypothesis is:

H_{O10}: *There is no significant association between high quality disclosure in interim financial reports and the size of companies.*

The alternative hypothesis is:

H_{A10}: *There is a significant positive association between high quality disclosure in interim financial reports and the size of companies.*

6.4.2 Hypothesis 11: Type of industry

Tan and Tower (1999) find no statistically significant relation between half-yearly report disclosure and industry type. In Kenya, the Central Bank stipulates how banks should formulate their interim financial reports (the format contains part of IAS 34); fines

are imposed for non-compliance. Also, agricultural companies have a strong incentive to announce their interim results in accordance with IAS 34. Their business is heavily influenced by factors which are beyond the control of managers – the weather; and the exchange rate between the Kenya shilling and the US dollar in which international trade in agricultural produce is denominated. Weather conditions can be markedly different in different parts of the country: the effects of fluctuations in the exchange rate can be misleading. Added to this, market prices depend on agricultural production in countries which compete with Kenya in international markets. Hence, the financial performance of agricultural companies is much more volatile than in other sectors of the economy. Agency theory predicts that in these circumstances, managers would want to reveal the true financial performance and position, and the effects of these factors on the balance sheet and the cash flow of the business as soon as possible; they would produce a more complete interim financial report.

Quoted commercial and service sector companies face competition in the service based Kenyan economy; they may perceive that they give away competitive advantage by ensuring interim report compliance with IAS 34. Industrial and allied sector companies are often given preferential treatment by the Government and regulators – Kenya's industrial industry has suffered seriously from globalization (Manda 2002, p.28): they would be lackadaisical in complying with IAS 34.

Contrary to the uncertainty in section 6.3.9, it seems that agricultural and banking companies would have superior interim disclosure. The null hypothesis is:

$\mathbf{H_{O11}}$: *There is no significant association between high quality disclosure in interim financial reports and company industry.*

The alternative hypothesis is:

$\mathbf{H_{A11}}$: *There is a significant positive association between high quality disclosure in interim financial reports and company industry.*

6.4.3 Hypothesis 12: Financial year end of the company being 31 December

Smith, D. and Pourciau (1988 –SP) point out that a number of researchers, from Ball and Brown (1968) and Beaver (1968) to Lipe (1986), Rayburn (1986) and Ettredge, Shane and Smith (1988) restrict their sample selection to companies which have either a December year-end or a non-December year-end. The generalizability of the findings of these studies is restricted as a consequence. SP select a number of company financial characteristics that are

often controlled for or used as matching variables in market-based research and find that many of these are statistically significantly different for companies with non-December and December year-ends. Of the 25 NSE companies that have a 31 December year end, 8 are banks: they will tend to have higher quality disclosure in interim reports.

Companies with a 30 June or 31 July year end prepare their interim financial reports in January or February, the hotter months of the year in Kenya, just after the Christmas holiday period, which is the main holiday period. Schools are commencing their new years throughout Kenya and parents are scrambling to ensure that their children have been accepted into "well performing" schools (all primary and secondary schools in Kenya do common examinations and are ranked publicly on the basis of the mean of their students' marks in these examinations). Education is highly valued in Kenya; the media give great prominence to school performance in these examinations; boarding schools generally perform better than day schools. Not only parents are involved in placing children but also any person who has any connection with a "good" school: accounting staff in general have often attended better schools: parents invoke the country's motto - "Harambee" – "let's pull together" to obtain assistance in getting their children into these better schools. This process is distracting and time consuming. Companies with a 31 March year end prepare their interim reports in October, a month in which there are two public holidays (Moi Day and Kenyatta Day); school children commence their examinations at the end of the month; the weather is warm and usually dry. Companies with a 30 September year end prepare their interim reports in April; school children are on holiday; Easter often falls in this month; the weather is hot and humid. Companies with a 31 December year-end prepare their interim financial statements in July which is the coldest month of the year. School children are busy studying. Accounting staff are generally more mentally alert during the cooler period of the year and free from concerns for children's examination performance. This would lead one to conclude that companies with a 31 December year end should have higher quality disclosure in their interim financial reports.

On this basis, there is an argument for there to be a relation between the financial year end of the company being 31 December and high quality disclosure in the interim financial reports. The null hypothesis is:

H_{O12}: *There is no significant association between high quality disclosure in interim financial reports and company financial year end being 31 December.*

The alternative hypothesis is:

$\mathbf{H_{A12}}$: *There is a significant positive association between high quality disclosure in interim financial reports and company financial year end being 31 December.*

6.4.4 Hypothesis 13: The company auditor being Firm E

Interim financial reports "issued" by companies quoted on the Nairobi Stock Exchange are not audited by the companies' auditors. It would seem therefore that there should be no connection between the quality of disclosure in the interim financial reports and the auditors of companies. In the US, even when auditors are involved with interim reporting, this involvement has no statistically significant effect on the quality of interim information (Alford and Edmonds 1981, as quoted by McEwen and Schwartz 1992).

However, Dunn and Mayhew (2004) provide evidence that a company selects its auditors as part of its overall disclosure strategy, signalling the company's decision to provide high quality disclosures. In the 2001 FiRe Award competition, two of the three most highly placed companies in the overall awards were clients of firm E; one company was in the agricultural sector, the other in the commercial sector; the overall winner was not audited by a Big 4 firm. In the 2003 FiRe Award competition, the winner was again not audited by a Big 4 firm; the runner up (an agricultural company) was audited by firm E. Behn et al. (1997) find that US companies want auditors to have industry expertise, among a number of qualities. In Table 6-1 above, Firm E has expertise in the agricultural and commercial sectors. Dunn and Mayhew find an association between audit firm industry specialization and disclosure quality for companies in unregulated industries.

All the companies on the Main Investments Market Segment (MIMS) of the NSE are audited by Big 4 firms. Firm E audits more companies on MIMS than any of the other Big 4 firms. In addition, firm E applies a strict policy of not auditing companies that are considered significant audit risks (interview with a partner of firm E). Smith, M., et al. (2001) find that audit firms classified as judgemental (or less structured) in the Kinney (1986) categorization are less tolerant of accounting choices selected by clients for income manipulation: firm E is the only firm in this category. Armstrong and Smith (1996) find that professionalism is the most important aspect of service quality to the clients of (then) Big 6 firms. The null hypothesis is:

$\mathbf{H_{O13}}$: *There is no significant association between high quality disclosure in interim financial reports and whether the company's auditor is firm E.*

The alternative hypothesis is:

$\mathbf{H_{A13}}$: *There is a significant positive association between high quality disclosure in interim financial reports and whether the company's auditor is firm E.*

6.5 Control variables

Chau and Gray (2002) include company size, leverage, auditor size, ownership structure, profitability and multinationality as control variables, based on a number of prior disclosure studies. Owusu-Ansah (1998) finds a significant positive association between mandatory disclosure and company age. Wallace et al. (1994) find a significant negative association between disclosure and liquidity. In regression models in this study, for annual reports, profitability and liquidity are included as control variables; for interim reports, leverage, profitability, multinationality, age and liquidity are included as control variables.

6.6 Summary and conclusions

This chapter reports the selection of independent variables and the formulation of testable hypotheses. For the annual report, nine independent variables are identified: (1) company size, (2) number of shareholders, (3) size of the shareholding owned by a holding/investing company, (4) company age, (5) leverage, (6) dividend pay-out ratio, (7) auditor identity being firm B, (8) multinationality and (9) industry type. For the interim report, four independent variables are identified: (1) company size, (2) industry type, (3) company year end being 31 December and (4) auditor identity being firm E. The criteria used to select these variables are enumerated in section 6.2. The theoretical backing for the independent variables' association with high quality disclosure in the annual and interim reports are discussed. The findings of prior empirical studies are examined to form expectations as to the extent and direction of the associations. For annual reports, all the company variables are expected to have positive associations with quality disclosure, except auditor identity being firm B, where it is expected to be negative and industry type, where it is not clear. For the interim report, all the company variables are expected to have positive associations with quality disclosure. Control variables are introduced in section 6.5. Statistical tests, outlined in section 5.5, are carried out in chapter 8 on the hypotheses formulated in this chapter to arrive at conclusions about the relationships hypothesized.

CHAPTER 7
High Quality Disclosure by Nairobi Stock Exchange Companies

7.1 Introduction

The purpose of this chapter is to address the first empirical research question, $\mathbf{EQ_1}$, which is "What is the extent of high quality disclosure among companies quoted on the Nairobi Stock Exchange (NSE)?" (section 1.5.2). The chapter analyses whether there is "high quality disclosure" in the annual reports of companies listed on the NSE for financial year ends between 30 June 2002 and 31 March 2003, using the three scoring systems (IFRS compliance, S&P Survey and FiRe Award), and using the definition developed in section 2.8. It also examines whether there are any associations between the three different scoring systems. It examines whether companies that enter the FiRe Award have higher quality disclosure: Deegan and Carroll (1993) find Australian companies that enter Annual Report Awards systematically different from those that do not, and enter competitions to mitigate political costs. The chapter also analyses and evaluates the results of measuring disclosure quality in the interim reports of the companies for the first half year.

The chapter is arranged as follows. Section 7.2 presents the results of annual and interim report compliance with IFRSs and comments on the World Bank's ROSC for Kenya. Section 7.3 presents the scores of the S&P survey applied to NSE companies and compares the mean NSE company score with those of several other countries. Section 7.4 presents FiRe Award scores. Section 7.5 examines whether any NSE company achieves "high quality disclosure" as defined by section 2.8. Section 7.6 points out that the three different measures of "quality disclosure" measure three different constructs: the results of the tests of association among the various disclosure indices are presented and the findings are discussed. Section 7.7 summarizes the findings and concludes the chapter.

7.2 High-quality disclosure: IFRS compliance

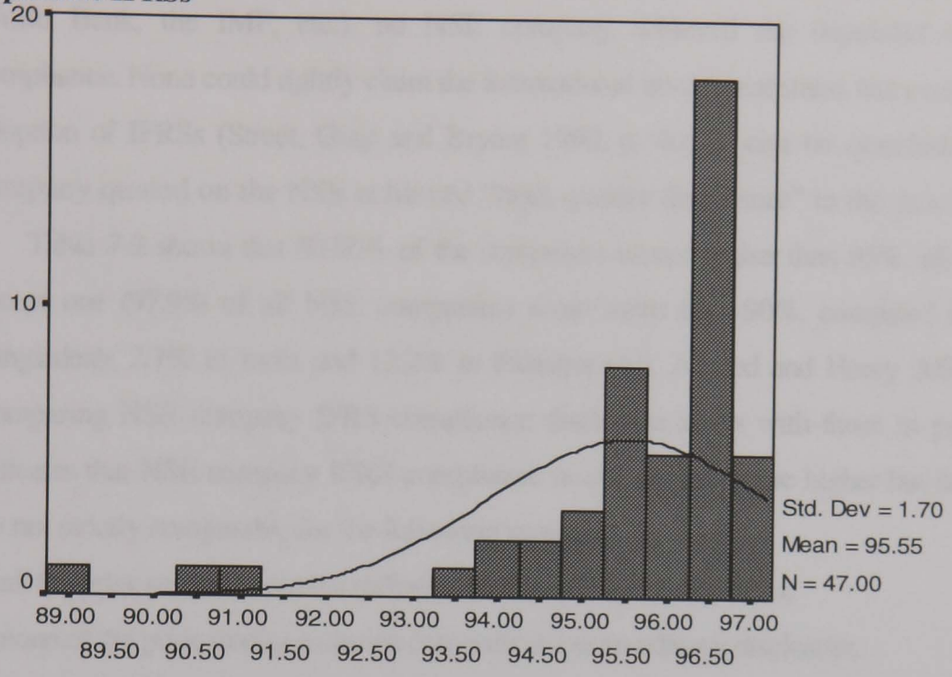
7.2.1 Annual report compliance with IFRSs

The purpose of this section is to discuss and evaluate the scores for NSE companies' annual report IFRS compliance. The descriptive statistics for these scores are shown in Table 7-1.

Table 7-1: Descriptive Statistics: Annual report compliance with applicable IFRSs

	No	Mean	Std.Deviation	Max	Min	Range
Annual report IFRS Compliance	47	95.6%	1.7%	97.1%	88.8%	8.3%

Figure 7-1: Histogram of scores: Compliance of the Corporate Annual Report with applicable IFRSs



The mean score of 95.6% is relatively high, when compared to the results obtained in prior studies. This is in line with expectations formed in chapter 4 and is in spite of the tensions present in Kenya. From the histogram of scores in Figure 7-1, it can be seen that scores are heavily negatively skewed. The highest score, achieved by two companies, was 97.1%. IAS 1: *Presentation of Financial Statements*, paragraph 11, states that "financial statements should not be described as complying with IFRSs unless they comply with all the requirements of each applicable Standard and each applicable Interpretation of the Standing Interpretations Committee" (IASB 2003, p. 1.10). From IASB's point of view (which would

Table 7-2: Frequency distribution of disclosure scores among companies

Disclosure Score	No. of cos.	%	Cum. % from top
100%	0	0.00	0.00
99%<score<100%	0	0.00	0.00
98%<score<99%	0	0.00	0.00
97%<score<98%	2	4.26	4.26
96%<score<97%	23	48.94	53.20
95%<score<96%	13	27.66	80.86
94%<score<95%	3	6.38	87.24
93%<score<94%	3	6.38	93.62
92%<score<93%	0	0.00	93.62
91%<score<92%	1	2.13	95.75
90%<score<91%	1	2.13	97.88
89%<score<90%	0	0.00	97.88
88%<score<89%	1	2.12	100.00
TOTAL	47	100.00	

be shared with regulatory and standard setting organizations around the world, as well as the World Bank, the IMF, etc.), no NSE company achieved the stipulated standard of compliance. None could rightly claim the international investment status that comes with the adoption of IFRSs (Street, Gray and Bryant 1999, p. 46). It can be concluded that no company quoted on the NSE achieved "high quality disclosure" in the year studied.

Table 7-2 shows that 80.86% of the companies scored higher than 95%: all companies except one (97.9% of all NSE companies) score more than 90%, compared to 7.6% in Bangladesh, 2.7% in India and 12.2% in Pakistan (Ali, Ahmed and Henry 2004, p. 192). Comparing NSE company IFRS compliance disclosure levels with those in prior studies indicates that NSE company IFRS compliance disclosure levels are higher but these results are not strictly comparable for the following reasons:

1) all the prior studies contain a different number of disclosure items;

2) none of the prior studies examine comprehensive mandatory disclosure;

3) many of the prior studies relate to a much earlier period, even earlier than the World Bank ROSC study in Kenya of 1999 annual reports; several studies have shown that disclosure levels tend to rise over time (eg., Barton and Waymire 2004);

4) none of these other countries had a World Bank ROSC study performed on it a few years prior to the study; the Hawthorne effect (Mayo 1933) may have contributed greatly to any improvement that Kenya may have achieved.

It can be deduced that there is room for improvement for all the companies in this study. Selected causes of the variation in the scores are summarized in section 7.2.2.

7.2.2 Areas of non-compliance

Areas of non-compliance of NSE quoted companies with IFRSs are listed in Table 7-3. A complete listing of areas of non-compliance would include 128 items. An item is included in Table 7-3 only if at least two companies have omitted the item, or if the item omitted represents 20% or more of the companies to which the item applies. In addition, it is not a complete listing in each area of non-disclosure – for example, all the 20 items omitted by more than one company in respect of segment reporting are not listed – this too would lead to an excessively long list. Appendix 7-3 deals in more detail with items where non-disclosure involves more judgement than a mere non inclusion of an item in the financial statements.

Table 7-3: Areas of non-compliance of NSE companies with IFRSs

IAS No.	Item	Applic-able to	Not disclosed	
			No	%
1.13 (c) iv	If the enterprise claims use of an IAS would be misleading, has the reason why it would be misleading been disclosed?	3	3	100
1.44	Financial statements not clearly identified	47	35	74
1.71	Property, plant & equipment measured on different bases: shown as different line items?	38	38	100
16.29 ii	If assets are carried at revalued amounts, are revaluations made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date?	38	17	45
SIC 21.5	Is the deferred tax liability or asset that arises from the revaluation of a non-depreciable asset under IAS 16.29 measured based on the tax consequences that would follow from recovery of the carrying amount of that asset through sale, regardless of the basis of measuring the carrying amount of the asset?	38	3	8
16.64 (a)	When items of property, plant and equipment are stated at revalued amounts, are the following disclosed in the financial statements: the basis used to revalue the assets?	38	3	8
16.64 (c)	whether an independent valuer was involved?	38	3	8
16.64 (e)	the carrying amount of each class of PPE that would have been included in the FS had the assets been carried at cost less any accumulated depreciation & any accumulated impairment losses?	38	19	50
32.47 (a) - 32.47 (b)	For each class of financial asset, both recognised & unrecognised, does the enterprise disclose: info about the extent & nature of the financial asset including significant terms & conditions that may affect the amount, timing & certainty of future cash flows?	22	2	9
	the accounting policies & methods adopted including the criteria for recognition & the basis of measurement applied?	22	5	23
32.66	For each class of financial asset, both recognised & unrecognised, has the enterprise disclosed information about its exposure to credit risk	22	11	50
32.77	For each class of financial asset, both recognised & unrecognised, has the enterprise disclosed info about fair value?	22	6	27
28.27 (a)	Was the proportion of ownership interest in an associated company disclosed?	5	1	20
12.82 (a) 12.82 (b)	If a deferred tax asset is dependent on future taxable profits being in excess of the profits arising from the reversal of existing taxable temporary differences & the enterprise has suffered a loss in either the current or preceding period, has the enterprise disclosed the amount of the deferred tax asset & the nature of the evidence supporting its recognition?	8 8	0 3	0 38
2.34 (c)	Is the carrying amount of inventories carried at net realisable value shown separately?	32	31	97
37.86 (a) 37.86 (b) 37.86 (c)	Unless the possibility of any outflow in settlement is remote, has the enterprise disclosed for each class of contingent liability at the balance sheet date an estimate of its financial effect?	47	5	11
	an indication of the uncertainties relating to the amount or timing of any outflow?	47	4	9
	the possibility of any reimbursement?	47	4	9
37.91	Where any of the information required re. contingent liabilities is not disclosed because it is not practicable to do so, is this fact stated?	47	3	6
27.32 (a) ii	Was the country of incorporation or residence of each subsidiary disclosed?	35	14	40
27.32 (a) iii	Was the proportion of ownership interest in the subsidiary company disclosed?	35	2	6
14.52	Was each segment result disclosed?	23	4	17
14.55	Was the total carrying amount of segment assets for each reportable segment disclosed?	23	5	22
14.56	Were segment liabilities disclosed for each reportable segment?	23	4	17
14.57	Was the total cost incurred during the period to acquire segment assets expected to be used in more than one period (property, plant, equipment & intangible assets) on an accrual basis not on a cash basis?	23	10	43
IAS No.	Item	Applic-able to	Not disclosed	%

14.58	Was the total amount of expense included in the segment result for deprec. & amortis. of segment assets disclosed?	23	11	48
14.67 iii	Is segment result reconciled to a comparable measure of enterprise operating profit or loss?	23	5	22
30.40	Has the bank disclosed any significant concentrations of its assets?	8	2	25
30.40	Has the bank disclosed any significant concentrations of its off balance sheet items?	8	4	50
30.43 (d) i	Has the bank disclosed the aggreg.amount included in the BS for loans & advances on which interest is not being accrued?	8	2	25
30.43 (d) ii	Has the bank disclosed the basis used to determine the carrying amount of such loans & advances?	8	2	25
30.58	Do the FS disclose, in respect of related party transactions, the amount included in or the proportion of: each of the principal types of income, interest expense & commissions paid?	8	6	75
30.58	advances, deposits, repayments & other changes during the period?	8	3	38
17.25	Has a lessee enterprise recognised lease payments under an operating lease as an expense in the income statement on a straight line basis over the lease term?	46	2	4

7.2.3 World Bank report on the observance of standards and codes

The World Bank's Kenya report on the observance of standards and codes (ROSC – WB 2001) states that "*the accountants for many corporate entities lack the skills to prepare financial statements in accordance with the mandatory accounting and reporting requirements*", but also "*limitations in the legal and regulatory environment provide little incentive for company directors to ensure that financial statements are prepared in accordance with financial standards . . . Kenyan entrepreneurs tend not to devote resources to ensuring compliance with the established accounting and reporting requirements*". The actual comments on IFRS non-compliance are fewer but similar to those in Table 7-3 and in Appendix 7-3. It is perhaps unfortunate that the World Bank prefaced the actual disclosure shortcomings with comments of the nature of those stated above: had the deficiencies been highlighted in a more positive tone, the report would have possibly had greater efficacy. The fact that the comments are similar points to a lack of improvement on the part of non-compliant companies. However, because the World Bank survey was not carried out with the rigour which is demanded by academic studies, whether or not there really is a lack of improvement is difficult to conclude.

7.2.4 Conclusion

The conclusion from the findings above is that NSE companies do not achieve disclosure compliance levels laid down by IASB (which would also be that specified by the SEC in the US). In addition, no NSE company achieves "high quality disclosure" as defined in section 2.8 in this study. However, it is still of interest to see how many companies are close to achieving high quality disclosure as defined in 2.8. Many NSE

companies do not achieve full IFRS compliance for a number of less important disclosure omissions. These should be able to be corrected without undue difficulty.

7.2.5 Interim report compliance with IAS 34: *Interim Financial Reporting*

The descriptive statistics for scores for compliance with IAS 34*: Interim Financial Reporting* of the interim financial reports for the first half of the financial year of companies quoted on the NSE are shown in Table 7-4.

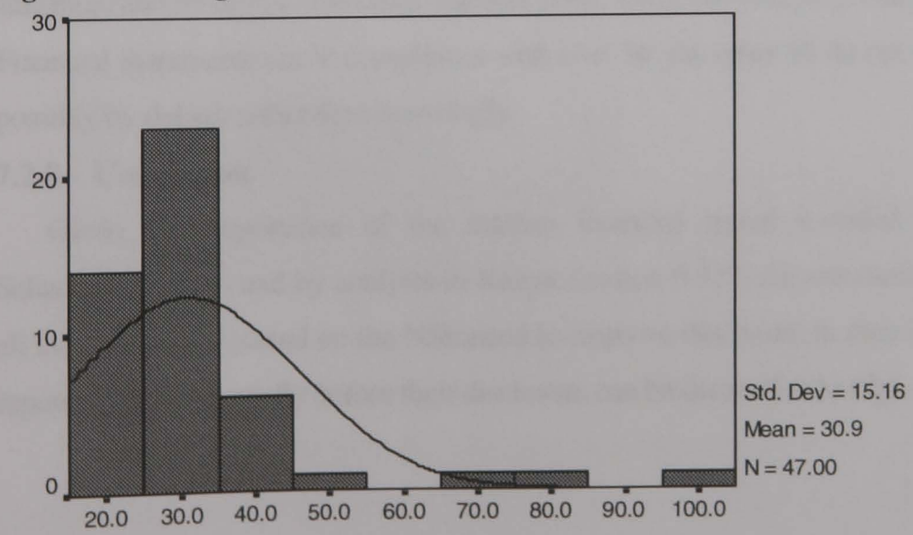
Table 7-4: Descriptive Statistics: interim report compliance with IAS 34 scores

	No	Mean	Std. Deviation	Max	Min	Range
IAS 34 compliance	47	30.9%	15.2%	100%	22.2%	77.8%

Although one company scored 100% by achieving full compliance with the 32 items required by IAS 34, the mean for the 47 companies quoted on the NSE is only 30.9%. The minimum score at 22.2% is not only exceptionally low, but it is achieved by 14 companies – 30% of those quoted on the exchange.

From the histogram of scores, Figure 7-2, it can be seen that these scores are positively skewed; substantially more companies earned scores below the mean than above it. Companies with scores above the mean, tended to have scores much further from the mean than companies with scores below the mean. 14 companies scored 22.2%, a further 14 scored 25% and 3 scored 27.8%; this means that 66% of the companies on the NSE obtain a score of 27.8% or less. There is little wonder why a partner in the Nairobi office of one of the Big 4 audit firms stated that there should be a requirement that the interim financial statements of these companies should be audited to ensure that they comply with IAS 34 (interviews chapter 9).

Figure 7-2: Histogram of scores of interim report compliance with IAS 34



It can be concluded that the confusion among the regulators mentioned in section 4.13.3.1 results in there being a very low level of compliance with IAS 34.

This is a matter of concern for the regulatory authorities in Kenya. Although some companies have discussed this subject at some length (see chapter 9 of this thesis), the regulators in Kenya seem to have little effective interest in this question.

7.2.6 Comparison with other studies

d'Arcy and Grabensberger (2003) study interim reports in the year 2001 for companies listed on the Neuer Markt, and arrive at a mean score of 63.67%, which is more than twice the NSE figure of 30.9%.

Kanto and Schadewitz (2000) study the information content in 26 single disclosed items in 573 interim financial reports of companies quoted on the Helsinki Stock Exchange between 1985 and 1993. They find that the interim report disclosures contain returns-related information over and above that contained in the earnings figure; the level and quality of financial analysis disclosed in the interim statements, together with earnings, are used by the market. However, neither they nor any other study I could find actually measure disclosure in the Interim Financial Statements of companies. If disclosure scores were available for other countries, it is doubtful that they could be lower than the mean for NSE quoted companies.

7.2.7 Main areas of non-compliance

Of the 47 NSE companies, 46 omit the selected explanatory notes required by IAS 34, 45 omit a statement that the same accounting policies and methods of computation are followed as in the previous annual report, 44 omit both a condensed cash flow statement and a condensed statement showing changes in equity, 43 omit a condensed income statement and 39 omit a condensed balance sheet. Only one company states that its Interim Financial Statements are in compliance with IAS 34; the other 46 do not make the claim, possibly by default rather than knowingly.

7.2.8 Conclusion

Given the importance of the interim financial report revealed by Kanto and Schadewitz (2000) and by analysts in Kenya (section 9.5.5), the conclusion is that almost all the companies quoted on the NSE need to improve disclosure in their interim financial reports very substantially before their disclosure can be deemed to be high quality.

7.3 Companies quoted on the NSE using S&P's survey methodology

7.3.1 Annual report scores

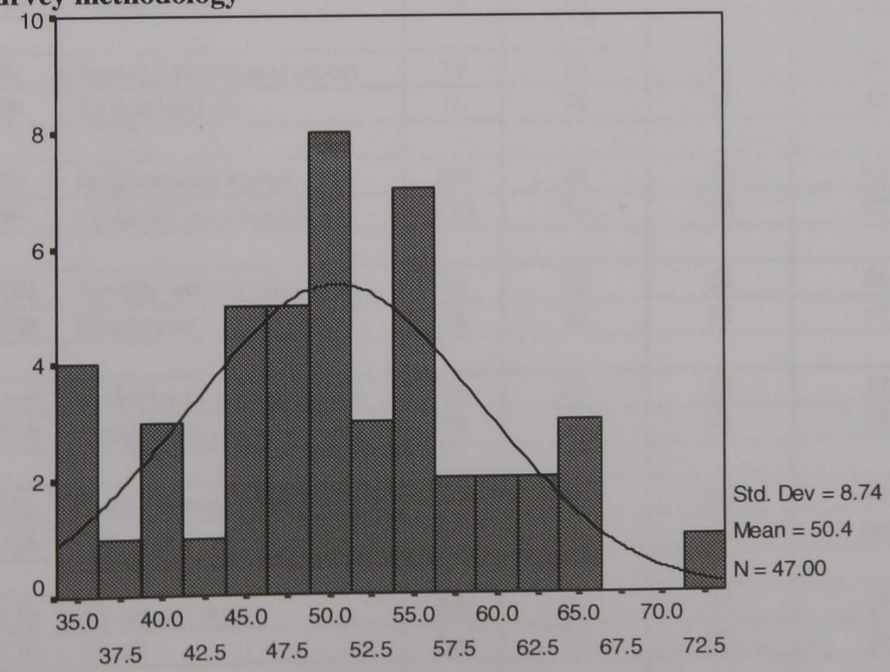
The descriptive statistics for disclosure scores for the NSE company annual reports using S&P's 2003 Survey methodology are shown in Table 7-5.

Table 7-5: Descriptive Statistics: Scores using S&P's survey 2003 methodology

	No	Mean	Std. Dev.	Max	Min	Range
S&P Scores for NSE companies	47	50.4%	8.7%	71.4%	35.2%	36.2%

The histogram in Figure 7-3 shows that the distribution of scores is quite close to a normal distribution. The maximum score achieved by any NSE company using S&P's survey checklist is substantially lower than the IFRS compliance mean score (95.6%), but this is to be expected, since the S&P checklist contains 49 items which are disclosed voluntarily in Kenya. The minimum score using the S&P checklist is greater than the mean score for IAS 34: *Interim Financial Reporting* of 30.9%. This reveals more about interim financial reporting by NSE companies than it does about S&P scores. Again, the variability in these scores makes it of interest to examine why this is the case.

Figure 7-3: Histogram of scores of NSE company annual reports using S&P's 2003 survey methodology



7.3.2 Comparison with S&P's scores for other countries.

The mean score achieved by NSE quoted companies is shown in Table 7-6. For comparison, Standard and Poor's mean scores for listed companies in other countries

Table 7-6: Transparency & Disclosure % scores Kenya arrived at by this study

		No of cos	Financial & Operat-ional Inform-ation %	Owner-ship Structure & Investor Relations %	Board & Manage-ment Structure & Process %	Com-posite %
	Kenya	47	70	56	26	50

Table 7-7: S&P's Transparency & Disclosure % scores for global markets based on (a) annual reports alone & (b) annual reports and other regulatory filings

		No of cos	Fin &Op Info %	Ow Struc & Inv Rel %	Bd & Man St & Pro %	Com-posite %
1	Latin America	89	58	28	18	35*
2	Russia	42	42	39	38	40
3	Emerging Asia	253	54	39	27	40
4	Asia-Pacific	99	60	41	42	48
5a	Italy-annual report	26	64	38	45	50
5b	Italy-all	26	68	43	50	55
6a	Spain-annual report	17	63	39	44	50
6b	Spain-all	17	68	44	49	55
7a	Germany-annual report	32	74	38	35	50
7b	Germany-all	32	76	44	44	56
8a	Switzerland-annual report	17	70	36	44	51
8b	Switzerland-all	16	74	44	54	59
9a	Japan-annual report	150	76	70	37	61
9b	Japan-all (no change)	150	76	70	37	61
10a	Sweden-annual report	18	72	52	56	61
10b	Sweden-all	18	73	53	57	62
11a	Netherlands-annual report	25	65	53	57	59
11b	Netherlands-all	23	69	58	65	65
12a	France-annual report	45	70	60	64	65
12b	France-all	45	73	63	66	68
13a	US-annual report	500	66	25	31	42
13b	US-all	500	77	52	78	70
14a	UK-annual report	127	78	54	71	69
14b	UK-all	127	79	57	73	73*

Source: Standard & Poor's: figures with an asterisk have been adjusted – the original composite S&P's score given is incompatible with the S&P scores for the individual categories.

around the world are shown in Table 7-7. Permission has been been obtained from Standard and Poor's to reproduce these details. Any comparisons made among the scores in this table must again be made with caution. The mean scores arrived at by Standard & Poor's are for the "largest and most liquid companies in more than 30 countries" (S&P 2003, p.2). (S&P also break down the samples of European companies between those that are listed in the US and those that are not. For all these countries, the mean of those listed in the US is substantially higher than those that are not.) The samples for all the countries are not random. Some of the companies on emerging markets may be substantially smaller than the S&P 500 in the US (S&P 2003, p.4), the S&P/TOPIX 150 in Japan (ibid.), and the S&P/Europe 350 (ibid.) Theory states and empirical research finds that disclosure for larger companies is on average higher than for smaller companies. Bushee (2004) points out that the Chinese companies coded by S&P are those that are listed in Hong Kong or London, and their disclosure practices likely differ from the domestic norm in China. The Kenya score is the mean for the population as a whole: an average annual report in Kenya scores higher than a US one (Figure 7-4). If only the largest companies quoted on the NSE were considered, the Kenya average scores could well be higher.

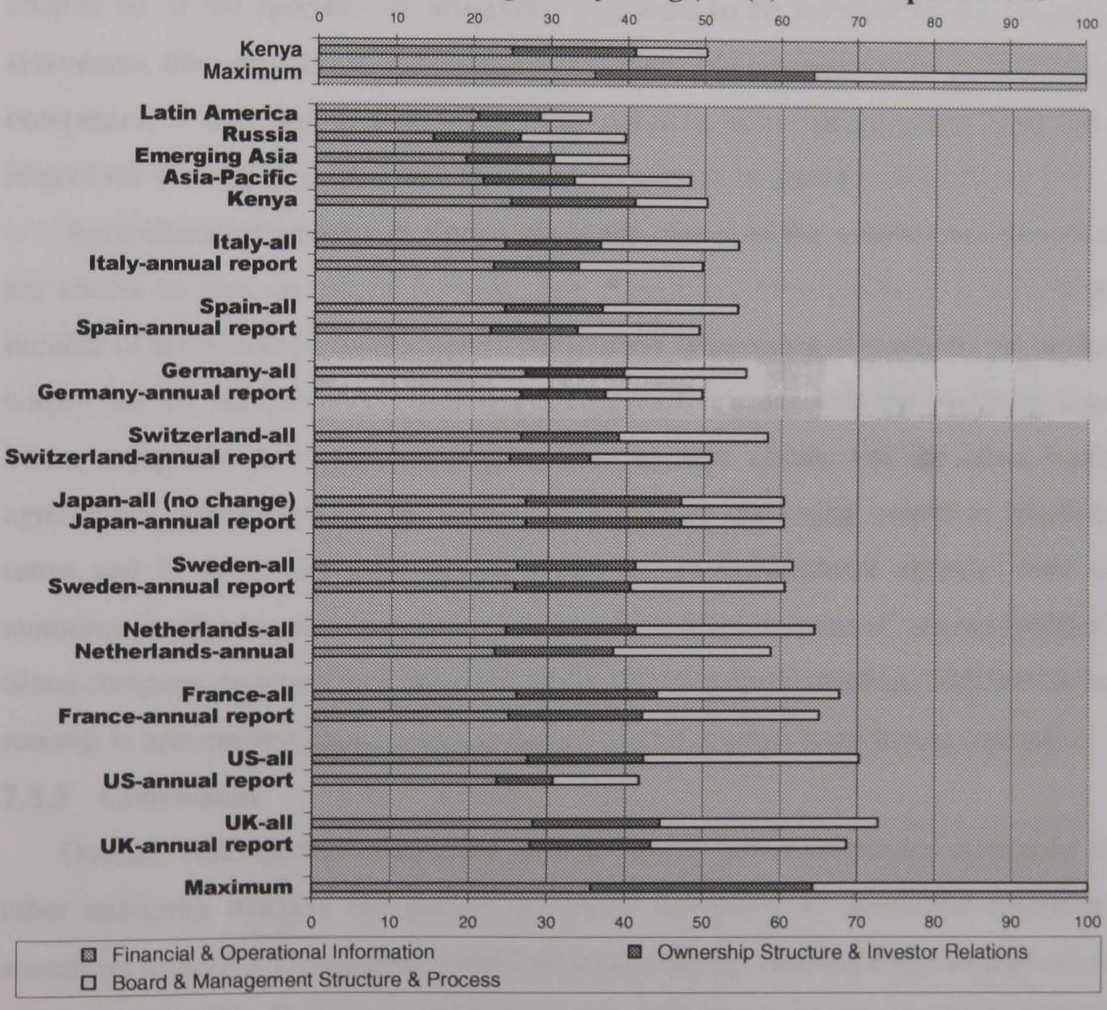
An examination of these scores for annual reports and other regulatory filings reveals that for "Financial and Operational Information", the Kenya companies' mean score is 8th overall, above that of Italy, Spain and The Netherlands, and equal 5th with France and Switzerland when annual reports alone are considered. Frost, Gordon and Pownall (2005, p.4) refer to this number as a "financial reporting and disclosure quality measure" and point out that the extent of company-specific reporting and disclosure "is not directly measured" in many studies; "many authors assume that when listing overseas, companies increase their financial reporting and disclosure quality to meet regulatory requirements, without testing that assumption" (ibid., p. 9).

In the "Ownership structure and investor relations" category, Kenyan companies on average score higher than companies in all countries except Japan, The Netherlands, France and the UK. The Kenya Companies Act (CA 1962) and the Capital Markets Authority Guidelines (CMAG) on Governance Practices (2002) mandate many of the disclosure items in this category. Compliance with CA 1962 is in general high but not 100%. Compliance with CMAG is much lower. Full compliance with the requirements of

both documents would increase Kenya's score substantially. Some items are not relevant to Kenya, eg., "a review of shareholders by type" (for the few NSE companies that have preference shares in issue, this is clear from the balance sheet), "a review of the last shareholders' meeting", "the transparency of the way that shareholders nominate directors . . or convene an extraordinary general meeting".

In the "Board and management structure and process" category, Kenyan companies score lower than those in all the other countries mentioned except Latin America. The highest scoring NSE company is an associated company of a Dutch multinational - it achieved a substantially higher score than the second highest scoring company; The Netherlands scores highly in this category. For items in this category which happen to be mandated by the NSE rules, compliance was 100%.

Figure 7-4: Transparency & Disclosure % Scores for (1) Kenya & (2) global markets based on (a) annual reports & other regulatory filings; & (b) annual reports alone



Compliance with those items required by the CMAG was low. Companies in Kenya avoid giving details of remuneration to directors and to senior management because

shareholders are in general paid much lower salaries, and resent the fact that directors and senior management are rewarded so well; this is in keeping with other countries, but directors in Kenya perceive it to be a more serious problem there. Wagacha (2001, p. 14) finds that over 30% of companies listed on the NSE state that listing rules are too onerous and over 25% state that fear of disclosure requirements prevent the company using the NSE to raise additional funds.

Some of the disclosure items in this category of the S&P disclosure checklist are not relevant to Kenya. Benefits in Kenya are taxed at their market value equivalent (Kenya Income Tax Act 2002, section 5). As a result, benefits are not viewed as particularly attractive and are often forgone by directors for cash remuneration. However, directors of a small number of companies were reluctant to expense share options and were reluctant to disclose these in the financial statements (interviews in chapter 9). If the specifics of managers' pay were to be revealed in the financial statements, this could act as a disincentive to some able managers from joining listed companies, if they had to justify their pay publicly; some shareholders have little idea of the scarcity of skilled managers and the price to be paid to attract them.

Agricultural companies in Kenya are at the mercy of the weather and therefore are unable to give an output forecast. Tea exporting companies have a very large number of tea pluckers; their union is particularly demanding in trying to get higher wages, but the Kenya shilling selling price of tea fluctuates with the exchange rate. These companies keep their strategies close to their chests. On the other hand, agricultural companies are the leaders in Kenya in disclosing output in physical terms and in disclosing their market share. Kenya Government agencies tend to announce in advance what they intend to do; often, these "promises" are not fulfilled. Since company directors face members in the annual general meeting, they tend to be reticent in announcing plans, which may be difficult to implement due to corruption.

7.3.3 Conclusion

Overall, NSE quoted companies have relatively better disclosure compared to other emerging markets but poorer disclosure compared to developed countries, according to S&P's Transparency and Disclosure Survey methodology. In particular, only company 27's disclosure achieves a score sufficient to qualify as "high quality" (2.8). If NSE companies had higher levels of compliance with the requirements of

the Capital Markets Authority Guidelines on Governance, they would have a higher ranking against all these countries, but more importantly, would have lower information asymmetry between managers and investors on the NSE.

7.4 Financial Reporting (FiRe) Award for Excellence 2003 Scores

7.4.1 FiRe Award 2003 Scores

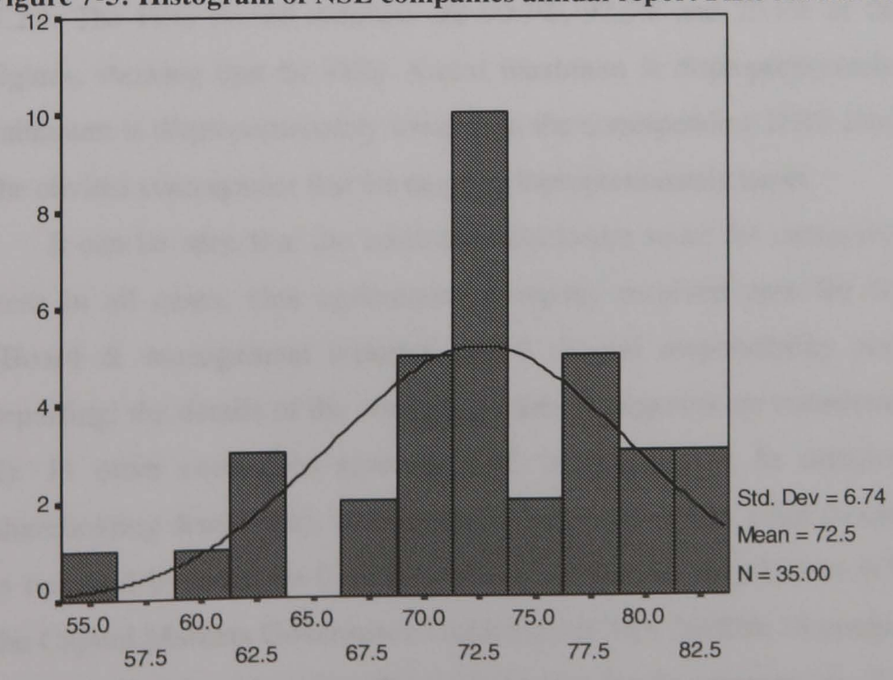
The descriptive statistics for Financial Reporting (FiRe) Award 2003 scores for the annual reports of the 35 companies quoted on the NSE that entered this competition are shown in Table 7-8.

Table 7-8: Descriptive Statistics: FiRe Award 2003 Scores for NSE companies

	N	Mean	Std. Deviation	Max	Min	Range
FiRe Award Total	35	72.5%	6.7%	83.5%	54.0%	29.5%

The mean score at 72.5% is not a really meaningful figure, given the method of scoring explained in section 5.4.3 earlier in this thesis. The maximum score of 83.5% would generally be regarded as a very good performance as a rule of thumb in Kenya (although this would not be the case in the US where a "high" score in school or university examinations would be above 90%). The range of 29.5% shows that there is a significant, but not unduly large, variation in the disclosure quality of the 35 NSE quoted companies that took part in this competition. The minimum score is two thirds of the maximum showing that judges view disclosure as fairly good overall.

Figure 7-5: Histogram of NSE companies annual report FiRe Award 2003 scores



The histogram in Figure 7-5 shows that the distribution of scores is quite close to a normal distribution, with a certain amount of negative skewness. A large number of companies achieve scores around the mean; the mean is closer to the maximum score than to the minimum. The number achieving scores around the minimum is small.

The FiRe Award score is a composite one, made up of the components listed in Table 7-9. The three right-hand columns in Table 7-9 show NSE companies' mean, maximum and minimum score in each of the categories, all expressed as percentages of the category maximum.

Table 7-9: Scores for Financial Reporting (FiRe) Award 2003

		Max poss.	Mean score	Mean as %	Max as %	Min as %
1	Compliance with IFRSs	37.5	32.5	86.7	94.7	66.7
2	Compliance with Cos Act	7.5	6.4	84.8	100.0	60.0
3	Clarity of accounting policies	5.0	4.0	80.0	95.0	60.0
4	Clarity of notes	10.0	8.8	87.6	100.0	65.0
5	Design, lay-out & appearance	2.5	2.1	82.6	100.0	40.0
6	Board & management reports	10.0	6.5	64.9	97.5	0.0
7	Graphs, charts, ratios & trends	5.0	2.5	49.1	100.0	20.0
8	Corporate governance	10.0	5.6	55.5	80.0	10.0
9	Soc.Resp. & environmental reporting	10.0	3.0	30.3	85.0	0.0
10	Disc. of principal shareholders	2.5	1.3	51.4	100.0	0.0
	TOTAL	100%	72.5	72.5	83.5	54.0

For IFRS compliance, the FiRe Award mean, maximum and minimum are 86.7%, 94.7% and 66.7%, as opposed to 95.6%, 97.1% and 88.8% using the IFRS checklist in section 7.2.1. The FiRe Award numbers are 90.7%, 97.5% and 75.1% of the IFRS checklist figures, showing that the FiRe Award maximum is disproportionately higher, and the minimum is disproportionately lower than the corresponding IFRS checklist figure, with the obvious consequence that the range is disproportionately larger.

It can be seen that the minimum disclosure score for categories 6, 9 and 10 is zero in all cases. One agricultural company received zero for both categories 6 (Board & management reports) and 9 (Social responsibility and environmental reporting: the details of the contents of these categories are contained in Appendix 5-2). 11 other companies received zero in category 9. In category 10 (Principal shareholding disclosure), 16 companies had a zero score, even though this disclosure is required by both the Capital Markets Disclosure Regulations (CMA 2002a) and the Capital Markets Governance Guidelines (CMA 2002b); 18 companies achieved a full score and for this reason the overall mean for the category was 51.4%.

7.4.2 Conclusion

The FiRe Award disclosure checklist covers a wide range of areas of disclosure. The process of awarding scores is rather subjective; inevitably the results will be subjective, although there is an averaging process in place described in section 5.4.3. Companies overall perform well on the disclosure requirements, but once again, a number of companies need to improve their disclosure of items which are mandated by a variety of bodies but, in particular, the Capital Markets Authority.

7.5 Is there "high quality disclosure" as defined by this study?

Section 2.8 gives an operational definition of "high quality disclosure". From Appendix 7-1, company 27 is the only one which achieves the S&P US average of 70% (Table 7-7, line 13b): its IFRS compliance and FiRe Award scores are 95.60% and 61.00%, both short of the numbers required for "high quality disclosure". Hence, no NSE achieves "high quality disclosure". But a number are within striking distance of doing so in their annual reports. Their interim reports have to improve substantially, even to be considered adequate.

7.6 Analysis of associations between different scoring systems

The purpose of this section is to report and analyse the findings of the associations among the different scoring systems.

The three indices used to measure the quality of disclosure in the annual report in this study measure three different constructs, although there is considerable overlap. Full IFRS compliance accounts for 25.51% of the S&P survey score and 38.50% of the FiRe Award score. Full compliance with the Kenya Companies Act 1962 makes up 7.5% of the FiRe Award score and 22.45% of the S&P survey score: in the S&P survey score, 16 (16.33% of the S&P maximum possible score) of the 22 (22.45%) disclosure items mandated by the Companies Act are also mandated by IFRS. 15% of the FiRe Award score is made up of S&P items. In spite of these overlaps, it could still be said that the three indices measure three separate constructs. Some companies will undoubtedly place more emphasis on full compliance with IFRS, thinking that doing so will reduce agency and political costs. Others will place more emphasis on social responsibility and environmental reporting (10% of the FiRe Award total; 0% of the IFRS and S&P scores) and performance data (5% of the FiRe Award total; 0% of the IFRS score, 5.10% of the S&P score), emphasizing their legitimacy, attention to stakeholders and quality, mimicking multinationals by including this information, and possibly thinking that agency and

political costs are best lowered by paying attention to these forms of voluntary disclosure, and relying more on auditors to ensure compliance with IFRS. Some managers will engage in decoupling: full compliance with IFRS is arduous – there is much tedious detail to deal with; managers may show initial enthusiasm for full compliance with IFRS but may tire in trying to achieve it; environmental and social disclosures on the other hand may appeal to the more "creative" side of managers' interests. These ideas lead naturally to the possibility of using the data generated by this study to examine whether annual report IFRS compliance scores are positively associated with annual report S&P scores and FiRe Award scores, and interim report IAS 34 compliance scores.

7.6.1 Results of tests of association

Table 7-10 shows a summary of the associations among the different scores used to measure high quality disclosure in this chapter, and sub-components of them. Kolmogorov-Smirnov and Shapiro-Wilk's tests indicate that annual report IFRS and interim report IAS 34 scores are not normally distributed. The non-parametric Kendall-tau test is used to test correlations between the various pairs of variables. The correlation coefficients between IFRS, S&P and IAS 34 scores are for all the NSE companies: those for all the other pairs of scores are restricted to the companies that entered the FiRe Award (FA) competition. $\mathbf{FA_{IFRS}}$ is the FiRe Award component score for IFRS compliance. Two scores are used for mandatory disclosure: $\mathbf{FA_{Man1}}$ comprises the FiRe Award subtotal of IFRS, Companies Act and Principal Shareholding disclosures; $\mathbf{FA_{Man2}}$ comprises $\mathbf{FA_{Man1}}$ and scores for the clarity of accounting policies and of notes to the financial statements. The score for voluntary disclosure, $\mathbf{FA_{Vol}}$ comprises scores for board and management reports, performance and corporate governance data, and social and environmental reporting.

Table 7-10: Correlation coefficients between different measures of disclosure

	IFRS	S&P	FA	IAS34	FA_{IFRS}	FA_{Man1}	FA_{Man2}
IFRS							
S&P	-.067						
FA	-.010	.221					
IAS34	.074	-.088	.209				
$\mathbf{FA_{IFRS}}$	-.080	-.063	.349**	.162			
$\mathbf{FA_{Man1}}$	-.119	.226	.391**	.125	.589**		
$\mathbf{FA_{Man2}}$	-.165	.217	.353**	.116	.491**	.830**	
$\mathbf{FA_{Vol}}$	.055	.171	.747**	.148	.216	.133	.072

Note: **Correlation is significant at the 1% level of significance.

From Table 7-10, it can be concluded that there is no significant association among the different measures of high quality disclosure. The significant associations between the

subtotals of components of the FiRe Award with the FiRe Award scores themselves are to be expected. However, there is no significant correlation among annual report IFRS compliance scores, S&P survey scores, FiRe Award scores and interim report IAS 34 compliance scores: nor between the various measures of mandatory disclosure and voluntary disclosure. Hence there is no significant association between mandatory and voluntary disclosure by NSE companies.

In addition, no significant associations are found among annual report IFRS compliance, the FiRe Award IFRS component ($\mathbf{FA_{IFRS}}$) and interim report IAS 34 compliance.

Finally, on the basis of Deegan and Carroll's (1993) finding (section 7.1), there is an expectation that companies that enter the FiRe Award competition have higher IFRS compliance and higher S&P scores, and possibly higher interim report IAS 34 compliance scores. The Mann-Whitney U test is used to test whether there are significant differences between scores achieved by companies which entered the FiRe Award competition and those that did not enter. From Table 7.11, the annual report scores for IFRS compliance for companies which entered the FiRe Award competition are actually lower, but not significantly, than those that did not enter the FiRe Award. S&P survey scores are not significantly higher for companies that entered their annual report for the FiRe Award than those that did not. But for interim report IAS 34 scores, interim report IAS 34 compliance scores are higher for companies that entered the FiRe Award competition, at the 5% level, than those that did not..

Table 7-11: Results of Mann-Whitney U tests

Mean ranks→	Entered	Did not enter	Sig. – 1 tailed
IFRS compliance scores	22.51	28.33	0.105
S&P survey scores	25.79	18.79	0.065
IAS 34 compliance scores	26.13	17.79	0.030

Note: Largest ranks assigned to highest scores.

7.6.2 Analysis of findings

The fact that there no associations among the various methods of measuring the quality of disclosure indicates firstly that each scoring system measures a different construct. It confirms that managers of different companies pay more attention to different areas of disclosure: some pay more attention to IFRS compliance; some pay more attention to other aspects of disclosure. The findings indicate that managers generally of NSE companies do not study the information contained in a high quality disclosing company in their industry quoted on the London or New York Stock Exchange with the aim of attempting to communicate information in a similar fashion, although a majority say they do (section

9.6). They are content to "get by". The enormous difference between average annual report and average interim report compliance indicates the importance of auditors examining the accounts and, to a lesser degree, the importance of effective regulation. Regarding regulation, one cannot point to a large number of cases of non-compliance having been investigated by ICPAK. Possibly, the fact that some cases of non compliance have been investigated and have resulted in the auditors being cautioned, has acted as a deterrent to would be non-compliers. The lack of association between the annual report IFRS compliance scores and $\mathbf{FA_{IFRS}}$ (the FiRe Award component scores for IFRS compliance) indicates either that one scoring system is faulty or that both are faulty: both cannot be robust. Since this study examined each annual report using a detailed checklist that had been checked against the PricewaterhouseCoopers (PWC) checklist, there is an argument that IFRS compliance is more accurately measured by this study. If this is the case, the FiRe Award scores for this subcomponent are not accurate, calling into question the validity of the FiRe Award results. Adjudicators are not paid for the time they spend doing their work. But the PWC checklist issued by ICPAK to adjudicators has to be used more assiduously.

A number of multinationals may be quoted on the NSE merely to give the Kenyan public the notion that they "own" these companies, whereas the fact is that the percentage of shares actually owned by shareholders in Kenya is 11.68% in the case of the largest agricultural company, 32% and 19% in the case of the largest and second largest banks and 36.5% of the largest industrial company (Ngotho 2005). These subsidiaries of multinationals probably pay more attention to ensuring that the accounts of the Kenyan subsidiaries are in a fit state to be consolidated with the overseas parents' accounts than to ensuring high quality disclosure to Kenyan shareholders; often the Kenyan subsidiaries make up a minute fraction of the world wide business of the multinationals, but still have to be consolidated with the parent.

Local companies do not see the NSE as a place to raise finance. Issue costs are so high that it is often cheaper to use bank finance (interview with the finance director of company 9). Kenyan shareholders are ready to accept that items they do not understand have to be put into the financial statements in the way they are because IFRS demand it: this is how the audit partner answered a query regarding the accounts, raised in an AGM (ibid.). There is an external show of "ownership" of IFRSs by preparers; but the tedium of ensuring

compliance with a large number of small details (the figures for which are not easy to arrive at if systems have not been set up to produce this information) deters preparers, auditors and regulators in ensuring full compliance. Sometimes the wording of some of the IFRSs is not as clear as it should be: this creates differences of interpretation which are difficult to resolve (ibid.) – on one occasion ICPAK sent a consultation to IFRIC; after an extended delay in replying, the response was tantamount to telling ICPAK to sort the problem out themselves (ICPAK 2002b).

7.7 Summary and Conclusion

The purpose of this chapter is to describe, analyse and evaluate the results of this study on disclosure by companies quoted on the NSE in 2002.

Not all the companies disclosed in their annual reports all that was required to be disclosed by IFRSs, but, in general, were close to achieving full compliance (7.2.4). Widespread non-compliance tends to be limited to a number of smaller points (7.2.2). More important areas of non-compliance were restricted to very few companies (appendix 7-3). A number of these shortcomings were mentioned in the World Bank ROSC (7.2.3): had the general tone of the ROSC been more positive, ICPAK could have sent it to all the NSE companies to assist them in improving compliance: because it was so negative, ICPAK became defensive, and kept it under wraps (1.2.2). Disclosure in the interim financial reports was far below what is required by IFRS, except in one case, where full compliance was achieved (7.2.5).

Disclosure measured using S&P's Survey Methodology show that NSE companies do moderately well (7.3.2). A much better performance would have been achieved if the companies had adhered to the disclosure requirements of the Capital Markets Authority's continuing disclosure requirements and the Capital Markets Authority Guidelines on Corporate Governance (appendix 4-3).

The Financial Reporting (FiRe) Excellence Award 2003, run jointly by ICPAK, CMA and NSE show that NSE companies that take part achieve a moderately good level of disclosure across a wide range of disclosure categories (7.4.2). This study finds that interim report IAS 34 compliance is higher for companies that enter the FiRe Award competition, significant at the 5% level, and S&P survey scores tend to be higher, but IFRS compliance tends to be lower for companies that enter the FiRe Award, although both the latter results are not statistically significant (7.6.1). This study also shows that the system of measuring IFRS compliance in the

FiRe Award needs to be changed: FiRe Award IFRS scores are not correlated with IFRS compliance scores as arrived at by this study (7.6.1).

It is also found that there are no correlations among the various indices of high quality disclosure, indicating that each measures a different construct, which is given a different level of importance by different preparers (7.6.2). When ICPAK has investigated non-compliance with IFRSs in the past, it has always summoned the auditors to appear before the Disciplinary Committee of the Institute. This may have sent the wrong signal to preparers: preparers may view ICPAK's action in this regard as confirmation that the responsibility for compliance lies with auditors. Higher quality firms of auditors will tend to ensure better compliance with IFRSs – and will be able to obtain better guidance from their international firm offices when the concept behind a particular IFRS is unclear (7.6.2): however, auditors will make no more than a cursory examination of corporate governance and social responsibility disclosures, the quality of which tends to differentiate higher scoring companies in the S&P survey and FiRe Award from lower scoring ones. The lack of correlation among the various indices of high quality disclosure could therefore be explained by the fact that annual report IFRS compliance measures the ability of the company's auditors; the S&P survey score is more dependent on whether the company is a subsidiary or associate of a multinational; the FiRe Award score is more dependent on the usual company variables (size, etc.); and the interim report IAS 34 compliance score is more dependent on the keenness of the company to keep the market informed of its performance – which would tend to be more the case in particularly volatile industries like agriculture. These suggested associations will be investigated further by univariate and multivariate analysis in chapter 8 and by interview research in chapter 9.

One final point to be made is that ICPAK's experience with IASB and the International Financial Reporting Interpretations Committee (IFRIC) was similar to that of Mercer (3.8.6) and opposite to that of the G_{100} (3.8.6). A matter which has enormous effects on the balance sheets of all organizations that own land in Kenya (which is Government leasehold land with a lease period varying between 99 and 999 years) was of no concern whatsoever to either IASB or IFRIC: ICPAK were told to sort the problem out on their own. This does not augur well for similar difficulties that will arise. Perhaps Kenya is too small for IASB to deal with Kenya's problems; perhaps IASB and IFRIC do not have the resources to deal with queries; perhaps the IAS was badly thought out; only time will tell which of these conjectures is correct.

CHAPTER 8
Univariate and Multivariate Analysis

8.1 Introduction

Addressing the second empirical question **EQ_2,** (*Is there a significant association between high quality disclosure and company characteristics on the basis of expectations derived from prior research and theoretical models?*- section 1.5.2), this chapter records the results of tests of hypotheses of the relative associations between company characteristics and high quality disclosure proxied by the scores achieved by companies quoted on the Nairobi Stock Exchange (NSE) for: (i) annual report compliance with IFRSs; (ii) annual reports, using the Standard & Poor's Transparency & Disclosure Survey 2003 methodology (S&P Survey), as measured by the researcher; (iii) annual reports in the Financial Reporting Award for Excellence 2003 competition (FiRe Award); (iv) interim financial report compliance with IAS 34: *Interim Financial Reporting*.

Section 8.2 reports on the examination of the data; sections 8.3 and 8.4 present the results of the univariate and multivariate analysis; the main conclusions of the chapter are summarized in section 8.5.

8.2 Examination of data

8.2.1 Descriptive Statistics for Financial Report Scores

For ease of reference, descriptive statistics for scores for annual report IFRS compliance, S&P Survey and FiRe Award, and interim report IAS 34 compliance reported in Chapter 7 are brought together in Table 8-1. Cooke (1998) points out that data should be reviewed carefully once it has been collected, irrespective of the type of analysis that is proposed to be carried out on it.

From Table 8-1, it can be seen that the mean score achieved by the annual reports for compliance with IFRSs, 96.74%, is almost twice (1.92 times) that achieved on S&P Survey scores, 50.36%, and one third higher than (1.33 times) the FiRe Award mean score of 72.51%. The annual report IFRS compliance mean score (96.74%) is 3.13 times the interim report IAS 34 compliance mean score (30.91%); annual financial statements are audited whereas interim financial report are not; in addition, annual financial statements are sent to all shareholders by all companies, whereas interim financial reports are sent to all shareholders in only three NSE companies (interviews with financial controllers):

Table 8-1: Descriptive Statistics for Corporate Annual Report Scores

Financial year end between 30 June 2002 & 31 March 2003.	IFRS Compl. scores		S&P T&D 2003 Survey scores		FiRe Award 2003 scores		IAS 34 Compliance scores	
	Statistic	Std. Error	Statistic	Std. Error	Statistic	Std. Error	Statistic	Std. Error
Number of companies	47		47		35		47	
Max. possible score	100.00		100.00		100.00		100.00	
Mean actual score	96.74	0.27	50.36	1.28	72.51	1.14	30.91	2.21
5% Trimmed Mean	96.96		50.22		72.80		28.34	
Median	97.41		50.41		72.50		25.00	
Variance	3.48		76.41		45.38		229.74	
Std. Deviation	1.87		8.74		6.74		15.16	
Minimum	89.88		35.20		54.00		22.22	
Maximum	98.68		71.43		83.50		100.00	
Range	8.80		36.23		29.50		77.78	
Skewness	-1.89	0.35	0.11	0.35	-0.67	0.40	3.14	0.35
Kurtosis	3.91	0.68	-0.37	0.68	0.53	0.78	10.78	0.68

The range of scores for S&P Survey (36.23 percentage points: %) is 4.12 times that for annual report IFRS compliance (8.80%). The FiRe Award range (29.50%) is 3.35 times that IFRS compliance. The interim report IAS 34 compliance range (77.78%) is 8.84 times that of the annual report IFRS compliance scores. While the ranges for annual report scores are to be expected, since IFRSs compliance is mandatory but S&P Survey and the FiRe Award contain voluntary items, the extremely large range for interim report IAS 34 compliance shows the consequences of ineffective surveillance by regulators in respect of interim reports, effectively rendering interim reporting voluntary.

The 5% trimmed means are very close to the population or sample means in all cases, which indicates that extreme scores do not have a strong influence on the means. In addition, the medians of the S&P Survey scores and the FiRe Award scores are very close to the means; the median of the IFRS compliance score is more distant from the mean but at only 0.67%, it is not markedly different. The median of interim report IAS 34 compliance scores at 25.00% is much lower than the mean at 30.91% showing the relatively larger number of scores below the mean.

The minimum score achieved by the companies' annual reports for IFRS compliance is 89.88%, which is 2.55 times the minimum score for the S&P Survey (35.20%), 1.66 times the minimum score for the FiRe Award (54.00%) and 4.05 times the minimum score for interim report IAS 34 compliance (22.22%).

Because of space constraints, descriptive statistics and the tests on them are omitted from this chapter and from the appendices but are available on request from the author.

Negative skewness of -1.89 and -0.67 for IFRS compliance and FiRe Award scores indicate that IFRS compliance and FiRe Award scores are quite heavily and moderately skewed to the right of the mean. Positive skewness of 0.11 and 3.14 for S&P Survey and for interim report IAS 34 compliance scores shows that the distributions of S&P and the IAS 34 compliance scores are clustered slightly and skewed heavily to the left of the mean.

The kurtosis values of 3.91 and 0.53 for IFRS compliance and FiRe Award scores indicate that the first distribution is heavily clustered around the mean value and the second is more clustered, but only slightly more, around the mean than a normal distribution; the small negative value of kurtosis for the distribution of S&P scores shows that the there are slightly more values in the extremes than would be the case for the normal distribution. The kurtosis value of 10.78 for IAS 34 compliance indicates that interim report scores are very heavily clustered around the mean. This information can be viewed in figures 7-1 to 7-3 and 7-5 in chapter 7, which show histograms, with the normal curve superimposed.

8.2.2 Tests for Normality.

Table 8-2 shows the results of tests for normality of the four distributions of scores (including normalized and ranked IFRS compliance scores).

In the Kolmogorov-Smirnov test, a non-significant result, which is indicated by the significance (sig.) value being more than 0.01 (at the 1% level of significance), indicates normality. The normalized and ranked IFRS compliance, the S&P Survey and the FiRe Award scores are normally distributed at the 1% level of significance; Cooke (1998, p. 216) points out that SPSS provides a significance level up to 0.200 but after that simply reports that the significance figure is greater than 0.200.

In the Shapiro-Wilk's test for normality, the null hypothesis is that the data are

Table 8-2: Tests for Normality

	Kolmogorov-Smirnov(a)			Shapiro-Wilk's Stat.		
Annual report:	Statistic	df	Sig.	Statistic	df	Sig.
IFRS Compliance scores	.225	47	.000	.801	47	.000
Normalized IFRS com. scores	.027	47	.200*	.996	47	1.000
Ranks of IFRS com. scores	.065	47	.200*	.956	47	.072
S&P T&D 2003 Survey scores	.076	47	.200*	.978	47	.506
FiRe Award 2003 scores	.153	35	.038	.948	35	.100
Interim report: IAS 34 compl.	.283	47	.000	.583	47	.000

a Lilliefors Significance Correction: * This is a lower bound of the true significance.

normally distributed. If the chosen alpha level is 0.01 and the p-value is less than 0.01, the null hypothesis has to be rejected, which was the case for annual report IFRS and interim report IAS 34 compliance scores. If the p-value is greater than 0.01, the null hypothesis is not rejected, which was the case for the normalized and ranked IFRS compliance, S&P Survey and FiRe Award scores.

Since this was the case, it was decided to carry out rank regressions for annual report IFRS, and interim report IAS 34 compliance scores, as suggested by Cooke (1998), and used in several prior studies (Lang and Lundholm, 1993, 1996; Wallace et al. 1994; Wallace and Naser 1995; Owusu-Ansah 1998).

8.3 Univariate Analysis

This section presents the results of univariate non-parametric analysis for annual report IFRS and interim report IAS 34 compliance. It also presents univariate parametric analysis for annual report S&P Survey and FiRe Award scores. Discussions of the results of univariate analysis are included with discussions of the results of the multivariate analysis in sections 8.4.1.3, 8.4.2.1, 8.4.3.1 and 8.4.5.1.

Results are presented in comparison for continuous variables with reference to annual report scores for IFRS compliance (using Kendall's rank correlation coefficient), the S&P Survey and FiRe Award scores (using Pearson's product-moment correlation coefficient), and for two-category dummy variables using the Mann-Whitney U test. Results for interim report IAS 34 compliance scores (using Kendall's rank correlation coefficient for continuous variables and the Mann-Whitney U test for categorical variables) are presented in a separate later section.

8.3.1 Company size

From Table 8-3, it is concluded that all five variables representing company size are significantly correlated at the 1% level with FiRe Award scores, with log of the profit showing the strongest association. This would lead to the rejection of the null hypothesis (6.3.1) for this measure of "high quality disclosure".

From Table 8-3 it is also concluded that annual report IFRS compliance and S&P Survey scores are not associated significantly with the size of the company: the null hypothesis (6.3.1) for these measures of "high quality disclosure" could not be rejected.

Table 8-3: Correlations between size variables and annual report "high quality disclosure" (HQD)

** Correlation is significant at the 0.01 level (1-tailed).	IFRS compl scores	S&P Survey scores	FiRe Award scores
	Kendall's tau	Pearson's p-m coeff	Pearson's p-m coeff
Log of the market capitalisation on 31 Dec 2002	-0.014	0.268	**0.487****
Sig. (1-tailed)	0.445	0.068	**0.003**
Log of shareholders funds at company year end	-0.029	0.286	**0.504****
Sig. (1-tailed)	0.388	0.051	**0.002**
Log of book value of assets at company year end	-0.082	0.123	**0.542****
Sig. (1-tailed)	0.207	0.412	**0.001**
Log of sales for the company financial year	-0.062	0.079	**0.432****
Sig. (1-tailed)	0.269	0.600	**0.010**
Log of the profit for the company financial year	0.065	0.112	**0.565****
Sig. (1-tailed)	0.282	0.503	**0.002**

8.3.2 Number of shareholders in the company

SPSS can allocate ranks to variables so that "one" is allocated to the highest or the lowest value. In an attempt to simplify the analysis, I allocated the rank "one" to the smallest value of the variable and the rank "forty seven" to the largest value. As a result, when a dependent variable is positively associated with an independent variable, it is also **positively** associated with the rank of the independent variable.

From Table 8-4 it is concluded that annual report IFRS compliance scores are not associated significantly with the log or the rank of the number of shareholders. The null hypothesis (6.3.2) for this association could not be rejected.

S&P Survey scores show medium (Cohen, J.W. 1988) positive association with the log and rank of the number of shareholders at the 1% & 5 % level of significance.

FiRe Award scores show medium positive association with the log of the number of shareholders at the 5% level of significance and large (Cohen, J.W. 1988) positive association with the rank of the number of shareholders at the 1% level. For these two measures of disclosure, the null hypothesis (6.3.2) is rejected.

Table 8-4: Correlations between the number of shareholders and "HQD"

** Correlation is sig. at the 0.01 level	IFRS	S&P	FiRe
Log of the number of shareholders	-0.098	**0.421****	**0.466***
Sig. (1-tailed)	0.198	**0.009**	**0.012**
Rank of the number of shareholders	-0.098	**0.404***	**0.561****
Sig. (1-tailed)	0.198	**0.013**	**0.002**

8.3.3 Shareholding held by holding or investing company

From Table 8-5, annual report IFRS compliance and S&P Survey scores are not associated significantly with the shareholding owned by the holding or investing company in NSE quoted companies which are subsidiaries or associated companies. The null hypothesis (6.3.3) for these associations could not be rejected. FiRe Award scores show large positive association with the size of the shareholding, at 1% level of significance: the null hypothesis (6.3.3) for this association is rejected.

Table 8-5: Correlations: holding/investing company shareholding & "HQD"

** Correlation is sig. at the 0.01 level	IFRS	S&P	FiRe
Percentage holding/investing company shareholding	-0.013	0.315	**0.535****
Sig. (1-tailed)	0.458	0.125	**0.006**

8.3.4 Age of the company

From Table 8-6, annual report IFRS compliance and FiRe Award scores are not associated significantly with the age of the company: the null hypothesis (6.3.4) for these associations could not be rejected. S&P Survey scores show medium (Cohen, J.W. 1988) negative association with the age, and the rank of the age, of the company at the 5% level of significance: the null hypothesis (6.3.4) is rejected.

Table 8-6: Correlations between age of the company and annual report "HQD"

* Correlation is sig. at the 0.05 level	IFRS	S&P	FiRe
Log of age	-0.114	**-0.337***	0.287
Sig. (1-tailed)	0.131	**0.021**	0.095
Rank of age	-0.114	**-0.316***	0.241
Sig. (1-tailed)	0.131	**0.030**	0.163

8.3.5 Leverage of the company

From Table 8-7, annual report IFRS compliance and FiRe Award scores are not associated significantly with leverage - the rank of the ratio of debt to debt plus equity: the null hypothesis (6.3.5) for these associations could not be rejected.

Table 8-7: Correlations between leverage of the company and "HQD"

* Correlation is sig. at the 0.05 level	IFRS	S&P	FiRe
Rank of ratios of debt to debt plus equity	0.003	**-0.302***	0.132
Sig. (1-tailed)	0.489	**0.039**	0.448

Table 8-8: Illustration of negative association between ranks & scores

Leverage	Rank of leverage	S&P Survey Scores
0.5	3	40
0.4	2	50
0.3	1	60

S&P Survey scores show medium negative association with leverage: a company with higher leverage is allocated a rank with a larger number which is associated with a lower S&P score, as illustrated in Table 8-8 (the numbers in Table 8-8 are for illustration purposes only): the null hypothesis (6.3.5) for this association is rejected.

8.3.6 Dividend payout ratio

From Table 8-9, annual report S&P Survey and FiRe Award scores are not associated significantly with the rank of the dividend payout ratio: the null hypothesis (6.3.6) for these associations could not be rejected. Ranked IFRS compliance scores show medium positive association with ranks of dividend payout ratios at the 1% level of significance (shown by Table 8-10: the numbers are for illustration purposes only): the null hypothesis (6.3.6) for this association is rejected.

Table 8-9: Correlations between dividend payout ratio and "HQD"

** Correlation is sig. at the 0.01 level	IFRS	S&P	FiRe
Rank of the dividend payout ratio	**0.333****	0.143	0.072
Sig. (1-tailed)	**0.001**	0.426	0.681

Table 8-10: Illustration of positive association

Dividend payout ratio	Rank of dividend payout ratio	IFRS compliance	
		Scores	Ranks
0.7	3	96	3
0.6	2	95	2
0.5	1	94	1

8.3.7 Scatterplots

Scatterplots of the distributions of the S&P Survey and FiRe Award scores against all continuous variables for which the correlations are significant are examined. All of the scatterplots show an acceptable strength of linear correlation between the dependent and the independent variables in Tables 8-3 to 8-7.

8.3.8 Mann-Whitney U Test

The non-parametric Mann-Whitney U Test is performed in relation to dichotomous (or categorical) company and market variables to examine whether there is a significant difference between this statistic for companies that fall into the class of companies created by one value of the dichotomous variable and that for those that fall into the class for the other value of the variable. The reason for this test under normal circumstances is to see if a valid inference about a population as a whole can be made based on the companies selected as a random sample. The annual report IFRS compliance and the S&P Survey scores relate to the whole population of NSE companies; as a result, if there is a difference for the two classes of companies, that difference exists for the population as a whole. In

reality, no test is required to prove this fact; it can be deduced by mere observation. For these two scores, the tests are performed to check the inferences that will be made on the basis of the regression analysis carried out below. Of the 47 companies that make up the population of NSE companies, the 35 companies that entered the FiRe Award 2003 competition do not make up a random sample. Although FiRe Award scores are normally distributed at the 1% level of significance from Table 8-2 above, since the sample is small, the Mann-Whitney Test was also used for this distribution.

Table 8-11 displays a summary of the Mann-Whitney tests that were carried out for annual report IFRS compliance, S&P Survey and FiRe Award scores. Significant results lead to the rejection of the null hypotheses (6.3.7, 6.3.8 and 6.3.9) relating to associations between high quality disclosure in annual reports and the appropriate independent variables.

Table 8-11: Mann-Whitney test: S* (S) = sig. at 5 (1) % level: NS = not significant**

	Annual report scores	**Sign**	**IFRS**	**S&P**	**FiRe Award**
a	Company audited by firm B	-	**S***	NS	NS
b	Co subsidiary/associate of a multinational	+	NS	**S****	**S****
c	Agricultural sector company	+	NS	**S***	NS
d	Commercial & services sector company	-	NS	NS	**S***
e	Banking & investment sector company	+	NS	NS	**S***
f	Industrial & allied sector company	-	NS	NS	NS

8.3.9 Interim financial reports

In Table 8-12, company size, represented by total assets, shows a low level (Cohen, J.W. 1988) of correlation at the 5% level of significance with IAS 34 compliance scores, using Kendall's tau: the null hypothesis (6.4.1) for this measure of interim report "high quality disclosure" is rejected.

Table 8-12: Correlations between size and "High Quality Disclosure"

*** Correlation is sig. at the 0.05 level**	**IAS 34**
Size: Total assets	**0.234***
Sig. (1-tailed)	**0.015**

Table 8-13: Summary: Mann-Whitney: S* (S) = significant at 5% (1%) level**

	Interim report IAS 34 compliance scores	**Sign**	**IAS 34**
(a)	Agricultural sector company	+	**S****
(b)	Commercial & services sector company	N/A	NS
(b)	Banking & investment sector company	+	**S****
(c)	Industrial & allied sector company	-	**S****
(d)	Company year end 31 December	+	**S****
(e)	Company audited by firm E	+	**S***

Table 8-13 displays a summary of the Mann-Whitney U test on categorical variables carried out for interim report IAS 34 compliance scores. These results lead to the rejection of the null hypotheses (6.4.2, 6.4.3 and 6.4.4) relating to associations between high quality disclosure in interim financial reports and the appropriate independent variables.

8.4 Multiple Regression Analysis

Gujarati (2003, p. 335) lists eleven assumptions which underlie the classical linear regression model. One, the regression model is linear in the parameters. Two, the values of the regressors (X's) are fixed in repeated sampling. Three, for given X's, the mean value of the disturbance u_i is zero. Four, for given X's, the variance of u_i is constant or homoscedastic. Five, for given X's, there is no autocorrelation in the disturbances. Six, if the X's are stochastic, the disturbance term and the stochastic X's are independent or at least uncorrelated. Seven, the number of observations must be greater than the number of regressors. Eight, there must be sufficient variability in the values taken by the regressors. Nine, the regression model is correctly specified. Ten, there is no exact linear relationship (i.e., multicollinearity) in the regressors. Eleven, the stochastic disturbance term u_i is normally distributed.

Tabachnick and Fidell (2001 - T&F, p. 77) state that the assumption of linearity (assumption one) is that there is a straight-line relationship between the dependent and independent variables, which can be assessed roughly by inspection of bivariate scatterplots. They go on to point out that if both variables are normally distributed and linearly related, the scatterplot is oval-shaped. This was checked as indicated in section 8.3.7 above; there were a small number of outliers in all cases but in no case was an outlier situated so that it caused a major shift in the line of best fit.

Gujarati (2003, p. 337) suggests that for assumption two, the practical strategy to follow is to assume that, for the study, the values of the explanatory variables are given, even though the variables themselves may be intrinsically stochastic or random. The results of the regression analysis are then conditional on these given values. As a result, assumption six is also satisfied.

Gujarati (2003, p.338) points out that if assumption three is not fulfilled, the original intercept cannot be estimated; but this term is of little importance, and the slope coefficients, which remain unaffected even if assumption three is violated, are more meaningful quantities.

For assumption four, T&F (p. 79) state that homoscedasticity is related to the assumption of normality because when the assumption of multivariate normality is met, the relationships between variables are homoscedastic. While Gujarati (2003, p. 441) states that cross-sectional data are often plagued by the problem of heteroscedasticity, T&F go on to point out that heteroscedasticity is not fatal to an analysis of ungrouped data; the analysis is weakened but not invalidated.

For assumption five, Gujarati (2003, p. 441) notes that, in cross-sectional studies, there is no reason to believe that the error term pertaining to one company is correlated with the error term of another company when data are collected on the basis of a random sample of companies. For the companies in this study, the values of independent variables for one company are not expected to influence the values for another company, eg., size, leverage, liquidity, etc.

For assumption seven, there is some controversy. Stevens (1996, p.72) states that about 15 subjects per predictor are needed for a reliable equation in social science research. T&F (p.117) suggest that the number should be greater than (50 + 8m), where m = the number of regressors; this condition would not be complied with in any study of the NSE, since there are fewer than 50 companies quoted on the NSE. T&F add that a higher subjects to regressor ratio is needed when the dependent variable is skewed, which is certainly the case in the distribution of annual report IFRS compliance and interim report IAS 34 scores. For stepwise regression, T&F specify the number of subjects for every regressor to be 40. Hebden (1981) specifies that there should be at least five observations for each regressor: the numbers in this study come close to this figure.

Gujarati (2003, p.342) states that assumption eight, that there is sufficient variability in the values of the regressors, is intimately related to assumption ten, that there is no exact relationship in the regressors. He points out that the chances of obtaining, in practice, a sample of values where the regressors are related in this way is very small indeed, except by design – which is not the case in this study.

For assumption nine, Gujarati (2003, p. 518) points out that, especially for cross-sectional data, if there are model specification errors, the residuals will exhibit noticeable patterns. Residuals were examined carefully to detect model specification problems. Gujarati (2003, p.547) mentions that when legitimate variables are omitted from a model, the ordinary least squares estimators of the variables retained in the model are not only

biased but inconsistent; the variances and standard errors of the estimators are incorrectly estimated, making the hypothesis-testing procedures faulty; if irrelevant variables are included in the model, the estimators of the coefficients of the relevant and the irrelevant remain unbiased and consistent, the error variance remains correctly estimated, but the estimated variances tend to be larger than necessary, introducing imprecision to the estimation of the parameters.

For assumption ten, the three tests explained in section 5.5.2.4 were carried out for each of the regression models.

Finally, for each regression, the histogram of standardized residuals was examined visually to check assumption eleven that the residual errors were normally distributed. Regression is robust in the face of some deviation from this assumption (Cooke 1998, Garson 1998); the skewness in each case was not major. As a result the validity of conclusions was not affected.

8.4.1 Annual report IFRS compliance scores

A single regression model was used to test for associations between annual report IFRS compliance, S&P Survey and FiRe Award scores and corporate characteristics. The model includes the nine (classes of) variables specified in Tables 8-3 to 8-11: company size, number of shareholders, shareholding owned by the holding/investing company, age, leverage, dividend pay-out ratio, auditor being firm B, multinational association and industry type (converted by dummy variable coding with 1s and 0s into a set of dichotomous variables numbering one fewer than the number of discrete categories, see T&F, p. 112 – hence, agricultural, commercial and industrial). Profitability and liquidity are introduced as control variables.

Cooke (1998) states that when the dependent variable is not normally distributed, rank regression can be performed. Lang and Lundholm (1993) use this technique in their paper, arguing that it has value when the theoretical relationship between the dependent and the independent variables is not known but is monotonic. Cooke (1998) adds that rank regression is useful when the relationship between the dependent and independent variables is not strictly linear and there is no theoretical basis for suggesting a relationship between the two. He goes on to point out rank regression suffers from the weaknesses that it is difficult to interpret the results, the tests are effectively non-parametric and are weaker than parametric tests. Cooke (1998) also suggests an alternative to Rank Regression: the

van der Waerden approach substitutes ranks by normal scores, which preserve monotonicity and transform a non-normal dependent variable into a normal one. Regression models for annual report IFRS compliance were developed for untransformed, ranked and normalized dependent variables. The outcome of only the ranked IFRS compliance scores is shown in Table 8-14: this outcome is identical to that for untransformed and normal scores, except that age is just significant at the 5% level of significance for untransformed scores.

The specification of the regression model for annual report high quality disclosure proxied by compliance with IFRS scores is:

$Y_{1i} = \beta_0 + \beta_1 Size_i + \beta_2 Numshldrs_i + \beta_3 Hoishareholding_i + \beta_4 Age_i + \beta_5 Leverage_i + \beta_6 Divpor_i + \beta_7 Aud_i + \beta_8 MNC_i + \beta_9 Agrico_i + \beta_{10} Comservco_i + \beta_{11} IndAllco_i + \beta_{12} Profitability_i + \beta_{13} Liquidity_i + \varepsilon_i$: ε_i = error term; i = 1, ... , 47, company number;

Y_{1i} = annual report IFRS compliance score measured as a proportion;

1. $Size_i$ = size at company year end;
2. $Numshldrs_i$ = log or rank of the number of shareholders in the company;
3. $Hoishareholding_i$ = percentage of shareholding of holding/investing company;
4. Age_i = rank (youngest =1, oldest = 47) of the age of the company;
5. $Leverage_i$ = rank (lowest = 1, highest = 47) of long-term debt to debt plus equity;
6. $Divpor_i$ = rank (lowest = 1, highest = 47) of the dividend pay out ratio;
7. Aud_i = 1 if the company has firm B as its auditor, = 0 otherwise;
8. MNC_i = 1 if the company is a subsid/associate of a multinational, = 0 otherwise;
9. $Agrico_i$ = 1 if the company is in the agricultural sector, = 0 otherwise;

Control variables:

10. $Comservco_i$ = 1 if the company is a commercial & service one, = 0 otherwise;
11. $IndAllco_i$ = 1 if the company is in the industrial & allied sector, = 0 otherwise;
12. $Profitability_i$ = net profit divided by shareholders' funds;
13. $Liquidity_i$ = rank (lowest = 1, highest = 47) of quick ratio;

β_i = parameters, with the constant β_0 adjusting for any excluded dummy variables.

If all the independent variables listed are fed into the regression model simultaneously, a non-significant result is obtained, with the maximum condition index being 43.84, showing that multicollinearity is severe.

In order to obtain a significant result, independent variables numbers 2 and 3 ($Numshldrs_i$ and $Hoishareholding_i$) are removed from the model since they are the most highly correlated with other independent variables. With these independent variables removed, the results in Table 8-14 are obtained.

Table 8-14: Regression analysis: annual report IFRS compliance transformed to ranks

Multiple R	0.692	**Mean square error**			132.599
R^2	0.479	**F**			2.595
$_{adj}R^2$	0.295	**F-significance**			0.018
Std. error	11.515				
Variables	**B**	**Std Error**	**Std Coeff: β**	**t-value**	**t-sig.**
Constant	43.049	10.397		4.140	0.000
Size (log of value of assets)	2.229	2.514	0.126	0.886	0.382
Age	0.265	0.145	0.265	1.833	0.077
Leverage	-0.389	7.621	-0.007	-0.051	0.960
Rank of the dividend payout ratio	0.768	0.198	0.597	3.871	0.001
Company auditor firm B	-14.924	6.747	-0.307	-2.212	0.034
Association with multinational	0.250	3.886	0.009	0.064	0.949
Agricultural sector company	-8.419	6.920	-0.173	-1.217	0.233
Commercial & services sector co.	-1.699	5.955	-0.045	-0.285	0.777
Industrial & allied sector co.	-5.827	4.212	-0.204	-1.383	0.176
Profitability	-0.125	0.081	-0.246	-1.542	0.133
Liquidity	-0.117	0.162	-0.117	-0.721	0.476

8.4.1.1 Multicollinearity and normality

Checks (section 5.5.2.4) indicate that multicollinearity is moderate (correlations between all pairs of independent variables are well below the criterion cut off figure of 0.7; the minimum "tolerance" for the independent variables is 0.570, well above the cut-off figure of 0.1; the maximum variance inflation factor is 1.755, well below the cut-off figure of 10; the maximum condition index is 18.35).

T&F (p.116) note that an analysis of the distribution of residuals provides information which is important both from a theoretical and a practical point of view in regression analysis. The normal probability plots of the regression standardized residuals show that the points lie close to the straight diagonal line from the bottom left corner to the top right corner; this suggests no major deviations from normality. The scatterplot of the standardized residuals is approximately rectangularly distributed, with most of the scores concentrated in the centre, around the zero point. However, there are some points to the left of the scatterplot which suggest some violation of the assumption of normality. The largest value of the Mahalanobis distance at 34.66 lies above the critical value of 31.26 in Table C.4 in T&F (p.933) for 11 independent variables; eliminating two outliers (companies 20 & 18) does not change any of the numbers significantly, and the outlier with the largest value for the

Mahalanobis distance (23.35) is now below the critical value. It is decided to include the outliers since excluding them had almost no effect on the results in Table 8-14.

8.4.1.2 Model Evaluation

From Table 8-14, the F-significance figure (0.018) indicates that the null hypothesis can be rejected for the regression model since the corporate characteristics included in the model explain a significant part of the variation in IFRS compliance disclosure. From Table 8-14, $\mathbf{R^2}$ is 0.479 which means that 47.9% of the variance in annual report IFRS compliance is explained by the model. The adjusted $\mathbf{R^2}$ is the corrected estimated variance for the population as a whole when a sample is randomly chosen from the population; $_{adj}\mathbf{R^2}$ is 0.295 which means that 29.5% of the variance would be explained by the model if it had been a sample of the whole population. Cooke (1998) argues that the coefficient of determination, $\mathbf{R^2}$, is not the ideal measure of the best fit of the regression model because $\mathbf{R^2}$ is not invariant to changes in parameterizations of the left-hand side variables. He states that it is preferable for the mean square error $\{1/n\sum (y_i - \hat{y}_i)^2\}$, where $\hat{y}_i$ is the inverse transformation of the regression equation, to be minimal. The mean square error of the regression model using the untransformed dependent variable is 0.000; using normalized scores it is 0.562; using ranks it is 132.599. Choosing the minimum would lead to the adoption of the regression model based on untransformed values for the dependent variable, which are not normally distributed. It was decided to base the multivariate analysis on the model based on ranked scores.

Cooke (1998) points out that a weakness of rank regression is that it is difficult to interpret β_i, the coefficients of the independent variables in the regression model (Table 8-14, column headed **B**). If β_i is +1 or -1, an increase of 1 in X_i produces an increase or a decrease of 1 in Y_{1i}. If $\beta_i = 0$, there is no association between the dependent and the independent variable. $\beta_6 = 0.768$ in the model above. An increase of 1 in the rank of the dividend payout ratio increases the rank of IFRS compliance scores by 0.768, but these ranks are integers. An additional assumption of linear interpolation between the values is necessary to enable a value to be obtained by Y_{1i}.

In order to compare the contributions of the independent variables to the prediction of the dependent variable, the standardised coefficients (all the different values have been converted to the same scale for comparison purposes, see Pallant 2001, p. 146) in the "Std. Coeff: β" column in Table 8-14 are examined. The rank of the dividend payout ratio is the

largest; an increase in one standard deviation in the rank of the dividend payout ratio (which is difficult to interpret since the ranks are discrete integers) would be associated with a 0.597 standard deviation increase in the rank of IFRS compliance scores, when the variance explained by all other variables is controlled for. Company auditor firm B is the second highest weighted variable. Since the significance figures in the column headed t-sig. are both less than 0.05 for these two variables, each variable is making a unique contribution to the prediction of the dependent variable which is significant at the 5% level of significance. If the significance figures were greater than 0.05, the conclusion would have been that the variable was *not* making a significant unique contribution to the prediction of the dependent variable, due to overlap being present among the independent variables.

If the variable, "number of shareholders", is introduced into the regression model, multicollinearity becomes severe: the correlation between any measure of "number of shareholders" and the size of the company is above 0.7; the tolerance is 0.044, the variance inflation factor 22.864 and the condition index is 95.99. If instead, "number of shareholders" is **substituted** for the size of the company, a very similar result to that in Table 8-14 above is obtained. If the variable "percentage of shareholding of holding/investing company" is introduced into the regression model in place of "association with multinational", it is not significantly associated with the ranks of IFRS compliance scores at the 5% level of significance.

8.4.1.3 Summary of results and interpretation

Table 8-15 summarizes Tables 8-3 to 8-11 for univariate and Table 8-14 for multivariate analysis: both analyses support the hypothesis that annual report high quality financial disclosure, proxied by IFRS compliance scores, is associated at the 5% level of significance (and in order of explanatory contribution) positively with "rank of the dividend payout ratio" and negatively with "company auditor firm B".

For the period examined in this study, a number of companies which have a high level of IFRS compliance have dividend payout ratios exceeding one. Company 27 has a dividend payout ratio of 4.7 and is tenth highest in IFRS compliance – it decides to return a lot of cash to its shareholders (mainly residents of Kenya) because it is clear that no suitable investments are available to it. A number of companies with low IFRS compliance scores pay no dividend. This provides support for the suggestion of higher quality companies wanting to minimize agency costs and to signal their high quality by paying out

Table 8-15: Univariate and multivariate results

Research Hypotheses: IFRS compliance scores	Significance Supported		Exp-ected Sign	Sign Supported	
	Univariate	Multivariate		Univariate	Multivariate
Company size	not supported	not supported	+	not supported	not supported
No. of shareholders	not supported	not supported	+	not supported	not supported
Shareholding of holding or investing co	not supported	not supported	+	not supported	not supported
Age of the company	not supported	not supported	+	not supported	not supported
Leverage of company	not supported	not supported	+	not supported	not supported
Dividend payout ratio	**supported**	**supported**	+	**supported**	**supported**
Company auditor B	**supported**	**supported**	-	**supported**	**supported**
Subsid/assoc of MNC	not supported	not supported	+	not supported	not supported
Agricultural company	not supported	not supported	?	not applic.	not applic.
Commercial company	not supported	not supported	?	not applic.	not applic.
Financial company	not supported	not supported	?	not applic.	not applic.
Industrial company	not supported	not supported	?	not applic.	not applic.

a higher dividend and, simultaneously, by complying with IFRS disclosure requirements. Higher dividends increase political costs; astute managers will ensure that compliance with IFRS is high, to avoid any possibility of their annual reports being queried by regulators, and also to substantiate their legitimacy. Stakeholder theory predicts that perceptive managers will ensure that important stakeholders are catered for: both overseas and local shareholders value dividends: managers will ensure high annual report IFRS compliance so that different stakeholders, such as customers, suppliers, regulators and the general public form a good opinion of the company and have fewer grounds on which to criticize it. Inchausti (1997) finds no association between disclosure scores and the dividend payout ratio; it is likely that political costs for Spanish companies are much lower than Kenyan ones, since poverty levels in Spain are much lower than in Kenya; this may be the most important factor explaining the difference in findings.

The other finding is that being audited by firm B is associated with a low level of compliance in agreement with the expectations in section 6.3.7. Firm B has to make a greater effort to attract high calibre staff, give them high quality training and demand higher standards of competence from them. Once these measures have been taken, the firm should try to win more audit clients amongst companies quoted on the NSE but concentrating on a single sector to gain expertize in this sector.

It is surprising that none of the company variables - size, the number of shareholders, age, leverage and industry type – that are found to explain the variability in disclosure in annual reports in prior studies, is associated with variations in IFRS compliance in Kenya at this date.

In particular, being an affiliate of a multinational is not an explanation of IFRS compliance variability, contrary to the claims of the World Bank (WB 2001), noted in section 6.3.8. Future research is needed to confirm whether IFRS compliance will continue to be independent of these variables with the passing of time, when the novelty of using IFRSs has passed.

8.4.2 S&P Transparency & Disclosure 2003 Survey Scores

The S&P Survey disclosure checklist contains 98 items, 49 of which are mandated for companies quoted on the NSE by IFRSs, the Kenya Companies Act 1962 and Gazette Notice No.3362 of 2002 (Capital Market Authority Guidelines on Governance Practices – appendix 4-3). The other 49 are voluntary.

The same regression model specified for annual report IFRS compliance is used to evaluate associations between high quality disclosure proxied by S&P Survey scores and corporate characteristics. Hence the specification of the regression model for annual report S&P Survey scores is:

$Y_{2i} = \beta_0 + \beta_1 Size_i + \beta_2 Numshldrs_i + \beta_3 Hoishareholding_i + \beta_4 Age_i + \beta_5 Leverage_i + \beta_6 Divpor_i + \beta_7 Aud_i + \beta_8 MNC_i + \beta_9 Agrico_i + \beta_{10} Comservco_i + \beta_{11} IndAllco_i + \beta_{12} Profitability_i + \beta_{13} Liquidity_i + \varepsilon_i$: where: i = 1, ..., 47, number of the company;

Y_{2i} = annual report S&P Survey score measured as a proportion; and independent variables have the meanings assigned to them in section 8.4.1 above.

When all the independent variables are included in the regression model, the model is singular and no values are computed by SPSS. After the independent variable ($Numshldrs_i$) with the highest correlation (0.851) with another independent variable ($Size_i$) is removed the results in Table 8-16 are obtained. The matrix of bivariate correlations shows that the correlations between all pairs of independent variables included in the regression model are below the criterion cut off figure of 0.7 discussed in section 5.5.2.4; the minimum tolerance for the independent variables is 0.494, above the cut-off figure of 0.1; the maximum condition index of the independent variables is 35.83, showing that multicollinearity is severe. If the "rank of the dividend payout ratio" (since it is the variable most highly correlated with other independent variables) is removed, the maximum condition index reduces to 33.22, and does not change the results obtained. If "size" is also removed, the maximum condition index becomes 30.44, but the significances of the results of the model are not changed.

Table 8-16: Regression analysis: determinants of S&P Survey scores for annual reports

Multiple R	0.784	**Mean square error**			0.005
R^2	0.615	**F**			2.791
$_{adj}R^2$	0.394	**F-significance**			0.019
Std. error	0.068				
Variables	**B**	**Std Error**	**Std Coeff: β**	**t-value**	**t-sig.**
Constant	0.635	0.125		5.098	0.000
Size	0.038	0.020	0.336	1.918	0.069
Shareholding of holding/investing co	0.000	0.001	0.067	0.353	0.727
Age	-0.143	0.065	-0.328	-2.196	0.039
Leverage	-0.002	0.001	-0.276	-1.434	0.166
Rank of the dividend payout ratio	-0.002	0.001	-0.248	-1.370	0.185
Company auditor firm B	0.042	0.045	0.136	0.937	0.359
Association with multinational	0.083	0.029	0.477	2.823	0.010
Agricultural sector company	0.033	0.050	0.108	0.667	0.512
Commercial & services sector co.	0.008	0.038	0.034	0.217	0.830
Industrial & allied sector co.	-0.017	0.030	-0.096	-0.574	0.572
Profitability	0.000	0.001	0.116	0.692	0.497
Liquidity	0.003	0.001	0.312	1.955	0.064

The normal probability plot of the regression standardized residuals shows that the points lie close to the straight diagonal line from the bottom left corner to the top right corner; this suggests no major deviations from normality. The scatterplot of the standardized residuals is approximately rectangularly distributed, with most of the scores concentrated in the centre, around the zero point. The maximum value of the Mahalanobis distance is 43.41, above the critical number of 32.91 in Table C.4 in T&F (p. 933) for 12 independent variables. If companies 10 and 18 are eliminated, the maximum Mahalanobis distance is reduced to 33.33, without changing the significances of any of the numbers in Table 8-16.

A second model is developed with "the log of the number of shareholders" replacing "size" (these two variables are highly correlated with each other). Multicollinearity is severe at 46.25. In order to reduce multicollinearity, the variables "shareholding of holding/investing company", "rank of the dividend payout ratio", "commercial and services sector" and "industrial sector" company" are eliminated because they are the most highly correlated with other variables. The result is shown in Table 8-17. It can be seen that "number of shareholders", "age" and "association with "multinational" make a unique contribution to the prediction of the dependent variable, significant at the 5% level of significance. Multicollinearity is checked as above with the maximum condition index being 32.37, where it begins to become severe. Normality was also checked as above with

the maximum Mahalanobis distance being 43.44: eliminating companies 10 and 18 reduces this number to an acceptable 20.04 but raises the maximum condition index to 35.73, while leaving the significances of the numbers in Table 8-17 unchanged.

Table 8-17: Regression analysis: determinants of S&P Survey scores for annual reports

Multiple R	0.768	**Mean square error**			0.004
R^2	0.590	**F**			5.046
$_{adj}R^2$	0.473	**F-significance**			0.001
Std. error	0.063				
Variables	**B**	**Std Error**	**Std Coeff: β**	**t-value**	**t-sig.**
Constant	0.582	0.110		5.319	0.000
Number of shareholders	0.045	0.017	0.408	2.560	0.016
Age	-0.118	0.054	-0.270	-2.179	0.038
Leverage	-0.002	0.001	-0.307	-1.981	0.057
Company auditor firm B	0.020	0.043	0.065	0.468	0.644
Association with multinational	0.065	0.025	0.377	2.656	0.013
Agricultural company	0.027	0.024	0.149	1.135	0.266
Profitability	0.000	0.001	-0.029	-0.207	0.837
Liquidity	0.002	0.001	0.210	1.593	0.122

8.4.2.1 Summary of results and interpretation

Tables 8-3 to 8-11 for univariate analysis and Tables 8-16 and 8.17 for multivariate analysis show that S&P Survey scores are associated (in order of contribution) positively with "the number of shareholders" (ownership diffusion) and "being associated with a multinational", and negatively with "the age of the company". Univariate analysis finds S&P Survey scores also negatively associated with "leverage" and positively with "being an agricultural sector company"; controlling for other factors, multivariate analysis finds no association. This is summarized in Table 8-18.

Khanna et al. (2004) take the S&P Survey scoring system as an index of convergence to US

Table 8-18: Univariate and multivariate results S&P Survey Scores (5% sig.)

Research Hypotheses: S&P Survey scores	Significance Supported		Exp-ected Sign	Sign Supported	
	Univariate	Multivariate		Univariate	Multivariate
Company size	not supported	not supported	+	not supported	not supported
No. of shareholders	**supported**	**supported**	+	**supported**	**supported**
Shareholding of holding or investing co	not supported	not supported	+	not supported	not supported
Age of the company	**supported**	**supported**	+	**contradicted**	**contradicted**
Leverage of company	**supported**	not supported	+	**contradicted**	not supported
Dividend payout ratio	not supported	not supported	+	not supported	not supported
Company auditor B	not supported	not supported	-	not supported	not supported
Subsid/assoc of MNC	**supported**	**supported**	+	**supported**	**supported**
Agricultural company	**supported**	not supported	?	not applic.	not applic.
Commercial comp.	not supported	not supported	?	not supported	not supported
Investment company	not supported	not supported	?	not supported	not supported
Industrial company	not supported	not supported	?	not supported	not supported

disclosure practices, which are adopted by multinationals. Their affiliates in Kenya would tend to do likewise. From Appendix 7-2, quoted Kenyan companies in general score highly on S&P financial information (mean 78.4%) and S&P ownership structure (63.7%); in the S&P shareholder rights category (Kenyan mean 40.4%), a number of items are irrelevant to all Kenyan companies – for example the transparency of the way that shareholders nominate directors to the board or convene an extraordinary general meeting. Affiliates of multinationals score more highly than Kenyan companies in providing information about the board of directors and management, and their remuneration: from the viewpoint of multinationals, Kenyan salaries are much lower than those in Europe (where the investing multinationals are incorporated), but generally higher than those in Kenyan companies. Board members and managers do not have to justify their remuneration to their major shareholders based in Europe: in some way, they are able to show their colleagues in business in Kenya that they are well off. They reveal information about themselves more openly. The result is that their overall scores are higher. This finding is in line with that of Barako et al. (2006) – between 1992 and 2001, NSE companies' voluntary disclosure increases with foreign and with institutional ownership.

Political costs are high for affiliates of multinationals and for companies whose ownership is widely diffused. Multinationals would like to reveal that Kenyans hold directorships and managerial posts in their affiliates and that Kenyan staff are well remunerated by the company. Individual shareholders may be envious that their fellow Kenyans are remunerated well; perceptive managers would attempt to be as open as possible about their details, their backgrounds, previous employment, and benefits from the company – these are areas where disclosure is extremely limited by NSE companies, which result in low scores in this area of the S&P index. Perceptive managers would realize that there is a need to signal their quality and reduce agency costs for the widely diffused owners by being open about these disclosures. This would enhance the managers' legitimacy and show stakeholders, other than the overseas multinational, that they are valued as a group whose information needs should be recognized.

Younger companies, with better S&P Survey disclosure, show that they are more aware of disclosures demanded internationally; there is a possibility that their directors are better educated and follow international trends better. Younger companies would want to stress their legitimacy; they would want to show shareholders that their interests in respect

of their information needs are being catered for as predicted by stakeholder theory; they would engage in mimetic isomorphism to show that they compete with older, more established companies. Older companies may tend to hold onto past disclosure practices which are less relevant today.

Univariate analysis finds leverage negatively associated with higher S&P disclosure, similar to Belkaoui and Kahl (1978) and Zarzeski (1996), but contrary to Barako et al.'s (2006) finding for NSE companies. Signalling theory would explain that lower levered companies wish to screen their financial structure by giving more disclosure (Leventis 2001) and higher levered ones disclose less to disguise their level of risk (Hossain 1999), especially when interest rates are high, as they tend to be in Kenya. This finding is not confirmed by multivariate analysis, in keeping with Wallace and Naser (1995).

Agricultural companies disclose better on their physical output, which results in their scoring more than other NSE companies in S&P's "operational and non-financial information" category; however, since these items account for only 5% of the total S&P Survey score, multivariate analysis does not confirm the association.

8.4.3 FiRe Award 2003 Scores

The same regression model specified for annual report IFRS compliance is used to evaluate associations between FiRe Award scores and corporate characteristics, except that $Bankinvco_i$ (banking & investment sector company – see Table 8-11) is substituted for $IndAllco_i$ (industry & allied sector company). The specification of the regression model for annual report FiRe Award scores is:

$Y_{3i} = \beta_0 + \beta_1 Size_i + \beta_2 Numshldrs_i + \beta_3 Hoishareholding_i + \beta_4 Age_i + \beta_5 Leverage_i + \beta_6 Divpor_i + \beta_7 Aud_i + \beta_8 MNC_i + \beta_9 Agrico_i + \beta_{10} Comservco_i + \beta_{11} Bankinvco_i + \beta_{12} Profitability_i + \beta_{13} Liquidity_i + \varepsilon_i$: where: $i = 1, \ldots, 47$, number of the company;

Y_{3i} = annual report FiRe Award score measured as a proportion; and independent variables have the meaning assigned to them in section 8.4.1 above. If all the independent variables are entered into the regression model, multicollinearity is extremely severe: the maximum condition index is 114.59. If $Numshldrs_i$ ("number of shareholders": tolerance 0.001), $Divpor_i$ ("rank of the dividend payout ratio": tolerance 0.054) and MNC_i ("association with a multinational": highly correlated with "shareholding of holding/investing co") are removed, multicollinearity is reduced: the maximum condition index is 35.66, at which it begins to be severe, even though the other numbers are well within the rule of thumb

Table 8-19: Regression analysis: determinants of annual report FiRe Award 2003 scores

Multiple R	0.835	**Mean square error**			0.002
R^2	0.698	**F**			3.230
$_{adj}R^2$	0.482	**F-significance**			0.023
Std. error	0.048				
Variables	**B**	**Std Error**	**Std Coeff: β**	**t-value**	**t-sig.**
Constant	0.618	0.109		5.646	0.000
Size (log of profit)	0.002	0.001	0.395	2.158	0.049
Shareholding of holding/investing co	0.001	0.000	0.467	2.349	0.034
Age	0.062	0.063	0.165	0.994	0.337
Leverage	0.011	0.024	0.080	0.483	0.637
Company auditor firm B	-0.062	0.040	-0.262	-1.535	0.147
Agricultural sector company	0.038	0.042	0.160	0.904	0.381
Commercial & services sector co.	0.009	0.036	0.051	0.250	0.807
Banking & investment sector co.	0.073	0.038	0.508	1.924	0.075
Profitability	-0.001	0.001	-0.277	-1.108	0.287
Liquidity	-0.001	0.001	-0.107	-0.369	0.718

guidelines. The maximum Mahalanobis distance is 23.43 which is below the critical number 29.59 for 10 independent variables given by Table C4 in Tabachnick and Fidell (2001, p.933). The results are shown in Table 8-19. If "company auditor firm B", "agricultural sector company" and "banking and investment sector company" which are significantly correlated to "profitability", "shareholding of holding/investing company" and "commercial and services sector company" are eliminated from the model, the maximum condition index is reduced to 33.19: multicollinearity is still severe but reduced. "Size" and "shareholding of holding/investing company" remain significant and the other variables remain insignificant.

An alternative model is developed by substituting "the rank of the number of shareholders" for "company size" in the model underlying Table 8-19. The result is shown in Table 8-20. "Agricultural sector company" is highly correlated with "the rank of the number of shareholders" and is eliminated. "Association with a multinational" is introduced: its high correlation with "shareholding of holding/investing company" seems to have no effect on multicollinearity. For this model, the maximum condition index is 10.04, indicating that multicollinearity is low. The maximum Mahalanobis distance is 32.43. If company 10 is removed and the regression is run again, numbers very similar to those in Table 8-20 are obtained, the maximum condition index becomes 10.27 and the maximum Mahalanobis distance is reduced to 27.64, below the critical value of 29.59 given by Table C4 in T&F (p.933) for ten independent variables.

The conclusion is that FiRe Award 2003 scores are associated significantly at the

Table 8-20: Regression analysis: determinants of FiRe Award 2003 scores for annual reports including number of shareholders

Multiple R	0.871	**Mean square error**			0.002
R^2	0.759	**F**			3.782
$_{adj}R^2$	0.558	**F-significance**			0.016
Std. error	0.045				
Variables	**B**	**Std Error**	**Std Coeff: β**	**t-value**	**t-sig.**
Constant	0.735	0.037		19.738	0.000
Number of shareholders (rank)	0.004	0.001	0.681	3.810	0.002
Shareholding of holding/investing co	0.001	0.000	0.471	2.477	0.029
Age	0.001	0.000	0.328	2.015	0.067
Leverage	0.003	0.024	0.022	0.133	0.896
Company auditor firm B	-0.077	0.041	-0.327	-1.898	0.082
Association with multinational	-0.043	0.028	-0.325	-1.535	0.151
Commercial & services sector co	-0.017	0.029	-0.096	-0.586	0.569
Banking & investment sector co	0.004	0.023	0.025	0.152	0.881
Profitability	0.001	0.001	0.320	1.662	0.122
Liquidity	-0.001	0.001	-0.085	-0.526	0.609

5% level of significance (in order of contribution) with "the number of shareholders" (ownership dispersion), "the shareholding of the holding or investing company" and "the size of the company". Although univariate analysis finds that "multinationality" and "industry type" are significantly associated with high quality disclosure proxied by FiRe Award scores, this is not borne out by the multivariate analysis; when other factors are controlled for, it is found that there is no association between these variables and high quality disclosure.

8.4.3.1 Summary of results and interpretation

Table 8-21 summarizes Tables 8-3 to 8-11 for univariate analysis and Tables 8-19 and 8-20 for multivariate analysis[7]. The FiRe Award competition assesses the quality of both mandatory and voluntary disclosure. Its scoring system is more subjective that using a pre-determined disclosure checklist, although ICPAK encourages adjudicators to use checklists prepared by firm E (ICPAK 2003b).

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[7] On 30 December 2002, the Presidency was handed over to Mwai Kibaki by Daniel arap Moi: the opposition parties, united to form the National Alliance Rainbow Coalition, gained the majority of seats in Parliament in the elections a few days previously, and the coalition's leader won the Presidential vote. There was a feeling in the business community that conditions imposed by the IMF and World Bank would be met by the new Government (Carson 2003). Business confidence rose and there was a rise in share prices across the board (Kestrel Capital 2004). Both univariate and multivariate analysis find a positive association at the 1% level of significance between high quality disclosure proxied by FiRe Award scores and the rank of the share price increase in the three months to 31 March 2003. This association has been omitted from consideration, since the share price increase may have been dependent on high quality disclosure rather than vice versa. Simultaneous equations would need to be used to enquire further into this relationship but it is considered beyond the scope of the present study to engage in further analysis of this association.

Table 8-21: Univariate and multivariate results FiRe Award Scores (5% sig.)

Research Hypotheses: FiRe Award Scores	Significance Supported		Exp-ected Sign	Sign Supported	
	Univariate	Multivariate		Univariate	Multivariate
Company size	**supported**	**supported**	+	**supported**	**supported**
No. of shareholders	**supported**	**supported**	+	**supported**	**supported**
Shareholding of holding or investing co	**supported**	**supported**	+	**supported**	**supported**
Age of the company	not supported	not supported	+	not supported	not supported
Leverage of company	not supported	not supported	+	not supported	not supported
Dividend payout ratio	not supported	not supported	+	not supported	not supported
Company auditor B	not supported	not supported	-	not supported	not supported
Subsid/assoc of MNC	**supported**	not supported	+	**supported**	not supported
Agricultural company	not supported	not supported	?	not applic.	not applic.
Commercial co.	**supported**	not supported	?	not applic.	not applic.
Bank & invest. co.	**supported**	not supported	?	not applic.	not applic.
Industrial company	not supported	not supported	?	not applic.	not applic.

The association between company size and high quality disclosure as proxied by FiRe Award scores is in line with many prior studies; larger companies are able to employ more capable staff involved in the production of the annual report, and a larger number of them; larger companies would want to signal their quality by reporting with high quality disclosure; their reporting with high quality disclosure can be explained by agency theory, political cost theory, their desire to be understood to the same degree as less complex, smaller companies, and their realizing that they report information to a large number of customers and suppliers.

Social responsibility and environmental reporting makes up 10% of the possible maximum score in the FiRe Award 2003. Large companies disclose with high quality in this area to substantiate their legitimacy, to reduce political costs, to manage the various social contracts they have with different stakeholder groups, to illustrate that they have accommodated the wishes of these stakeholders by adopting their concerns (coercive isomorphism) and follow what the largest companies around the world do (mimetic isomorphism). Certain companies, especially those which trade in commodities which can be harmful to the health of their customers, could be said to engage in decoupling, in so far as they promote extensive use of their products while they call for moderation in their use: they report the safety measures taken to avoid accidents in their factories but make no mention of fatalities among those who use their products.

Larger companies tend to have larger numbers of shareholders. For the same reasons as stated above, it is to be expected that companies with a more widely dispersed

ownership should disclose with higher quality to minimize agency and political costs, and to signal their superior quality. This finding is in agreement with Barako et al. (2006), who find disclosure and ownership concentration negatively associated for NSE companies from 1992 to 2001. Some individual shareholders of the larger companies in Kenya have their share certificate framed and hanging in their sitting rooms to show visitors that they have a stake in this widely admired entity: they also often have annual reports on coffee tables (Kenyans generally spend little money on books other than school books for their children, see Odini 2000): perceptive managers would be aware of this practice, and would ensure that the annual report acts as a good advertisement for the company; they would be aware that visitors will peruse the document – it would not be a good advertisement for the company if a visitor who is an accountant points out shortfalls in disclosure in the annual report.

Companies in which the shareholding of their holding or investing companies is larger are associated with higher quality disclosure as proxied by the FiRe Award score. The managers of these companies report with higher quality disclosure to ensure that they show that they are working for the benefit of the major shareholder, as predicted by agency and stakeholder theory. At the same time, they realize that their companies' political and legitimacy "costs" increase with the increase in the size of the shareholding by the holding or investing companies – since free float available to the investing public at large will be smaller. For these reasons they will also ensure disclosure is high quality. They will ensure disclosure is higher quality for minority shareholders in line with predictions from stakeholder theory. On one occasion in the past, minority shareholders voted down an increase in the directors' remuneration of Kakuzi Limited because of a poorly worded resolution.

Univariate analysis also finds FiRe Award scores associated positively with "being an affiliate of a multinational" (possible reasons why this is so are detailed in 8.4.2.1) and "being a banking and investment company" (they have higher political and legitimacy costs, and a higher level of regulation) and negatively with "being a commercial and service company" (competition between these companies and a large number of unquoted businesses makes them more hesitant to improve disclosure). However, these findings are not confirmed by multivariate analysis.

8.4.4 Overall conclusion on high quality disclosure in annual reports

The three different proxies used in this study for high quality disclosure are found to be associated with three sets of company variables which are almost completely disjoint from one another; there is an overlap between the two sets of company variables associated with S&P Survey and FiRe Award 2003 scores – ownership dispersion: the numbers of shareholders in companies. Table 8-22 summarizes the results shown in Tables 8-15, 8-18 and 8-21: it shows the associations and the directions of the association.

Table 8-22: Associations and signs found by multivariate analysis (5% sig.)

Research Hypotheses:	IFRS	S&P	FiRe Award
Company size	n/s	n/s	**+ supported**
Number of shareholders	n/s	**+ supported**	**+ supported**
Shareholding of holding or investing company	n/s	n/s	**+ supported**
Age of the company	n/s	**- supported**	n/s
Leverage of company	n/s	n/s	n/s
Dividend payout ratio	**+ supported**	n/s	n/s
Company auditor firm B	**- supported**	n/s	n/s
Subsidiary or associate of multinational	n/s	**+ supported**	n/s
Agricultural sector company	n/s	n/s	n/s
Commercial and services sector company	n/s	n/s	n/s
Banking and investment sector company	n/s	n/s	n/s
Industrial and allied sector company	n/s	n/s	n/s

Key: n/s = not supported

This finding calls into question the practice of researchers developing a disclosure checklist, measuring disclosure using this checklist and finding associations between company and market variables and disclosure scores.

Researchers often select a disclosure index that has been used in a prior study, for example, to measure mandatory or voluntary disclosure. If the latter, some of the items in the index are mandated by the laws of the environment in which they want to apply the index; these items are eliminated and "voluntary disclosure" is measured using the amended index. When associations between mandatory or voluntary disclosure (the latter as measured by this amended index), and company and market variables are established, conclusions are often found which are "in line with" or "contrary to" earlier findings in the same environment or in a different environment.

However, this study shows that if disclosure is measured in a single environment using three different disclosure indices, almost entirely different company and market variables are found to be associated with each index. Researchers use an index to measure the

abstract concept of "disclosure"; each index in fact measures a different construct, which invariably will contain a certain amount of noise.

The question then arises: what is the best index to use to measure disclosure, whether mandatory, or voluntary, or a composite of the two? And would it be expected to be associated with identical company characteristics in different stock exchanges? Does an international index, eg., IFRS disclosure, fit all countries? Further research is required to answer these questions.

What is clear from the results obtained in this part of this study is that the practice of finding associations with disclosure measured by an index needs to be re-thought: each new index developed is likely to produce an association with a different set of variables, or possibly, the same set: the association depends on the index selected for the study more than the "disclosure". More time has to be given in justifying why the index selected will give a true measure of the abstract concept "disclosure".

8.4.5 Interim Financial Reports

From Tables 8-12 and 8-13, test variables are: "size", "agricultural / banking / industrial sector company", "year end 31 December" and "audit firm E". Half-yearly interim financial reporting by NSE companies is mandatory; ineffective surveillance by regulators means that, in practice, it is voluntary. Control variables for multinationality, age, profitability (all Owusu-Ansah 1998), leverage (Barako et al. 2006) and liquidity are included in the model: size and industry type (Barako et al.2006) are covered by test variables. The specification of the regression model for interim financial report compliance with IAS 34: *Interim Financial Reporting* is:

$Y_{4i} = \beta_0 + \beta_1 Size_i + \beta_2 Agrico_i + \beta_3 Bankinvco_i + \beta_4 IndAllco_i + \beta_5 Coyrend_i + \beta_6 Aud_i + \beta_7 MNC_i + \beta_8 Age_i + \beta_9 Profitability_i + \beta_{10} Leverage_i + \beta_{11} Liquidity_i + \varepsilon_i$: where:

Y_{4i} = interim report IAS 34 compliance score measured as a rank, with 1 assigned to the lowest and 47 assigned to the highest score; i = 1, ...47, company number ;

1. $Size_i$ = total assets at company year end;
2. $Agrico_i$ = 1 if the company is in the agricultural sector, = 0 otherwise;
3. $Bankinvco_i$ = 1 if the company is in the banking & investing sector, = 0 otherwise;
4. $IndAllco_i$ = 1 if the company is in the industrial & allied sector, = 0 otherwise;
5. $Coyrend_i$ = 1 if the company's year end is 31 December, = 0 otherwise;
6. Aud_i = 1 if the company's auditor is firm E, = 0 otherwise;

Control variables:

7. MNC_i = 1 if the company is an affiliate of a multinational, = 0 otherwise;

8. Age_i = log of the age of the company;

9. $Profitability_i$ = net profit divided by shareholders' funds;

10. $Leverage_i$ = rank (lowest = 1, highest = 47) of long-term debt to debt plus equity;

11. $Liquidity_i$ = rank (lowest = 1, highest = 47) of quick ratio; ε_i = error term;

β_i = parameters, with the constant β_0 adjusting for any excluded dummy variables.

Table 8-23: Regression analysis: interim report IAS 34 compliance transformed to ranks

Multiple R	0.831	**Mean square error**			72.001
$\mathbf{R^2}$	0.690	**F**			6.893
$_{\mathbf{adj}}\mathbf{R^2}$	0.590	**F-significance**			0.000
Std. error	8.485				
Variables	**B**	**Std Error**	**Std Coeff: β**	**t-value**	**t-sig.**
Constant	37.618	13.128		2.866	0.007
Size (total assets)	0.000	0.000	0.109	0.860	0.396
Agricultural sector company	20.336	5.039	0.437	4.036	0.000
Banking & investment sector co.	11.373	4.483	0.370	2.537	0.016
Industrial & allied sector co.	-4.232	3.267	-0.154	-1.296	0.204
Company year end 31 December	7.673	3.062	0.292	2.506	0.017
Company audited by firm E	4.659	2.988	0.172	1.559	0.128
Association with multinational	-4.373	2.925	-0.167	-1.495	0.144
Age (log)	-11.571	6.860	-0.174	-1.687	0.101
Profitability	0.005	0.094	0.005	0.050	0.961
Leverage	0.000	0.159	0.000	0.002	0.999
Liquidity	0.035	0.125	0.037	0.283	0.779

The details of the result are included in Table 8-23. Multicollinearity once again is severe with the maximum condition index being 34.34, although the entries in the matrix of bivariate correlations are all below 0.7 (the highest is the correlation between leverage and liquidity at 0.644) and the minimum tolerance is 0.395 (above the cut-off figure of 0.1: the maximum variance inflation factor is therefore 2.533, well below the cut-off figure of 10). Normality is checked; no deviations from normality are found (the maximum Mahalanobis distance is 25.33, below the critical value of 31.26 mentioned in section 8.4.1.1 above).

From Table 8-23, it can be seen that the quality of disclosure in interim financial reports, measured by compliance with IAS 34, is positively associated (in order of explanatory contribution) with the company being in the agricultural sector (at the 1% level of significance) or in the banking and investment sector, and having a 31 December year end (the latter two at the 5% level of significance).

8.4.5.1 Summary of results and interpretation

Table 8-24 summarizes the findings: univariate analysis finds high quality disclosure in interim reports, proxied by IAS 34 compliance scores, associated with (1)"size" (+), "being an (2) agricultural (+) / (3) banking (+) / (4) industrial (-) sector company", (5) "having a Dec 31 year end" (+) and (6) "being audited by firm E" (+). Multivariate analysis confirms only the second, third and fifth. As Tabachnick and Fidell (2001, p. 116) point out, a regression solution is extremely sensitive to the combination of variables included in it: whether a variable appears particularly important in a solution depends on the other independent variables in the set.

Table 8-24: Univariate and multivariate results: Interim Financial Report compliance with IAS 34: *Interim Financial Reporting*

Research Hypotheses: Interim reporting	Significance Supported		Exp-ected Sign	Sign Supported	
	Univariate	Multivariate		Univariate	Multivariate
Company size	supported	not supported	+	supported	not supported
Agricultural sector co	supported	**supported**	+	supported	**supported**
Banking & inv co	supported	**supported**	+	supported	**supported**
Industrial & allied co	supported	not supported	-	supported	not supported
Co year end 31 Dec	supported	**supported**	+	supported	**supported**
Company auditor E	supported	not supported	+	supported	not supported

The average quality of disclosure in interim financial reports of NSE quoted companies is so low in the period considered by this study that the use of the phrase "high quality disclosure" is inappropriate when applied to interim reports, except possibly for the best three.

As predicted by agency theory in section 6.4.2, agricultural companies comply best with IAS 34 when announcing their interim results. Banks have strong incentives to comply with Central Bank of Kenya regulations, which ensure slightly better than average disclosure. The financial sector is composed of 8 banks, 2 insurance companies and an investment trust. The latter three companies each achieve 27.8%, not far above the minimum score, 22.2%, for NSE companies. The banks' scores range from 31.6% to 47.1%, raising the mean score for this group to 34.06%, which is significantly higher than 29.95% the mean for the remaining 36 NSE companies. No quoted bank produces an interim report which is 100% compliant with IAS 34, whereas at least one non-quoted bank, The Commercial Bank of Africa Limited, does so, for the period examined by this study, matching the score achieved by agricultural company 39. The smaller quoted banks

produce information additional to what is laid down by the Central Bank; the two largest banks which hold 71.4% of deposits in Kenya (Ngotho 2005), each scored 35.3%.

The third characteristic significantly associated with disclosure in NSE companies' interim reports is having a 31 December year end. The two companies (one agricultural, one industrial) with the highest interim report scores both have 30 September year ends; but four of the five remaining companies with that year end have the lowest score possible. 25 companies have a 31 December year end; only 3 of these have the lowest score possible; companies that have a 31 December year end have a mean score of 31.4% as opposed to 30.4% for the remaining 22 NSE companies. All the banks have a 31 December year end but make up only 8 of the 25 companies: there must be other factors which raise the quality of disclosure. The fact that the weather is cooler in July when accountants prepare interim reports for 31 December year end companies, and that they are less distracted at this time of the year, could be possible reasons why this is the case.

Univariate analysis finds interim report IAS 34 compliance scores associated positively with "size" (in line with agency, signalling and political cost theories, cost benefit analysis considerations, legitimacy, stakeholder and institutional theory) and "being audited by firm E" (in line with the expectations formed in section 6.4.4) and negatively with "being an industrial and allied sector company" (on the basis of the expectations formed in section 6.4.2): multivariate analysis fails to confirm these.

8.5 Summary and conclusions

This chapter presents the results and discusses issues related to univariate and multiple regression analysis.

Univariate analysis (8.3) shows that, for annual reports: (a) the first measure of high quality disclosure, compliance with IFRSs, is significantly related positively to the dividend payout ratio of the company and negatively to whether the company's auditors are firm B. No significant association is found for company size, the number of shareholders, the shareholding in the company owned by the holding or investing company, the age of the company, its gearing, whether it is a subsidiary or associated company of a multinational, and its industrial sector; (b) the second measure of high quality disclosure, the S&P Survey score, is significantly related positively to the number of shareholders, whether the company is an affiliate of a multinational and whether the company is an agricultural company, and negatively to the age and the leverage of the company. No significant association is found for

company size, the shareholding in the company owned by the holding or investing company, the dividend payout ratio, and whether the company is audited by firm B; and (c) the third measure of high quality disclosure, the Financial Reporting (FiRe) Award 2003 score, is significantly related positively to company size, the number of shareholders in the company, the shareholding of its holding or investing company, whether the company is an affiliate of a multinational, whether it is a banking and investment sector company and negatively to whether it is a commercial and services sector company. No significant association is found for the age or leverage of the company, its dividend payout ratio, whether it is audited by firm B and whether it is an agricultural company. Univariate analysis also shows that high quality disclosure in the interim financial report, measured by compliance with IAS 34, is significantly associated, positively with company size, whether the company is agricultural or banking and investment sector, or has a 31 December year end, or whether it is audited by firm E, and negatively with whether it an industrial and allied sector company.

Although associations are brought out using univariate analysis, greater reliance is placed on multiple regression analysis, since it controls for the effects of the other independent variables in the equation.

Multivariance analysis finds no association between IFRS compliance (and FiRe Award scores) and whether the company is a subsidiary or associate of a multinational. This gives empirical proof of the falsity of the World Bank's claim reported in section 6.3.8, which was: "*except for local subsidiaries of multinational enterprises, the corporate sector in general does not have access to adequately trained accountants*" (WB 2001). Company size is not associated with IFRS disclosure and S&P survey scores: this shows that for the more technical size of financial reporting, a single accountant who tries to ensure compliance with IFRS and Capital Market Authority rules (which ensures a higher S&P scores), who is ready to go through the tedium of ensuring compliance, is more effective than even a large team, each of whom has a hazy knowledge of these requirements.

Section 8.4 explains assumptions behind the multiple regression analysis model. A regression model is developed and is used to analyse associations between high quality disclosure in annual reports: (a) IFRS compliance is found to be associated, in order of explanatory contribution, positively with the dividend payout ratio and negatively with whether or not the company auditor is firm B; (b) the S&P Survey score is found to be associated, again in order of explanatory contribution, positively with the number of

shareholders, positively with being an affiliate of a multinational, and negatively with age; (c) the FiRe Award score is found to be associated, again in order of explanatory contribution, positively with the number of shareholders, shareholding of the company's holding or investing company and size. Disclosure theories are used to interpret the results in the context of Kenya.

A major finding in this chapter is that different indices used to measure "high quality disclosure" in annual reports published by NSE companies in the period of study are associated with almost completely different sets of company and market characteristics – the one exception being "the number of shareholders", associated with both S&P Survey and FiRe Award scores. This finding questions the practice of using disclosure indices to measure the abstract concept "disclosure". Further thought and research is needed to investigate whether a "best" index exists and whether it can be expected to be associated with the same characteristics in all markets, to introduce greater robustness to disclosure index methodology.

Section 8.4.5 describes the development of a separate regression model which finds that high quality disclosure in interim financial reports, measured by IAS 34 compliance, is positively associated, in order of explanatory contribution, with being an agricultural sector, or a banking and investment sector, company, and having a 31 December year end. Agency theory, regulation and working environment were used to interpret this finding.

These models provide some of the factors explaining the variability in high quality disclosure in annual and interim reports produced by NSE companies in the period reviewed. However, a significant portion of the variation in the quality of disclosure remains unexplained. One reason why this is so is that information theories are not fully developed: the models based on these theories therefore lack full explanatory powers. Another reason is the unavailability of data: this restricts the number of explanatory variables that can be considered, eg., major shareholdings in NSE companies. Also, some of the assumptions outlined in section 8.4 may have been violated.

A number of insights into high quality disclosure in annual and interim reports published by NSE companies in the period of study have been arrived at using quantitative methods above. Interview research, reported in the following chapter, will be used to confirm, complement and question these findings. The chapter on interview research will conclude with a discussion of how the two sets of findings complement each other.

CHAPTER 9
Perceptions of experts in Kenya regarding High Quality Financial Reporting

9.1 Introduction

This chapter addresses the third empirical research question, (EQ_3, section 1.5.2), which is: "What are the perceptions of preparers, auditors, regulators and analysts of 'high quality financial reporting' and how do these observations help the interpretation of the quantitative results of this study?"

The aim of the chapter is to report on the insights obtained by investigating the views of preparers, auditors, regulators and analysts of corporate financial reports. Semi-structured interviews were planned to gather information which would have been omitted in an investigation that was restricted to a quantitative study of high quality disclosure in financial reporting. As a result, a clearer understanding of "what is high quality financial reporting" is obtained. Answers to the following questions will be sought. What is the meaning of the phrase when used by accounting experts in Kenya? Is this meaning similar to its meaning when used elsewhere in the world? Is it a simple or complicated construct? Is it something objective or subjective? Is it something achievable or does it exist only in the mind? Can the pressures which militate against its being achieved be exposed? Can the results of the quantitative study be explained or queried? Can the tensions present in trying to produce high quality financial reports be exposed?

Interview research can reinforce, complement, question or challenge the prior literature or the quantitative research (reference will be made to an earlier section), or generate new ideas (dealt with in chapter 10) which may not have been exposed by the quantitative research, as shown in Table 9-1 below. Conversely, sometimes quantitative research contradicts views held by experts: eg., the World Bank's statement that only

Table 9-1: Interaction between Quantitative & Interview Research

Research finding regarding disclosure quality (Q)	Quantitative Research (QR)	Interview Research (IR)	Effect of IR on QR
Ineffective regulation leads to low Q	Section 7.2.5	Section 9.3.1	Reinforce
Banks' interim reports little above average	Section 8.4.5.1	Section 9.3.3	Reinforce
IFRS non-compliance: lack of knowledge	Section 7.2.1	Section 9.7.3	Complement
FiRe scores/size assoc: big team helps Q	Section 8.4.3.1	Section 9.5.1	Complement
Agency - high Q: shareholders understand?	8.4.1.3, 8.4.3.1	9.5.1 – patience	Question
Discussing high quality financial reporting leads to clearer ideas about the concept	–	Section 9.3.1	Generate new finding
There is/is not connection between the price of shares on the NSE and disclosure quality	Section 8.4.3.1	Section 9.3.1	QR contradicts IR

associates of multinationals have access to adequately trained accountants (6.3.8), or experts in Kenya stating that there is no connection between high quality disclosure and the price of shares on the NSE (9.3.1). No interview research findings challenged the quantitative research findings.

This chapter is organized as follows. Section 9.2 states the main objectives of the interview research. Sections 9.3 and 9.4 deal with the perceptions of the meaning of high quality financial reporting and of the purpose of the financial report. Sections 9.5 and 9.6 examine whether financial reporting disclosure by listed companies in Kenya can be said to be high quality and how it compares with that of other countries. Section 9.7 presents the opinions of experts as to whether or not the introduction of IFRSs has improved the quality of financial reporting disclosure in Kenya. Section 9.8 presents a summary and the conclusions of the contribution of the interview research.

9.2 Objectives of the interview research

A quantitative study is unable to explore certain aspects of disclosure. A number of preparers of financial reports may not comply with International Financial Reporting Standards (IFRSs), or may, or may not, supply voluntary information, for a variety of reasons other than those which can be discovered by quantitative methods. These reasons can be established by means of a one-to-one discussion rather than a survey. Some preparers of financial statements of companies listed on the NSE spend a substantial amount of time gearing up the Board of Directors for potential queries that can arise at the Annual General Meeting (AGM) of their company. They ensure that every possible question which they think may be raised at the AGM is put to the Board before the AGM so that a convincing response can be prepared to be given at the AGM. A confidential meeting may well reveal real reasons for some disclosures, rather than ones that would placate a gathering of shareholders. This researcher knows many of the persons involved in the production, audit, analysis and regulatory examination of the financial reports of companies quoted on the Nairobi Stock Exchange (NSE). This made access easy. The possibility of having frank discussions was enhanced. But the researcher had to be extremely careful to avoid pre-judging facts that were revealed in the interviews. This familiarity could introduce bias. A conscious effort had to be made to ensure that interviewees were able to state their position without any influence on the part of the interviewer – such as a change in the tone of voice, a surprised look, or a smile when some

fact was revealed. In spite of these efforts, there was still the possibility of bias. This was acknowledged at the start of the interview process; every effort to minimize it was made.

The interviews were reckoned to be a means by which extensions to the research findings and interpretations of the quantitative study could be made. This interview research aims to assist achieving the general objective of this study **GO** (1.3). This general objective is divided into three sub-objectives, $\mathbf{GO_1}$, $\mathbf{GO_2}$ and $\mathbf{GO_3}$. $\mathbf{GO_1}$ is to contribute to an understanding of the meaning of the phrase "high quality financial reporting" and to clarify the distinction between "high quality disclosure" and "high quality measurement". $\mathbf{GO_2}$ is to contribute to understanding the applicability of disclosure theories to a capital market in a developing country with particular reference to high quality disclosure. $\mathbf{GO_3}$ is to contribute to understanding the relevance of IFRSs in achieving high quality disclosure in financial reporting to investors in a developing country. The interview objectives $\mathbf{IO_i}$ are:

$\mathbf{IO_1}$: To obtain opinions as to what is meant by high quality financial reporting, how it can be achieved and whether there is any link between the price of a company's share and the quality of its financial reporting.

$\mathbf{IO_2}$: To explore opinions as to the audience for financial reports and their purpose.

$\mathbf{IO_3}$: To gather opinions as to whether financial reporting by quoted companies in Kenya is high quality.

$\mathbf{IO_4}$: To explore views as to whether the quality of financial reporting by quoted companies in Kenya is comparable with that of companies listed on other stock exchanges.

$\mathbf{IO_5}$: To obtain opinions as to whether the introduction of IFRSs improved the quality of financial reporting by listed companies in Kenya.

Table 9-2: Interview objectives and general objectives

Interview Objectives (IO)	Chapter Sections	General Objectives (GO)
$\mathbf{IO_1}$	9.3	$\mathbf{GO_1, GO_2, GO_3}$
$\mathbf{IO_2}$	9.4	$\mathbf{GO_1}$
$\mathbf{IO_3}$	9.5	$\mathbf{GO_1}$
$\mathbf{IO_4}$	9.6	$\mathbf{GO_1}$
$\mathbf{IO_5}$	9.7	$\mathbf{GO_2, GO_3}$

9.3 The meaning of "high quality financial reporting"

The purpose of this section is to report the perceptions of accounting experts in Kenya as to what is meant by "high quality financial reporting", how can "high quality financial reporting" be achieved, how important it is to have a knowledgeable auditor involved in the financial reporting process, whether additional reports in the

annual report add to the quality of financial reporting and whether there is any link between the price of a company's shares on the Nairobi Stock Exchange (NSE) and the quality of the company's financial reporting. Table 9-2 summarizes the results to this set of questions.

Table 9-3: Perceptions of accounting experts on high quality & how to achieve it

What makes the corporate annual report high quality:	39 Controllers	4 Regulators	3 Auditors	10 Analysts	56 Total
IFRS compliance alone?	6	0	0	0	6
A combination of various factors?	32	4	3	10	49
Necessary for high quality:					
IFRSs & regulations knowledge?	38	4	3	10	55
Knowledgeable auditor?	39	4	3	10	56
Additional reports in annual rep?	26	4	3	10	43
Any link between share price and quality of financial reporting?	0	0	0	0	0

9.3.1 Preparers' perspectives

The experience in nearly all interviews was that as the interview progressed, many interviewees would change their stance; they came around to seeing quality as a much richer concept than at the start of the interview. A sizeable number came to realize the importance of the Chairman's Statement being an informative document. There were exceptions; some held on to their views and changed little.

6 financial controllers (controllers) of companies quoted on the Nairobi Stock Exchange believed that IFRSs on their own ensured that financial reporting would be "high quality", because standardization in itself ensured that readers of the accounts obtained all the information they needed.

32 of the 39 controllers stated that compliance with IFRSs, combined with clarity of exposition of the accounting policy notes and the notes to the financial statements, together with accuracy in the accounting numbers and the timely communication of these numbers to shareholders were the hallmarks of high quality financial reporting.

The controllers of companies 4, 12 and 36 stated that "high quality" was a relative term. If the corporate annual reports of companies listed on the NSE were compared to those of unlisted companies, they would be declared to be high quality; but compared to those of US or UK listed companies, they may not appear as if they were high quality. One added that quality was constantly changing - each year companies quoted on the NSE gave more information; but even more information was still demanded by analysts.

26 controllers stated that the Chairman's Statement and/or the management review should give a good overview of the business; if these did not give a clear explanation of the

figures in the financial statements, the financial reporting would not be high quality. because users would not have a clear explanation of the figures that appear in the financial statements. 14 referred to the importance of relevance.

9 controllers stated that if fund managers wanted to invest in their company, the fund managers would first examine past annual reports in detail and then interview the controller to clear up any queries that had arisen from this examination and seek additional information. If the controllers had included this additional information in the original annual reports, it would probably have been irrelevant for individual shareholders. These controllers all agreed that drawing the line between useful information and non-useful information for users becomes subjective and increasingly difficult to weigh up as one approaches an "optimum amount". More sophisticated users generally demand more information because they are aware of the interaction of the many forces which drive the financial success of the company. Individual shareholders tended to be "rural folk" who were interested only in the dividend (and a calendar for the new year if the date of the AGM was late in the calendar year) and expected a dividend whenever the company made a profit (even if this was legally impossible because of accumulated losses which was the case in company 36); this was at odds with Wagacha's (2000) findings (section 4.2).

The controller of company 37 said that the minimum information on strategy should be given; even when this information was not given, within six months of her bank introducing a new product, many of the other banks had copied the product – the banking sector was extremely competitive; the daily newspapers were perused each day to discover what the other banks were offering. The moment one bank offered a product at a particular price, many banks would follow suit within a short space of time.

The controller of company 40 stated that the conditions necessary for high quality financial disclosure were: (1) senior accounting staff in the company must have up to date knowledge of the accounting requirements of the IFRSs and the other regulatory bodies; (2) audit firms must ensure that best practice is being adhered to; and (3) regulators must carry out effective surveillance.

10 controllers stressed that timeliness was an important aspect of "high quality". The controller of company 36 owned shares in NSE quoted companies; he would go through "everything" in the accounts if a company reported late, and more often that not, he would discover the reason for the delay. 32 controllers agreed that an increase in information

provided would improve the quality of reporting but they were aware of the existence of an optimum amount. If more information than this optimum was given, a decrease in quality occurred. The controllers of companies 3, 28 and 36 said that cost was a major constraint on the amount of information given in the annual report; giving more information took greater managerial time, cost more to print and cost more to send to members. The annual report of company 3 had possibly the greatest amount of voluntary disclosure among all the companies examined. 4 controllers mentioned that more information should continue to be given until the point where the cost of additional information becomes greater than the benefits derived from that additional information.

The controller of company 7 noted that both the New York Stock Exchange (NYSE) and the London Stock Exchange (LSE) set higher disclosure requirements than those of IFRSs and the NSE. However, he was of the view that these additional disclosures do not add information which is useful for the ordinary shareholder. While acknowledging that more detail should be given in the management report especially for analysts, he stated that a briefer, more focused and more pertinent set of financial statements would be better than voluminous ones; users should not be overwhelmed with excess information.

All the controllers felt that regulation was necessary to achieve high quality financial reporting. 9 said there were unnecessary over-laps of regulation on the part of ICPAK, the NSE, the Capital Markets Authority and the Central Bank of Kenya or the Commissioner of Insurance, which makes compliance excessively costly. 4 bank controllers stated that there was reporting over-regulation, but at the same time conceded that they did their utmost to avoid falling foul of Central Bank inspections. The controller of company 37 stated that she told the Central Bank that she was working for them, because she had to file daily, weekly, monthly and quarterly returns. The Central Bank insisted that certain information had to be given in a form different to what the IFRSs required; this caused unnecessary expense. Sometimes the same thing happened with the Capital Markets Authority. Regulators needed more coordination in their disclosure demands – "*they have to speak to one another*" (Controller company 37).

No controller thought there was any connection between the price of shares on the NSE and the quality of financial reporting. One controller summed up the general view:

> "*If there is any connection between the price of shares on the NSE and the quality of financial reporting, it is very little – high quality just makes good reading*" (Controller of company 10).

9.3.2. Buy-side analysts' perspective.

Buy-side analyst (analyst) W stated that the accounts of a company are "high quality" if they accurately reflect the economic realities of the company. Analyst S defined "high quality" more comprehensively: there should be: full compliance with the disclosure requirements of the Companies Act, IFRSs and the Capital Markets Authority; movement reconciliations for all material items in the notes and discussions of those items in a manner that non-finance professionals can understand; breakdowns of items which are summations of different components, in the notes, for further analysis; segment analysis; a management review to convey an understanding of what the business does, key risks and challenges, important cost and value drivers, the link between performance and strategy, major corporate events over the year (eg., acquisitions – their rationale and benefits), segment performance and how macro-economic factors impact performance; 5-10 year performance summaries, including important financial ratios; forward looking statements on plans; disclosure of each director's remuneration, by component and in total; and appropriate corporate governance disclosure.

The remaining analysts had definitions which were very similar to those given by the 33 controllers in section 9.3.1, except that all insisted on the importance of a management review. One analyst expressed the general view as follows:

> *"Management discussion is vital. If I look at the numbers, I may interpret them in many ways. I need to know the underlying reasons why they are as they are. Management discussion and analysis improves the quality of the annual report. And this would not be too much information for users"* (Buy side analyst X).

Analysts Y and Z sought, in addition, forward projections, but admitted that, since Kenya is largely an agricultural country and since agriculture is so dependent on the weather, forward projections were extremely difficult, not only for agricultural companies, but for those in other business sectors as well - see section 4.3 for details on the effects of rain shortages on the Kenya economy in 2000 and 2001.

One analyst spoke of the value of historical summaries:

> *"Five or ten years' summaries are very useful because I can examine the trend over this period of time even if I was not able to obtain the financial statements for the period. If I wanted to invest in the company, I would want to see its performance over a few years rather than just two"*. (Buy side analyst R)

This agrees with Baker, H. and Haslem (1973) - that the greatest importance is placed on historic data that allow investors to develop their own projections about the future.

5 analysts stated timeliness is essential for financial reporting to be high quality.

9.3.3. Regulators' perspective.

One regulator spoke immediately of the two distinct dimensions in which an annual report could be considered to be high quality: disclosure, and the numbers representing assets, liabilities and earnings. The definitions of "high quality financial reporting" were again similar to the 33 controllers mentioned in section 9.3.1, and stated that the management review an important element of the annual report of a listed company. All regulators had the view that surveillance was necessary for the production of high quality financial reporting.

Central Bank regulators stated that accounting in the banking sector was fully harmonized: all banks had to follow the format given by Central Bank and had to comply with IFRSs. They insisted that all companies under their jurisdiction followed the format laid down by them to enable easier and speedier supervision. This ensured that disclosure was high quality in the banking sector. In addition, Central Bank carried out very comprehensive surveillance of all the banks in the country, requiring them to furnish different returns on a daily, weekly, monthly and quarterly basis. Central Bank knew the largest 50 debtors of every bank in the country and examined whether these were being serviced. If they were not, provision had to be made, but the banks were "*not always*" forced to provide. As a result of this supervision, the numbers in the financial statements were also high quality. A member of Central Bank's regulation department stated:

> "*Banks disclose because they are forced to. Banks want to trade secretly. They do not want to give any information to their competitors. They tell us this when they come for their tripartite meetings with their auditors, prior to the publication of their annual reports. It is war to get them to disclose information – especially in relation to liquidity risks and interest rate risks. They do not want to reveal information about their derivatives and how they make their money. They do not want to disclose to other banks the names of customers who are defaulters because they do not want to reveal that they have a relationship with that person. The Central Bank feel it is our duty to force disclosure so that members of the public are able to find out about the financial performance and position of the bank*" (Regulator L).

Timeliness was an essential characteristic of high quality financial reporting, in the Central Bank's and Capital Markets Authority's view.

9.3.4 Auditors' perspective

All of the auditors I interviewed were from the Nairobi offices of Big 4 firms. Their definitions of "high quality financial reporting" were very similar to the first 33 controllers mentioned in section 9.3.1 above. They viewed the Chairman's Statement as important;

they would read this statement to check that it was not at variance with the general tenor of the accounts but they made clear that they did not audit this statement.

A partner in firm E and a manager in firm A pointed out that many preparers of financial statements of companies quoted on the NSE, and to an even greater extent among non-quoted companies, did the minimum amount possible to ensure that the financial statements complied with IFRSs. The three auditors I interviewed mentioned that accounting staff in companies were not as conversant as they should have been with IFRSs, and assumed that compliance with IFRSs was a matter for auditors to deal with. One summed up the position:

> "*In Kenya, few company accountants know the IFRSs well. Reliance has been placed squarely on the auditors to be experts*" (firm D audit manager).

The firm E partner pointed out that in spite of the "Statement of Directors' Responsibilities" (section 4.7.4), finance directors continued to be of the view that the company's financial statements were the responsibility of the auditors. When the results of the FiRe Award were announced in the press, some finance directors would still telephone him and ask why their company's annual report had not won this competition.

However, some improvements have occurred:

> "*With the passing of the Sarbanes-Oxley Act in the US, a number of financial departments of companies have realized that the preparation of the financial statements is their responsibility and have started taking more interest in IFRSs. They have even had the audit firms give their accounting staff training*". (firm D audit manager in charge of the audit of company 19.)

Only three Kenyan listed subsidiaries have holding companies listed on the NYSE (Companies 5, 7 and 19, see FT 2005).

An audit manager with firm A stated that users of annual reports were not concerned with the information in the accounts. Very few people took the time to read accounts. This view was shared by a preparer:

> "*Disseminating this information is performed much more successfully in the press than in the annual report. The press is really powerful. In fact, very few people read the annual report. If there was no statutory requirement to publish the annual report, we would not even produce it. So far as we are concerned, this is work with no value. It is a repetition of work we have already done – we simply put, in another format, the information we have already supplied to the board*" (Controller of company 19).

When I suggested to the controller of company 19 that it may be better for the company not to be listed on the NSE, he disagreed. The company had experienced greater

customer loyalty precisely because it was quoted: many customers owned 100 or 200 shares in the company. A leading multinational had tried to enter the Kenyan market thinking that it would capture the market as it had done in Tanzania and in a number of other countries. After gaining only 6% of the market after a number of years' operations, the competitor pulled out of Kenya, leaving the market to company 19.

9.3.5 Analysis

This analysis shows the links between the findings of the interview research and the literature and/or the quantitative research.

Confirming Leftwich's (2004) view that the "quality" of accounting information is a nebulous term (section 2.4.6), many interviewees were not able to immediately state what they meant by "high quality financial reporting (HQFR)". But as they spoke about the phrase, the vast majority of accounting experts in Kenya that I interviewed explained HQFR as a multi-dimensional construct which covers a number of aspects of the annual report (9.3.1, 9.3.2, 9.3.3 and 9.3.4).

6 controllers stated that compliance with IFRSs (on its own) would ensure high quality reporting (9.3.1), just as Barron et al. (1999) regard "high-quality MD&As" as those compliant with standards (2.4.8). However, with many of these controllers, a discernible change of view occurred over the course of the interview – they would probably agree with the majority if the interview was repeated (9.3.1). Analyst S, who had working experience in Johannesburg, gave a very comprehensive definition of the phrase (9.3.2). Overall, they did not spend as much time as was necessary to educe every aspect of Jonas and Blanchet's (2000) model (Table 2-2), but their ideas were similar to it.

3 controllers regarded "quality" as a relative term (9.3.1), in agreement with Crowther (1996) (2.2.3). One controller added that analysts constantly asked for more information, even when more information had been supplied to them. The result was that "quality" was constantly changing - what was quality today may not be quality tomorrow (9.3.1).

26 controllers (9.3.1) and all the analysts (9.3.2), regulators (9.3.3) and auditors (9.3.4) thought a Chairman's Statement and/or a management review should give a good overview of the business. If this did not give a clear explanation of the figures, the reporting would not be "high quality", in accord with Clarkson et al. (1999), Barron et al. (1999) and Beattie et al. (2004) (2.4.8). 9 controllers added that analysts wanted additional information that may not be relevant to ordinary shareholders (9.3.1). "Relevance" was covered by points 1 to 4 of J&B's

model in Table 2-2, but it was a relative term. There was a certain tension in drawing the line to demarcate relevant from irrelevant information (9.3.1); what was relevant for sophisticated investors was irrelevant for unsophisticated ones – who tended to be "rural folk" (9.3.1), questioning Wagacha's (2000) findings (4.2). Few individual investors even read annual reports (9.3.4): one controller suggested that publishing information in the press would be more effective than producing the annual report (9.3.4): a significant advantage of being quoted was that individual shareholder customers were likely to remain loyal buyers of the company's products (9.3.4).

A controller in one of the middle sized banks, where business competition is particularly intense, advised that strategy should not be disclosed (9.3.1) because it gave away competitive advantage. This went some way to confirm the Central Bank's view that the banks did not want to disclose information (9.3.3). But an analyst wanted disclosure of strategy (9.3.2) in order to evaluate it. This showed a multi-dimensional tension: preparers perceived that a loss of competitive advantage occurred if full disclosure was made; they also perceived that time consuming investigations might be initiated if even a minor departure from regulations was revealed (especially in an environment where corruption was widespread). Analysts demanded full disclosure possibly being unaware of the regulatory angle. And regulators sometimes forgot how competitive some markets were, because regulators operated in an environment where there was no competition.

Another controller mentioned that audit firms should ensure that best practice was adhered to (9.3.1), to enable "high quality reporting", in line with the SEC's view (3.7) and with Francis et al.'s (1999) view (2.6.4). The same controller pointed out that high quality disclosure required companies' staff to have up to date knowledge of IFRSs (9.3.1), but the auditors were unanimous in stating that this was not the case in Kenya (9.3.4). The World Bank had stated that professional knowledge was a precondition to serious implementation of quality standards (3.8.9); less than full compliance with IFRSs by all the NSE quoted companies (7.2.1) likely confirmed that this precondition was not fulfilled in the case of Kenya. Moreover, companies had the attitude that compliance was a matter for the auditors (9.3.4), did the minimum to ensure compliance (9.3.4) and relied excessively on auditors, even in the preparation of the financial statements (9.3.4). Signing off statements in Kenya seemed to have little effect on the attitude of directors (9.3.4). However, three companies in Kenya had changed their attitude because they were affected by the Sarbanes-Oxley Act in the US (9.3.4).

10 controllers (9.3.1), 5 analysts (9.3.2), and 3 regulators (9.3.3) viewed timeliness as an essential characteristic of high quality financial reporting. (point 4 in Jonas and Blanchet's 2000 model in Table 2-2).

32 controllers thought that an increase in information (up to some optimum point) would improve the quality of reporting (9.3.1), in line with Botosan's (1997) statement (2.5.2). One controller claimed that briefer, better "focused" and more pertinent financial information would improve quality (9.3.1), in keeping with "focus point 11" in J&B's model in Table 2-2. Three controllers mentioned that reporting costs were a major constraint on the amount of information included in the annual report (9.3.1). 4 controllers stated that more information should continue to be given provided the benefit derived from the additional information exceeded the cost of providing it (9.3.1).

Two analysts stated that forward projections would improve the quality of reporting (9.3.2), in line with Hussainey et al. (2003) (2.4.8). Although only one analyst defined "high quality" accounts as those portraying the economic realities of the company, in line with Cohen, D.'s (2002) definition (2.6.1), much of the discussion in the interviews revealed that all experts were of the view that accounts should do this.

One regulator immediately spoke of "high quality disclosure" and "high quality earnings" (9.3.3), separating out the two major constituent classes of elements required for high quality financial reporting (Figure 2-1). Regulators wanted preparers to provide information; but to ease the work of regulators and speed it up, regulators stressed unduly adherence to a format that they had laid down (9.3.3), which could be detrimental to the information communication process: just as this may have resulted in the regulator taking a "box ticking" approach to checking disclosure, so also preparers could do the same in effecting disclosure. All regulators stated that regulation was necessary for "high quality reporting" (9.3.3), in line with the view of the SEC (3.7) and of the World Bank (3.8.9); one controller mentioned that this surveillance had to be "effective" (9.3.1), in agreement with the World Bank (3.8.9).

None of the experts stated that there would any connection between the price of the company's shares on the NSE and the quality of the company's financial reporting, questioning Barth et al. (2005) (2.3), Miller and Bahnson (2002) (2.3), Barton and Waymire (2004) (2.4.6) and this study's finding a positive relation between FiRe Award scores and share price increases in the 3 months to 31 March 2003 (8.4.3.1). Moreover, the comment made by the controller about a high quality financial report being merely a good read (9.3.1)

seems to imply a deeper problem. Many preparers produce financial statements because Company Law and regulation requires them to do so. The idea of communicating information to users who need to make a decision based on the information seems to be hazy. It appears that the connection between the information in an annual report and the reality which is the company is lost to the mind-view. Further research needs to be carried out to explore whether this is the case or not.

9.4 The purpose of the Corporate Annual Report

The purpose of this section is to report the perceptions of accounting experts in Kenya on: (i) for whom are financial reports prepared? and (ii) what is the purpose of the financial reports? Table 9-3 summarizes the results to these questions.

Table 9-4: For whom are financial reports prepared & what is their purpose?

Financial reports for:	39 Controllers	4 Regulators	3 Auditors	10 Analysts	56 Total
shareholders	38	4	3	10	56
loan providers	21	4	3	10	38
regulators	35	4	3	10	49
analysts	39	4	3	10	56
income tax department	39	4	3	N/A	
To give info about performance	39	4	3	10	56
To give info about position	39	4	3	10	56

There were no comments of note from regulators and auditors on these questions.

9.4.1 Preparers' perspective.

All the controllers, except one, stated that they saw the financial reports that they prepared as a means of conveying information about the company's financial performance and financial position principally to shareholders, loan providers and the income tax authority. Some loan providers obtain further information in the form of management accounts. Shareholders were normally placed before loan providers and analysts in the hierarchy of users. The 7 controllers of banks stated that major clients, especially those who had sizeable deposits with the banks, were as important as shareholders. But one controller did not rank users as more or less important; "*all interested parties*" was the reply that I received from the controller of company 15, when I asked him to identify his principal target audience – "*and the information needs of all those people should be catered for*".

One controller summed up what the majority of controllers thought about regulators:

> "*the regulators are the watch dogs for the shareholders; if there is something which should be in the annual report and has been omitted, they will make you improve*" (controller company 20).

However, the controllers of companies 2, 10, 40 and 42 did not see regulators as "users" of the financial reports: these controllers were of the view that there was over-regulation and regulators were almost a mere nuisance.

When I enquired of controllers whether there could be other uses for the annual report, 19 stated that they saw the document as an opportunity to sell the products of the company. The controller of company 9 said that his company had never used the annual report for this purpose but noticed that a number of other companies advertised their products in the annual report. His company would do so more fully in future. The cover of the company's 2002 accounts had three photographs of company products for the first time ever.

The one exception to the controllers' view that the annual report conveyed information to users was the controller of one of the largest companies quoted on the NSE (company 19), a subsidiary of a multinational. It ran an accounting shared services centre for the various subsidiaries in the East Africa region. The company has a very high profile and is known throughout the country. Its financial health is taken by many to reflect the state of the economy in the country. The directors of this company saw little value being added to the business by its published annual report and this view was shared by the controller. As a result, the company outsourced the production of the annual report to the company's auditors, firm D. Responsibility for compliance with IFRSs and Kenya company law was handed over to the firm. To ensure compliance with IFRSs, the company had the completed accounts peer reviewed by the London office of another Big 4 audit firm, which varied from one year to another. The company argued that the expense of employing a person who was fully conversant, and who kept up to date, with IFRSs, would not be cost effective. It had a small team which used as much technology as possible to prepare the management accounts of all the group companies for management purposes. These members of staff made no attempt to keep up to date with the latest IFRSs. They concentrated entirely on producing internal information. The financial controller spent no time comparing the annual report of the company against those of other companies locally or elsewhere. He did watch the share price of the company. But it moved, in his opinion, because of trading conditions in the market-place for the company's products or because of positive or negative news of legal liabilities arising out of its trading or marketing practices. Adverse media coverage on problems associated with a competition which was part of a marketing strategy for the company had caused a 2% drop in the share price of

the company. The share price picked up again when the company announced in the press the measures it had taken to deal with the adverse situation. The controller spent a fair amount of his time benchmarking each individual company's and the East African group's financial performance against fellow subsidiaries in other parts of the world – Asia, Latin America, other African countries including South Africa, etc – he obtained the information from their annual reports. In keeping with what is reported in section 9.3.1 above, in his opinion, the market price of the shares has almost no association with whether disclosure in the financial statements is high quality or not.

The danger of outsourcing the preparation of the financial statements is that the staff of the audit firm that does the accounting work in Nairobi may not be fully conversant with the all the relevant facts to make adequate decisions on how to deal with all the items in the financial statements. Furthermore, the London office of the Big 4 audit firm may not be sufficiently conversant with Kenyan conditions to ensure that IFRSs are fully complied with. The result could be that a local phenomenon is overlooked by the staff in the London office. The accounts of this company were one of the two that did not deal with leasehold land in accordance with IFRSs in the period under review; the auditors of the other company qualified their report because of this departure, but the auditors (really the preparers) of company 19 did not. The day that I interviewed the financial controller, he had been discussing the applicability of the IASs which deal with leasehold land with the company's audit firm in Nairobi. Although it is one of the three largest companies in Kenya, it was ranked 42nd out of 47 companies for compliance with IFRSs, 30th for S&P's survey score and 11th out of 35 companies in the FiRe Award 2003 competition.

All 39 finance controllers (FCs) stated that their companies provided voluntary information in their annual reports and did so to improve the image of the company. 11 FCs had a difficult task in persuading members of their Board of Directors to give information which was additional to that required by regulation. 19 FCs noted that they used the annual report as a marketing document. 13 FCs thought that voluntary information should be kept to a minimum. One of these 13, the FC of a bank stated:

> *"If we had a choice, we would not add any voluntary disclosure. But the Donde Act* (section 4.14) *made the banks look bad. The price of our shares hit their lowest point. So we now put a lot of publicity into the annual report about our social responsibility activities. We never used to put photographs in the annual report but a shareholder said that it would be nice to know who they are dealing with, so the Board decided to add them"* (FC of company 37).

9.4.2 Buy-side analysts' perspective.

All ten buy-side analysts interviewed attach real importance to the annual report. They use the information in the annual report to make decisions as to whether to invest in, or disinvest from, a company. They never make an investment in a company without first examining the latest annual report of the company.

In addition, they attach importance to the people behind the annual report – the management and the directors of the company. They use the annual report to supplement what they hear about the ability and the character of the management. They sometimes decide to sell shares in a company if they deduce that what is being reported in the annual report is at variance with what they have heard from other sources in the market. At the same time, they use the financial statements as a reliable source of information about increases or decreases in the net assets of the company.

9.4.3 Analysis

Controllers almost unanimously stated that financial reports were prepared to convey information to investors and other users, including, for the majority, regulators (9.4.1). Some also saw the annual report as a marketing tool (9.4.1). However, in the light of the comments in section 9.3.5 as to whether preparers see the connection between the annual report and the reality of the company, it is difficult to judge whether controllers understand the importance of the annual report. They say the annual report is to convey information about the performance and position of the company. But is this really the case? Or do they prepare the annual report because that is what the rules say must be done? Do they understand that "high quality financial reporting (HQFR)" conveys better information, or are they content merely with the fact that HQFR satisfies the rules better and may even win the FiRe Award?

One controller attaches almost no importance to the annual report (9.4.1). But the views of analysts confirm the importance they attach to the annual report (9.4.2), in agreement with Chang and Most (1985), Vergoossen (1993) and AIMR (2000) as mentioned in section 2.4.3, the Chartered Financial Analysts' Institute in 3.2.1 and the SEC in 3.7. They see it as a vital source of information for decision making purposes, in line with Saudaragan (2004) in section 2.2.2. Preparers may not be aware that their calibre and that of their co-managers are being assessed by analysts when analysts examine annual reports (9.4.2); if preparers were aware, it could possibly be a spur to produce "higher

quality" financial reports: further research is required to investigate this in some depth – possibly knowledge of this fact may make no change whatever.

9.5 Are financial reports in Kenya "high quality"?

The purpose of this section is to report the perceptions of accounting experts in Kenya on whether financial reporting by quoted companies in Kenya was high quality. Financial controllers were asked whether the annual reports prepared by them were high quality, and if so, what factors ensured that they were high quality. They were asked to name companies whose annual reports they deemed to be high quality and those they deemed to be low quality. They were also asked about the quality of their interim reporting. Table 9-4 summarizes the results to these questions.

Table 9-5: Perceptions of accounting experts on quality of reports in Kenya

Which of the following financial reports are high quality?	39 Controllers	4 Regulators	3 Auditors	10 Analysts	56 Total
Annual report of your company?	37	N/A	N/A	N/A	
Interim report of your company?	3	N/A	N/A	N/A	
Company 6	19	2	1	6	28
Company 27	16	2	0	5	23
Company 35	14	2	0	5	21
Company 19	13	1	0	5	19

9.5.1 Preparers' perspective: annual financial statements.

37 of the 39 controllers I interviewed deemed the annual reports prepared by themselves to be high quality. One said that his company's were not high quality, and pulling out the annual reports of a number of quoted companies added that there was no great variation between any of them; his company had an informative "Review of Operations" – they copied their parent company quoted in London. However, after having spoken about the annual report of his company for some time and examining the different features, he said:

> "*Well now that you have mentioned these points, I think our annual report is a lot better than those of other plantation companies*" (Controller company 39).

This change of opinion occurred in a number of interviews and in relation to a number of different areas covered in the interviews. However, the controller of company 39 did not go so far as to rate his annual report, nor that of any other company listed on the NSE, as "high quality" – they were all "*much of a muchness, as one would expect; they all try to comply with IFRSs*".

The controller of company 19 admitted that he would be unable to say anything about the annual reports of any companies other than his own – he had never examined the

annual reports of any other companies quoted on the NSE - and even in the case of the annual report of his own company, he had not prepared it; there was no value added by preparing the annual report – it would be better to put an abbreviated set of figures into the newspapers. However, he did examine the annual reports of other companies in the group, both within Africa and elsewhere in the world, but this was purely to measure the financial performance of Kenyan, Ugandan and Tanzanian subsidiaries against that of subsidiaries elsewhere in the world. His company's annual report was low scoring on all counts and the interim report tied with 13 other companies for the lowest score for IAS 34 compliance (Appendix 7-1). However, 13 controllers, 1 regulator and 5 analysts rated the annual report of company 19 "high quality" (Table 9-5), questioning the quantitative research.

12 controllers stated that the accounts of their companies were high quality because they complied with IFRSs, in spite of only 6 saying that compliance with IFRS alone was the criterion for HQFR (see Table 9-3). One added that compliance with Capital Markets Authority (CMA) regulations was also important, but few had any knowledge of these regulations:

> *"The accounts are high quality because they now comply internationally – IFRS are much more comprehensive than Kenyan Accounting Standards and Kenya Company Law. We are* ***growing*** *into better compliance with IFRS as we exchange views with other preparers. CMA regulations on corporate governance are also helping to improve the quality of disclosure. However, we do not comply with all the requirements of related party disclosure because transactions with a related company are too voluminous to track down; so we just put an opening and a closing balance. We do not have the capacity to show the value of transactions between the companies and we do not see the need for it.* " (Controller of company 37, a bank).

When controllers were asked to name companies whose annual reports were high quality, 19 named company 6, 16 named company 27, etc. – as shown in Table 9-5. In the quantitative research (Appendix 7-1), company 6 was ranked 3rd in annual report IFRS compliance, 3rd using S&P's survey methodology and 10th in the FiRe Award. The controller of company 6 recognised that the interim financial report did not comply with IFRS 34; it was placed 20th out of the 47 companies on the NSE (appendix 7-1).

The controller of company 36 stated that global companies with subsidiaries in Kenya normally ensured that the accounts of their Kenyan subsidiaries were high quality; their accounts were prepared to be similar to their "mother" companies.

When I asked the controller of company 6 whether he thought the accounts of his company were high quality, he answered they were. Why? He argued that none of the questions asked at the company's AGM related to the accounts:

> *"I concluded that they must have been high quality. To achieve this high quality was not easy. Once I had prepared the financial statements, the Finance Director, the Finance Manager and I sat down and brain stormed over the whole annual report. The auditors' opinion was sought for any corrections or clarifications suggested by the Finance Director or the Finance Manager – even if it was a matter of deleting one word from the annual report. We paid a lot of attention to the clarity of the wording in the report.*
>
> *In the previous year, in relation to inventory at the end of the year, the auditors required us to recount stock because they thought some of the stock had been counted twice – some of the items had been moved in the stores. However, when we re-counted the stock, we arrived at the same figure as we had earlier. That year, the auditors required us to write down stock by KShs.30 million (*the figure for stock in the 2001 balance sheet after the write down was KShs. 1,979 million*) because of slow moving items.*
>
> *The computerised accounting system makes it very easy to ensure that debtors, prepayments, purchases and accruals are stated at the correct amounts. Reconciliation is done on a daily basis, so that all the transactions that occurred on Thursday are recorded in the general ledger by Friday evening* (we had the interview on a Saturday morning*).*
>
> *At the year end, the figures are checked by a committee of not less than three people; no figure in the accounts is decided by an individual on his or her own. The auditors carry out their checks and have never raised queries about any of these items. The only queries they have raised were in relation to the stock write-down in 2001 and in relation to property, plant and equipment (PPE). PPE is physically counted every year and checked against a fixed asset register. Any movement of PPE has to be authorised by a Fixed Asset Movement Order (FAMO). The problem that we have had is that not all movements were documented properly with a FAMO. But there have not been any discrepancies as such on the fixed asset register"* (Controller of company 6*).*

Although many who were interviewed rated the accounts of company 6 highly, using questions at the AGM as a measure of quality was likely not valid, judging from the comments of another controller:

> *"you need a lot of patience to answer the questions at the AGM. Most of the shareholders are rural folk; they do not understand the contents of the annual report. The questions they ask are not really serious questions. The annual report is really aimed at analysts, foreign investors, corresponding foreign banks and international rating agencies*". (Controller of company 37)

The controller of another company was extremely balanced when he said that:

"obviously I would like to blow my trumpet: I would like to think that it is high quality, but I also think it can be improved: there is other information that could be given to elucidate what is already given in the document" (controller of company 3).

The controller of company 23 revealed that she had real problems in reporting in a timely way (the company wanted to release its figures within two months of the year end) because non-quoted associated companies and a quoted associate, company 45, often reported later than this. On one occasion she had used management accounts in company 45 to expedite her reporting but found that there was a large difference between the management and the audited figures, when the audited figures were later issued. Rather than restate the accounts for the year, the comparative figures were restated in the following year's accounts. On another occasion she had to wait until the associate revealed its loss to avoid a negative share movement in the associate's share price which would have occurred as a result of company 23 (the investing company) revealing this loss. Showing company 23's share of the loss of the associate in the income statement of company 23 had prompted the board to suggest that company 23 abandon the equity method of accounting. The company solved the problem for the following year by selling its shareholding in the associate.

5 controllers, whose companies had subsidiaries or branches in Uganda and/or Tanzania stated that those operations prevented the Kenya operation from reporting in a more timely way. The controller of company 20 would do all the accounting work in Nairobi if a reliable satellite link existed between Nairobi and Kampala/Dar es Salaam, where it could be done more cost effectively, since there were many more accountants available in Nairobi.

Company 8 was the first bank in Kenya to obtain a rating from an international rating agency – it received a B rating because its earnings were too dependent on its core business of lending – but there was no query on its accounts. The controller of this bank claimed that this, together with the fact that lending institutions and correspondent banks overseas had never queried the accounts, were signs that the bank's accounts were high quality.

36 controllers found the assistance given by auditors in ensuring compliance with IFRSs helpful. Client companies of the two largest Big 4 firms in Kenya, which audited 18 (firm A) and 17 (firm E) companies listed on the NSE, use a template provided by their audit firm, which unfortunately can reduce the controller's work to reproducing "boilerplate".

9.5.2 Buy-side analysts' perspective

The view among buy-side analysts (analysts) was mixed as to whether financial reporting in annual reports of companies quoted on the NSE was high quality.

Analyst S, who was working in Johannesburg at the time of the interview, stated that the annual reports of companies 5, 19 and 27 are among the best in sub-Saharan Africa – but added "*there is still room for improvement*". He rated the annual report of company 31 as very low quality:

> "*the company performs poorly and stretches the rules to avoid reporting the truth; it failed to show an interest expense of Shs.1.2 billion* (approx. $17 million) *in its 2002 accounts even though this interest is reported as income in the electricity generating company's accounts (the company that provided the loan) and both companies are audited by the same Big 4 audit firm*" (Buy side analyst S).

- but analysts T, U and V rated the annual report of company 31 high quality, because of the amount of information given.

Analyst X stated that he was of the opinion that the financial reporting of a number of companies on the NSE was high quality, and named companies 6 and 19.

Analysts Y and Z did not rate any financial reporting high quality. Z stated:

> "*The financial reporting of the majority of companies is good; many need to give much more information about the business and the relationship between the business and its financing and its profitability. The financial reporting of quoted companies is better than that of unquoted companies. We are unhappy with the financial reporting of unquoted companies. Unquoted companies do not give us the returns we expect. We attribute this to weak management. And a significant indicator of their inability to manage properly is the extended delay of their financial reporting. We received the annual report of Z Limited, an unquoted company, for the year ended 31 December 2001 the other day* (the interview was conducted on 25 September 2003)*.Those figures are now out of date and we cannot make any projections based on them. We were asking the controller of the company 'what happened in 2002 and also what is happening now as we speak?' One very important feature of high quality financial disclosure is timeliness.*
>
> *Amongst the quoted companies, main market (MIMS) companies' financial reports are better than those of alternative market companies. Within MIMS, those of banks are the best. We do not follow all the banks but we monitor very carefully the reporting of the banks that we have invested in. Accounts have been better since 1999, when IAS were introduced. The banks are now required to report on a quarterly basis, which is better from our point of view.*
>
> *Amongst the top annual reports are those of companies 5*(a bank) *and 6* (an industrial company - both subsidiaries of UK multinationals)*, and 27* (a service company - an associate of a Dutch multinational)" (Buy-side analyst Z).

Analyst Y stressed the importance of the "Chairman's Review" and the "Managing Director's Statement" being focused, well-thought out and well-expressed reports. He stated that the reports of Chairmen tended to be very similar to one another, often stating economic factors whose connection with the performance of the company was valid but not obvious to all users. "*Poor infrastructure and the high cost and inadequate supply of electricity also played a big part in the poor economic performance (of the country)*"was a typical topic that was alluded to, as he showed me an annual report of a listed company. While some Chairmen then showed the connection between this state of affairs and the performance of the company, for example "*as with other sectors of the economy, the insurance industry suffered as a result of the depressed economy in 2002*" (company 38), others did not, or seemed to use it as a reason for a poor performance by the company but expressed few ideas that management had taken to overcome this problem. He went on to stress the importance of information disclosed being relevant to the financial performance and position of the company.

9.5.3 Regulators' views

The regulator who spoke of the two distinct dimensions in which an annual report could be considered to be high quality, stated that disclosure was not as good as it should be amongst quoted companies in Kenya but generally earnings quality was "good". Regulators in general were careful in selecting companies which had high quality financial reports and careful to avoid naming companies with low quality financial reports. There were no other points of note in relation to this area of study.

9.5.4 Auditors' perspective.

Auditors had mixed views as to whether financial reporting disclosure by NSE companies is high quality.

The audit manager with firm D stated that she would rate the financial reporting disclosure as of moderate quality but not of high quality, for two principal reasons. The first was that the directors' remuneration was not a transparent figure in a number of cases; in one company she had audited, share options were not included in directors' remuneration. The second was that earnings quality was low in a number of companies she had audited. Subsidiaries of multinationals did not manage their earnings directly; but if the Kenyan subsidiary or associated company had already reported to its "head office", it resisted any changes required when errors were uncovered. Subsidiaries of multinationals had very tight

reporting deadlines (in one company monthly returns had to be in London within 3 days of the month-end and yearly returns within 5 days of the year-end). Only after extreme pressure from the auditors did it change its figures to correct a materially erroneous stock figure, and increase provisions for bad debts. She mentioned other cases where the company had refused to change its figures – the numbers in all cases were material.

This reluctance to correct material mis-statements was corroborated by the partner of firm E. He stated that a lot of earnings management was stopped by the auditors. The partner had refused to sign the audit report for one company unless certain provisions were made. When he met the finance director some days after the accounts had been published, the finance director commented that the audit partner had prevented him from receiving a substantial bonus to which he was entitled. It took some time for the audit partner to obtain the director's reluctant agreement that he was not due the bonus since the company did not achieve the bonus target figure.

Reluctance to correct mis-statements was also corroborated by the controller of company 4, a subsidiary of a multinational. Stock issued from the stores over the year had been priced consistently at below cost. At the year-end stock-take it transpired that the value of stocks on hand was materially over-stated. The auditors informed the company that the difference between the book value and the value of the physical stock would have to be charged against income for the year. The company insisted that the error should be rectified in the following year's financial statements. The auditors refused. The company counter-proposed that 50% should be charged. After protracted negotiations, agreement was reached finally that 75% of the difference would be charged against income in the correct year.

But the controller of company 3 said that it would be very difficult for earnings to be managed, because it would be very difficult to fool management in their South African holding company, even if they were able to fool shareholders in Kenya.

Six controllers that I questioned admitted that they manage earnings, especially when they have had a very successful year and the outlook for the future was not so good. The controller of 23 said that companies were under pressure to perform – "*everyone wants to say they did well; they recognise income earlier and defer the recognition of expenses*". One bank managed earnings by creating additional reserves in the good years to release in the not-so-good; however, it was more prudent in bolstering profits by understating provisions where there was no slack available. 33 controllers stated that their companies do

not engage in earnings management. These have clearly laid down procedures for examining slow moving stock, bad debts, accruals and prepayments. 30 have committees which are consulted as part of this laid-down procedure. Often, these are asked to decide on the provisions required before the profit figure for the year has been arrived at.

The controller of company 37, a bank, sat on the Banking Committee of ICPAK. She stated that the banks were trying to be careful with their reporting, because they feared being fined by the Central Bank, and the result was that the quality of reported earnings was high; in the case of her bank, loan loss provisions were made consistently in accordance with the bank's internal regulations.

In spite of the problem of sometimes being unable to coerce the company to change the numbers in the financial statements to the correct ones, the audit manager of firm D was of the opinion that the financial reporting of subsidiaries or associates of multinationals was of higher quality than those of companies which were neither subsidiaries nor associates of multinationals. In her opinion, since the holding or investing company had itself to produce financial statements for a demanding stock exchange, the subsidiary tended to follow suit, and worked to a higher level of "quality".

Another area where auditors found difficulties in dealing with financial statements was contingent liabilities. These were not explained with sufficient clarity. In many cases these were stated only in very broad terms or in a vague way. Often, specific events or items were not disclosed with clarity and precision.

On the other hand, clarity sometimes led users to doubt the statements. Analysts T and V criticised the accounts of company 27 because they felt that many of the contingent liabilities reported in the financial statements should have been provided for and included in liabilities in the balance sheet. With the passing of time, it has turned out that these liabilities did not need to be provided for – they were indeed merely contingent at the time the balance sheet was prepared.

9.5.5 Interim financial reports

The partner of audit firm E stated that interim financial statements were not of much use in Kenya because they were not audited before they were published. The other two auditors expressed no views about interim financial reporting.

Very few controllers had any knowledge about the requirements of IAS 34 and on learning in outline what they were, admitted their interim accounts did not comply.

Companies 12, 39 and 40 actually sent a copy of the interim reports to each shareholder, the only companies to do so; a number of controllers stated that the high cost of sending these reports to members prevented the company from doing so. The controller of company 46 had a protracted meeting with his board prior to placing the interim report in the newspaper; the board prevailed on him to do what the majority of companies did – report the minimum, namely an extract of the income statement.

Regulators in the NSE and the Capital Markets Authority were aware that companies did not comply with IAS 34 but seemed reluctant to do anything to address the problem. Central Bank had been proactive. With effect from the quarter ended 30th June 2002, Central Bank required the banks to publish in one major daily newspaper in Kenya their quarterly Income Statement and Balance Sheet and certain financial ratios, within 60 days of the end of the quarter. The Central Bank regulators stated that this was a necessary step in ensuring timely reporting of financial information by banks. Unfortunately, the format Central Bank had laid down for the interim reporting of the banks was not in conformity with IAS 34; the regulators thought full compliance with IAS 34 would be too costly, since some of the bigger banks already used a full page of the newspaper for these accounts.

The controller of one bank, a rival to company 5 (one of the biggest banks in the country), criticised company 5's quarterly reports because bad debt provisions had been ignored in the first three quarters but charged in full in the fourth quarter. When I mentioned this to one buy-side analyst, he admitted that his organization's projected profits for company 5 had turned out incorrectly as a result of these charges. He stated:

> *"Even in the year 2001, they had a high restructuring cost which was charged in the fourth quarter. This definitely makes the quarterly reports less useful. This was bad for us because we had our projections and then suddenly, out of the blue, an unexpected material expense is charged against income. Our forecasts become unreliable. As a result, we now meet them and ask them for an estimate of the charges so that we can factor them into the publicly reported figure. This forces us to visit them more frequently than we used to in the past"* (Analyst Z).

Unfortunately I interviewed this buy-side analyst after I had interviewed the controller of company 5 and the regulators at the Central Bank of Kenya, and very close to my departure from Kenya. I was unable to arrange a meeting with either of the two latter mentioned to ask their reactions to these claims.

Both analysts Y and Z stated that it would seem that quarterly reporting by some banks is viewed as merely the fulfilment of a reporting requirement laid down by the

Central Bank of Kenya with little attention being paid to the accuracy of the numbers disclosed, provided ratios considered critical by Central Bank were satisfactory.

9.5.6 Are there accounts which are low quality?

In general, preparers were very guarded in saying that other quoted companies' reports were low quality; one had come across several accounts which were low quality:

> *"I do not want to mention their names – they are smaller companies. They give no details of what they do. The notes do not indicate the essence of the numbers in the financial statements"* (Controller of company 3).

When the controller of company 12 was asked whether he knew of any listed companies which under-report their turnover and profit to discourage new entrants to their market, he did not know of any but he gave several reasons why he thought it would be difficult for any to do so. It would be reporting using IFRSs; it would be audited by "*an audit firm that is worth its name*"; shareholders would want exactly the opposite to occur – if it was reporting to the Government, it could be different. But there may be one or two isolated cases. Controllers generally stated that they did not try to lower profits to avoid corporate tax – "*it catches up with you eventually*" was the comment made by the controller of company 1.

Both analysts Y and Z thought that the annual report of company 45, a supermarket group was of particularly low-quality. Both had complained to the directors of this company about the inferior quality of the annual report. The profitability of the company had declined after the departure of the previous Managing Director (MD) of the company. Despite falling profits, the company seemed to be intent on increasing its floor space by opening new branches (6 in 2002 in addition to the 19 previously operated – 2002 annual report of company 45, p.7). Each new branch opened lowered profit because of its initial start up costs, and probably its operating losses, but the Chairman's report gave a confused picture, raising suspicions of a cover-up. The turnover for the year net of Value Added Tax (VAT) had actually decreased from KShs.7,954 million in 2001 to KShs.7,937 in 2002, in spite of the new branches having started operations. Both the Chairman and the new MD announced that new outlets would continue to be opened, but neither mentioned in their reports the sales per unit area of the floor space. The analysts could not obtain information on this from the company.

However, company 23, had a large investment in, and had representation on the board of, company 45; the controller of company 23 said that the monthly management accounts of company 45 were low quality but the annual report was high quality. She attributed the difference to regulation and to input from company 45's auditors, firm E.

"Now they are talking about their new IT system" was the phrase analyst Y used in reference to an Enterprise Resource Planning (ERP) system company 45 had announced it was investing in. The MD had stated in his report that "the modernization of our IT systems . . .is one key area that has begun well". But it was known in the market that there were major problems in the implementation of this new computer system. The analyst stated that the level of disclosure of this company was vastly inferior to Woolworths in Australia, whose annual report he had examined. Unfortunately I was unable to corroborate this information from the controller of company 45. Although I had fixed an appointment to interview him, he cancelled the meeting at the last moment; he was totally occupied with trying to solve the malfunctioning ERP system.

The partner of audit firm E singled out the financial statements of company 27 as an example of low quality financial reporting, for two reasons:

(i) the company had not complied with IFRSs in dealing with its fleet of aircraft and its concomitant foreign currency borrowings; and

(ii) the way it had dealt with these assets and liabilities was clumsy; he had worked out a much neater solution, which, needless to say, he did not communicate to the researcher.

When I mentioned this fact to the controller of company 27, he produced a manual published by the International Air Travel Association (IATA) which authorised this treatment and gave the number of airlines around the world that were using this treatment. However, the treatment was not in compliance with IFRSs.

Many preparers and analysts claimed that company 27 had produced a high-quality annual report, confirming one set of quantitative findings: the company had the top score using S&P's survey methodology (Appendix 7-1).

An audit manager with firm A stated that the accounts of company 38 were low quality because to understand the accounts one had to be an expert in insurance; his view was that the accounts had been prepared solely to satisfy the reporting requirements of the Commissioner of Insurance. The accounts of Berkshire Hathaway were a source of information about how the insurance industry works; everything was explained so that any user can understand what contributes to the success of the company. He also felt that three years' income statement figures (as required by US GAAP) gave a clearer picture of the performance of the company.

Analyst W rated the accounts of company 28, a bank, low quality; he knew from inside sources that the company's auditors (firm B) had insisted that dormant accounts recognised as income should be disclosed appropriately in the accounts. It had had a new MD appointed two years previously to turn the company round; he was forced to do something to be able to report a profit. The analyst's opinion was that the company was engaging in gross earnings management. The result was that the ratio of the share price to net book value was 0.5 as opposed to 2.0 and 3.0 for companies 5 and 41, Kenyan subsidiaries of UK banks.

9.5.7 Analysis

It can be seen from Table 9-5 that the vast majority of controllers are of the view that their own annual reports were high quality. However, few of even their peers would agree, except for certain companies, confirming Crowther's (1996) observation that "quality is subjective" (2.2.3). They were ready to admit that their interim reports were not high quality after the requirements of IAS 34 had been pointed out to them.

Quite a common experience was that interviewees became more aware of even their own accounts as the interview progressed (9.5.1). It would seem that more open discussion of the annual report with members of the board and with audit committees would bring about an improvement in the quality of the annual reports. In larger companies this occurred as part of the process of preparing the annual report (eg., company 6, mentioned in 9.5.1). This would be another factor in explaining the regression model's findings for the FiRe Award (8.4.3.1) that scores are positively associated with the size of the company.

The fact that the annual report of company 19 was rated so low on all three quantitative methods (Appendix 7-1), and yet was mentioned relatively frequently as an example of "high quality financial reporting" (9.5.1) was perhaps because the controllers, regulator and analysts had confused the financial success reported with the quality of reporting, in agreement with Mercer's (2005) findings (2.4.1).

The claims by controllers that the accounts of their companies were high quality because they were IFRS compliant (9.5.1), and that controllers were becoming better at ensuring compliance as they used IFRSs more (9.5.1), are challenged by the less that full compliance with IFRSs (7.2.1) and by the fact that some of the areas of non-compliance with IFRSs reported in section 7.2.2 and appendix 7-3 were referred to by the Report on the Observance on Standards and Codes (ROSC) carried out by the World Bank in relation to reporting in

1999 by the same companies. From some comments it is clear that a certain amount of "picking and choosing" items for compliance was engaged in, rather than in trying to set up systems so that all the information items required by IFRSs were produced (9.5.1).

It also became clear that arriving at "high quality financial reporting" is not an easy task (9.5.1). It requires rigorous fulfilment of laid-down procedures, painstaking attention to detail, consulting when one is not sure of the consequences of changing something, and getting the opinions of a number of members of a knowledgeable team; smaller companies, depending possibly on a single experienced qualified accountant, whose knowledge of IFRSs may be weak, would find this hard to achieve – again confirming the positive association between FiRe Award (8.4.3.1) scores and company size. But even in large companies, slip ups occur (9.5.1). There is no substitute for detailed knowledge of the IFRSs together with hard work and a checklist to ensure the details are correct.

The tension between reporting for the needs of individual shareholders and buy-side analysts working for investment trusts and asset management groups was discernible (9.5.1). The temptation to "dumb down" the annual report would be strong. But IFRS compliance and analysts, foreign investors, corresponding foreign banks (in the case of banks) and international rating agencies demanded "high quality financial reports" (9.5.1).

Chairmen could be asked questions at AGMs which were difficult to answer because individual investors often did not understand some of the simplest concepts (9.5.1). In addition, if the Chairman gives a reply that is not understood, or if he gives a reply that is not accepted by the individual who asked it, it can be picked up by members of the press, who understand little about economics, business and accounting, and turned into negative publicity for the company. Auditors stated that greater clarity was needed in describing contingent liabilities (9.5.4) but there could have been deeper reasons for the lack of clarity – controllers may have expressly avoided clarity to forestall arguments with "financial experts" at companies' AGMs.

A number of controllers spoke of the need to continue to improve (9.5.1). "High quality financial reporting" is a moving target; it keeps getting "higher".

Some companies had found it difficult to report in a timely way because of the delay in obtaining audited reports from their investees (9.5.1); this possible cause of failure to achieve high quality financial reporting was not revealed in the quantitative research.

Better communications links within the region would enable the accounting of branches, subsidiaries and associates to be done in Nairobi (9.5.1).

Some banks had obtained ratings from international rating agencies using their annual reports; no queries were made on the accounts (9.5.1). These banks were of the opinion that this was a signal of the high quality of their annual reports, confirming the findings of the univariate analysis in section 8.3.8 where FiRe Award scores are associated positively with banking companies; regression analysis did not confirm this association.

Generally, controllers acknowledged that auditors assisted in improving the quality of reporting (9.5.1), in keeping with the findings of the Elliot Commission (AICPA 1997) reported in section 2.2.2.

All the buy-side analysts expressed a desire to see more relevant, focused, well thought out and well-expressed management reports (9.5.2), reflecting Beattie et al.'s (2004) claim that narrative communication is crucial (2.4.8) and Barron et al.'s (1999) finding of the importance of "high-quality MD&As" (2.4.8). A couple of analysts rated banks' annual reports the best (9.5.2) supporting the univariate analysis which finds a positive association between the FiRe Award scores and banks (8.3.8).

A regulator stated that earnings quality amongst Kenyan quoted companies was "good" (9.5.3). In the same way as Graham et al. (2005) used interview research to reveal earnings management (2.6.7), the interview research revealed that forms of earnings management took place (9.5.4), a fact which may have been difficult to prove using quantitative methods, since there are so few companies listed on the exchange. This could lead to a perception of poor earnings quality. The interview research also revealed that auditors had to constantly prevent earnings management (9.5.4), especially where a bonus was linked to reported profits – in spite of a number of controllers stating that their companies did not engage in earnings management (9.5.4), and had laid down procedures to prevent it (9.5.4). The claim that auditors reduce earnings management was confirmed by a number of controllers and a specific example of this was given by one of them (9.5.4). Another controller claimed that his overseas holding company would see through any earnings management (9.5.4): his comment, "the truth will set you free" probably reflected that he thought it important to state the true figure. Banks generally ensured that loan loss provisions were adequate because of Central Bank supervision (9.5.4).

Interview research also revealed one of the reasons for earnings management: subsidiaries that had already reported to their overseas holding company were extremely reluctant to change figures after the audit was complete (9.5.4). In spite of these problems, auditors (9.5.4) and one controller (9.5.1) rated the annual reports of subsidiaries and associates of multinationals better than those of local companies, reinforcing the same findings in the regression model for S&P's survey methodology (8.4.2.1).

The fact that interim financial reporting was so poor by NSE companies would seem to confirm one auditor's claim that interim reports would be of use only if they were audited (9.5.5). Controllers were ready to acknowledge that interim reporting was not in accordance with IAS 34 (9.5.5); some were reluctant to incur the cost of sending IFRS compliant interim reports to members (9.5.5), which some regulators agreed with (9.5.5).

Analysts confirmed that quarterly reporting by the banks was of assistance only if those reports were of "high quality": because of their low quality, analysts actually had to incur greater costs than if the reports had not been published (9.5.5). It seemed that they had been published merely to fulfil Central Bank's directive, with little attention being paid to the accuracy of the numbers disclosed (9.5.5). This casts doubt on whether quarterly reporting is as useful as the Central Bank holds it out to be.

Preparers were reticent in naming examples of companies with "low quality financial reporting" (9.5.6) and generally held that profits would not be under-reported to avoid political costs or reduce taxation charges (9.5.6). Some of the analysts stated that a company's annual report was "low quality" because there was a discrepancy between the management report and the figures reported in the annual report and facts that were known in the market about the company (9.5.6).

Company 27's annual report was singled out by an audit partner as being low quality because of non-compliance with IFRSs (9.5.6), which was confirmed by its low score on IFRS compliance (Table 7-1: its interim report tied with 13 other companies for the lowest IAS 34 compliance score). However its annual report was highly rated by 16 controllers, 2 regulators and 5 analysts (Table 9-5), which was confirmed by its being the top scoring company using S&P's survey methodology (Table 7-1). This confirms Beattie et al.'s (2004) observation that "quality is context-dependent": the audit partner examined the annual report from an IFRS compliance perspective whereas analysts were looking for other information – they probably relied on the unqualified audit report (the auditors

concurred with the company that compliance with IAS 21 would have been misleading). The fact that 16 controllers thought the company's annual report was high quality could possibly confirm their lack of detailed knowledge of IFRSs. The annual report of an insurance company was rated low quality because it was not easily understandable (9.5.6) – in line with FASB (2005) in section 2.2.6 - and that of a bank because earnings had been perceived to have been managed (9.5.6).

9.6 Comparison with other countries corporate annual reports

The purpose of this section is to report the perceptions of accounting experts on whether financial reporting in Kenya is comparable with financial reporting by companies listed on other stock exchanges.

Table 9-6: Is financial reporting by Kenyan quoted companies comparable to that of companies listed on other stock exchanges?

	39 Controllers	4 Regulators	3 Auditors	10 Analysts	56 Total
Examine accounts of other exchanges	29	3	3	9	44
NSE accounts comparable	14	1	1	2	18

9.6.1 Preparers' perspective.

29 controllers examined the annual reports of companies quoted on other stock exchanges. All the controllers of subsidiaries of multinationals study the annual report of their holding company. Their comments were along the following lines:

> *"The one thing that makes their accounts much more 'high quality' is the level of detail that is required of them by their local regulatory environment. But in terms of what disclosures they make under IFRSs, we are at the same level"* (Controller of company 3).

The controller of company 39 did not think that there was a material difference between the accounts of his company and the accounts of its holding company quoted on the London Stock Exchange.

9.6.2 Buy-side analysts' perspective

Nine of the ten buy-side analysts I spoke to had examined the annual reports of companies quoted on other stock markets around the world. All of them agreed that the amount of detail given in those accounts exceeded substantially that given by even the best reporting NSE companies. They examined foreign annual reports especially when they wanted to assess the performance of a monopoly company in Kenya, for example, E. A. Breweries Limited. To obtain metrics that were currently used in the brewing and distribution industry, by which they could measure the performance of the Kenyan

company, they examined the annual reports of companies quoted on the Johannesburg, London, Australian and New York Stock Exchanges. Analysts Y and Z also did this where a company's competitors were of no real consequence, for example – in the cement industry – they were of the view that Bamburi Cement dominated the cement industry - E.A Portland Cement and Athi River Mining did not provide any significant competition.

The analysts found that companies quoted on those foreign exchanges had a much more detailed management report than companies in the same industry in Kenya. Kenyan companies would have to include comprehensive management reports in their annual reports if they wanted to achieve high quality financial reporting, comparable with that achieved by quoted companies around the world. A detailed management report was now the accepted norm around the world.

At the same time, analysts Y and Z pointed out that there was a shortage of equity available on the NSE for Kenyan institutional investors. The market capitalisation of the NSE was approximately US$4 billion. However, of the 47 companies on the exchange, 6 were controlled by or under significant influence of the Kenya Government, 10 companies were controlled by or were associates of private Kenyan companies and 24 companies were under the control, or were associates, of overseas multinationals. Liquidity was very thin on the NSE. As a result of this, since companies realized that demand for their shares outstripped supply, there was a lower incentive to inform investors using high quality financial reporting.

One analyst stated that, for disclosure, London and New York led the pack (he awarded both 8.5/10); in sub-Saharan Africa, South Africa (7/10), was followed by Zimbabwe (6/10) and possibly Botswana (no score given), then Kenya (best 5.5/10, lower end 3.5/10). West Africa had "*appalling reporting standards; Ghana, though poor, is better than Nigeria*" (Analyst S).

9.6.3 Regulators' and auditors' perspective

Three out of the four regulators had examined annual reports of companied quoted on the London Stock Exchange (LSE). They stated that the main difference between these annual reports and Kenyan ones was the "enormous" amount of disclosure given by LSE companies. The two Central Bank regulators thought the amount of information disclosed by banks quoted on the LSE was "excessive".

All the auditors I interviewed had read the annual reports of companies quoted on the Johannesburg Stock Exchange (JSE) and the London Stock Exchange (LSE). The audit manager in firm A had studied the annual report of Berkshire Hathaway and stated that this should be used as a model for insurance companies in Kenya. The partner in firm E had previous experience of auditing companies quoted on the LSE. The audit manager in firm D had joined a London office of firm E and was involved in audits of companies quoted on the LSE when I interviewed her. She mentioned that companies quoted on the LSE were far more careful in fulfilling the reporting requirements of regulatory authorities because they feared incurring the heavy penalties that could result from non-compliance; those quoted on the NSE gave little thought to the requirements of regulators because: (1) there was less regulation, except in the banking sector, and, to a lesser extent, in the insurance sector; (2) no action was taken in cases where there was non-compliance with the regulations in place, for example, interim reporting. In her opinion, the level of disclosure required by the LSE was higher than that required by IFRSs and the Kenya Companies Act in a number of areas, including the management report and directors' remuneration – companies quoted on the LSE have to show the remuneration paid to each director individually, as opposed to the Kenya position where only the total paid to all non-executive directors and the total paid to all executive directors have to be disclosed. In addition, the corporate governance statements are more comprehensive and transparent for LSE companies.

Quoted companies in Kenya often used key performance indicators in monitoring the operations of the enterprise, but, in many cases, they preferred to keep these numbers to themselves. Referring to company 19, she stated:

> "*they think that if they put this information into the public domain, their competitors would use it to their advantage They did not want their competitors to know how well their production plant was doing or how well their sales was doing in a certain region. Personally, I do not think that this is a valid argument. I examined the annual report of a similar company quoted on the JSE. It had disclosed this information. I do not think that put the South African company at any disadvantage. Moreover, if companies quoted on the LSE have been disclosing this in the past, and it has not been detrimental to their performance, I do not think it is a valid reason for companies not to give this information*" (Audit manager with firm D, auditors of company 19).

9.6.4 Analysis

From the comments made by those experts who had examined annual reports of companies quoted on other stock exchanges, it was again evident that "high quality" was a relative term (Crowther 1996: also Beattie et al. 2004); if Kenyan listed companies' annual

reports were compared to those of companies on, say, the LSE, they would not be regarded as high quality. A preparer claimed that IFRS disclosures made by a Kenyan company would be "at the same level" as that elsewhere (9.6.1): but if companies in London take a far more serious approach to compliance, as seems to be the case as reported by the audit manager in audit firm D, and non-compliance was punished more severely (9.6.3), it is likely that compliance in Nairobi would be lower than in London – showing that the less than perfect IFRS compliance (7.2.1 and 7.2.4) and the lower S&P survey score (7.3.2, Figure 7-4) in the quantitative research seem to be confirmed. An example of indecisiveness by regulators was their inability to ensure that interim financial reporting was performed properly by listed companies (9.5.5).

Another reason for a lower quality of disclosure, adduced by analysts, was that the demand for shares on the NSE exceeded supply substantially (9.6.2). Although this is known in the market, it is a new finding for this study, since it was not revealed by the quantitative research.

Just as the analysts and auditors studied and learnt from the annual reports of companies on other stock exchanges (9.6.2 and 9.6.3), it would be beneficial for controllers to examine the annual reports of companies quoted on other exchanges, involved in the same industry as their own company. The internet makes this easy.

Another issue which NSE listed companies needed to address was the management report. Without a more detailed management report (9.6.2), which should include industry key performance indicators (9.6.2 and 9.6.3), the annual reports of Kenyan companies will fail to be rated "high quality" by analysts and knowledgeable audit staff.

9.7 The introduction of IFRSs.

The purpose of this section is to report the opinions of the accounting experts

Table 9-7: Perceptions of accounting experts as to whether the changeover to IFRS improved the quality of financial reporting in Kenya

	39 Controllers	4 Regulators	3 Auditors	10 Analysts	56 Total
Switch to IFRS improved quality	37	4	3	10	54
IFRS better enforced than KAS	38	4	3	N/A	N/A

interviewed as to whether the introduction of IFRSs improved the quality of financial reporting in Kenya. Regulators made no comments of note other than agreeing to the two points shown.

9.7.1 Preparers' perspective

The controllers of companies 19 and 39 did not think that the switch to IFRSs brought about any real improvement in the quality of financial reporting. Company 39 owned leasehold land, where the leases had more than 900 years to run; under IAS 17 and IAS 40 these had to be shown as operating lease assets. His opinion was that the accounts no longer portrayed economic reality in relation to the land the company "owned", which was a material figure in the accounts. This was very different to what another thought:

> "*To the extent that the world is becoming one village and many companies in Kenya are subsidiaries of multinationals, and people who invest in Nairobi also invest in other countries, that was the right thing to do. We wasted a lot of time arguing about minor points when the Standards Committee of ICPAK was formulating Kenyan Accounting Standards*" (Controller of company 36).

Among the 37 controllers who thought the introduction of IFRSs in 1999 brought about an improvement in financial reporting, a typical reply was:

> "*Absolutely. 1999 was the first year we produced a good quality set of accounts. Our eight page document increased to thirty four pages. The additional pages were not advertising. There was much more disclosure. But also, overseas companies that use IFRSs saw our profits measured in the same way as they measure their profits; and this is the case for all companies in Kenya*" (Controller of company 3).

The introduction of IFRSs forced companies to change the way they prepared their accounts. Company 23, which had investments in a number of associated companies, started using the equity method only when IFRSs were introduced; it had not followed Kenyan Accounting Standard 12: *Accounting for Associated Companies* (see Appendix 4-2a), which also required the equity method. Although she thought IFRSs were an improvement to Kenyan Accounting Standards, the controller actually saw the use of the equity method as a disadvantage because the company now reported a higher profit and individual shareholders could not understand why they did not get higher dividends.

In addition, the introduction of IFRSs gave staff an impetus to formalize the procedures used to make provisions for bad debts and slow moving stock, to check accruals and prepayments and to question the useful lives of different assets. The controller of company 37 (a bank) stated that there was information that she would have preferred not to put into the financial statements, but she was forced to do so because of IFRSs. The change made controllers more conscious of the need for greater disclosure. In addition, as controllers became more familiar with IFRSs, their perception was that they found compliance easier to deal with. A culture of continual improvement was *beginning* to be built up.

The controller of company 9 stated that when members asked what the meaning of certain items in the accounts were, as reported under IFRSs, the senior partner of the firm that audited the company's accounts (and who attended the company's AGM) was unable to explain the logic of some items in simple terms. He resorted to stating that the items should be reported in the way they were stated because IFRSs demanded this. A small number of controllers felt that some users would never understand some concepts, for example, a deferred tax asset; even analysts and regulators would say that this was not a "real asset".

9.7.2 Buy-side analysts' perspective

All the analysts saw the introduction of IFRSs in Kenya as beneficial. IFRSs required more items to be disclosed than Kenyan Accounting Standards, but more importantly, they required a full income statement (or profit and loss account), which communicated to users of accounts an array of items that was previously not contained in the statutory profit and loss account, and which presented a picture of the costs of operating the company which enabled a better analysis of operations to be made.

One analyst stated:

> *"Under Kenyan Accounting Standards, in the income statement, one was presented with the turnover figure which was doubled underlined and the next figure on the page was operating profit – between turnover and operating profit one had no idea of what had happened. Unless a user of the statements was to visit the company and obtain the information privately, he would not know what was going on; the common investor would not have that opportunity - which we do since we are a large institutional investor"* (Analyst Z).

Analyst W said that disclosure was more complete under IFRSs but also, foreign investors did not have to incur any costs in translating the accounts from Kenya to International standards. However, he mentioned that, under IAS 19, employees included directors, whether executive or non-executive; IAS 1 requires "staff costs" to be disclosed. Some companies on the NSE included directors' remuneration under staff costs, others did not. The IFRSs needed tightening up on small points like this.

9.7.3 Auditors' perspective

The firm A audit manager felt that IFRSs' "benchmark" and "allowed alternative" treatment of some items should be narrowed down to a single treatment to enhance comparability. Also, in the Kenya Accounting Standard cash flow statement, dividends and interest received and paid appeared under "Returns on investments and the servicing of finance"; now they could appear in a variety of places. The decrease in precision resulted in a lowering of quality.

But overall, he thought IFRSs were sound because they were principles based:

"in the US rules are created for compliance; but financial instruments are coming out faster than rules can be formulated; a set of principles could be created to guide preparers to give a 'true and fair view' – in the US, if there is no rule, the preparers can do whatever they like" (firm A audit manager).

He felt that auditors added to the quality of the financial statements but there was a severe constraint on auditors' ability to do this because of budget constraints on the amount of time that could be spent on the audit – which had become more acute because IFRSs demanded more time. Also knowledge of IFRSs was wanting not only on the part of preparers, where, in his opinion, it was severe, (there were exceptions), but also on the part of audit staff – who, under pressure of time and lack of immediately available knowledge, simply allowed a treatment to pass, even though it may not have complied with IFRS. He mentioned that IFRS non-compliance could be reduced considerably by using IFRS disclosure checklists, but preparers did not care much in doing so and audit staff were under excessive time pressure to be able to do so comprehensively.

9.7.4 Analysis

The interview research revealed points which would not have been revealed in a quantitative study. The changeover from Kenyan Accounting Standards to IFRSs had resulted in an improvement in the quality of financial reporting, in the opinion of the majority of experts, in agreement with the World Bank's finding (1.1). Their perceptions were that IFRSs were being enforced better (9.7.1). The amount of information in the annual report had increased (9.7.1 and 9.7.2); this saved analysts costs – they no longer had to obtain these numbers from companies in face-to-face meetings (9.7.2). Investors anywhere in the world familiar with IFRSs would be able to understand any Kenyan company's accounts, even non-quoted ones (9.7.1 and 9.7.2). The profits of Kenyan companies would be computed on the same bases as those anywhere else in the world that used IFRSs (9.7.1). Time would be saved in not having to keep KAS up to date (9.7.1). Preparers took IFRSs more seriously than KAS (9.7.1).

However, this process of changing over to IFRSs was not without its problems. In some areas, improvements in IFRSs needed to be made so that the changeover was not retrograde in certain areas of corporate reporting (9.7.1, 9.7.2 and 9.7.3). Some aspects of accounting under IFRSs were beyond individual investors, eg., deferred tax and leasehold land treated as an operating lease asset (9.7.1). An audit manager stressed that the knowledge of IFRSs of some preparers, and even some audit staff, was inadequate (9.7.3):

this could explain the finding in the regression model in section 8.4.1, where IFRS compliance varies negatively with audit firm B – unfortunately no interview of auditors from firm B was possible. There were budget constraints on the amount of time that could be spent on audits and this was likely to be greater under IFRSs because more information had to be included in the financial statements (9.7.3). These last two points made achieving "high quality reporting" difficult, complementing the quantitative findings that IFRS compliance is wanting.

9.8 Summary and conclusions

The findings of the interview research on the meaning of "high quality financial reporting" are summarized in Table 9-8. Preparers and analysts have the idea that high quality financial reporting is a multi-dimensional construct. They give a number of characteristics that must be fulfilled for financial reporting to be high quality. A number of these aspects of financial reporting deal with disclosure, but were not covered by the tentative definition proposed by this study: the interview research assisted in arriving at the final definition of high quality disclosure proposed by this study in section 10.4.1.

Table 9-8: Findings of the interview research on meaning of high quality financial reporting

No.	High Quality Fin. Reporting – HQFR: interviews	Support - prior studies	Section
1	"Quality" a nebulous term, difficult to define (9.3.1)	Leftwich (2004)	(2.4.6)
2	HQFR a multi-dimensional construct (9.3.1 – 4)	Jonas & Blanchet (2000)	(2.2.4)
3	HQFR portrays economic realities of company (9.3.2)	Cohen, D. (2002)	(2.6.1)
4	HQ disclosure & HQ earnings give HQFR (9.3.3)	Jonas & Blanchet (2000)	(2.2.4)
5	Timeliness of reporting essential for HQFR (9.3.1–3)	Jonas & Blanchet (2000)	(2.2.4)
6	Focused & pertinent info essential for HQFR (9.3.1-2)	Jonas & Blanchet (2000)	(2.2.4)
7	More info improves quality (up to optimum) (9.3.1)	Botosan (1997)	(2.4.2)
8	More information if benefits outweigh costs (9.3.1)	Wallace & Naser (1995)	(2.4.5)
9	Regulation must be effective (9.3.1)	World Bank (2000)	(3.8.9)
10	Auditors should ensure best practice followed (9.3.1)	Francis et al. (1999)	(2.6.4)
11	"Quality" a relative term; keeps improving (9.3.1)	Crowther (1996)	(2.2.3)
12	Regulation necessary for HQFR (9.3.3)	Hope (2003a)	(2.4.2)
13	Focused & relevant management review important in achieving HQFR, inc key performance indicators (9.3)	Clarkson et al. (1999), Barron et al. (1999), Beattie et al. (2004)	(2.4.8)
14	Forward projections improve quality (9.3.2)	Hussainey et al. (2003)	(2.4.8)
15	IFRS compliance sufficient for quality (9.3.1)	Barron et al. (1999)	(2.4.8)

The findings of the interview research on whether financial reporting in Kenya is high quality are summarized in Table 9-9. The purpose of Table 9-9 is to summarize the findings of the interview research and point out where theories, prior research and quantitative results in chapters 7 - 9 are reinforced, complemented, questioned or challenged. Any new ideas will be dealt with in chapter 10.

Table 9-9: Findings of the interview research on financial reporting in Kenya

No.	Issue re High Quality Fin. Reporting -HQFR	Dealt with in earlier chapters by:	Discuss-ed in
1	Preparers: reports convey info to investors & others (9.4.1)	Jonas & Young (1999) Healy & Wahlen (1999)	2.2.5 2.6
2	Do preparers really understand the purpose of reports? (9.4.3)		10.7
3	Change to IFRSs improved quality in Kenya (9.7.1)	WB (2001), Barth et al. (2005)	1.1, 2.3
4	Some IFRSs need to be improved (9.7.1 – 3)	Napolitano & K (2000)	3.8.3
5	Amount of information in the annual report had increased (9.7.1, 9.7.2)	WB (2001), Erhardt (2005)	1.1, 3.9.5
6	Changeover to IFRSs had saved analysts costs (9.7.2)	Supp. agency, signalling (Bhattacharya & D 2003)	2.5.1, 2.5.2
7	Some investors do not understand IFRSs (9.7.1)	World Bank (2000)	3.8.9
8	Experts aware that users of financial statements anywhere in the world able to "read" Kenyan annual reports – even non-quoted companies (9.7.1, 9.7.2)	IFAC (2005b)	3.2.1
9	Kenyan companies' profits computed in the same way as those around the world that use IFRSs (9.7.1)	IFAC (2005b)	3.2.1
10	Time would be saved in not having to keep Kenyan Accounting Standards up to date (9.7.1)	ICPAK (1997)	1.2.1
11	Enforcement of IFRSs perceived to be better (9.7.1)		10.7
12	Preparers took IFRSs more seriously than Kenyan Accounting Standards (9.7.1)	Supports legitimacy & institutional theories	2.5.4, 2.5.6
13	Knowledge of IFRSs among preparers & audit staff inadequate (9.3.4, 9.7.3)	No co complies fully with IFRSs: interim poor	7.2.1, 7.2.5
14	Cost constraints reduce the amount of information in annual reports (9.3.1)	Radebaugh & Gray (1997) supported (2.5.1)	10.7
15	Cost constraints limit the amount of time audit staff can spend on the audit (9.7.3)	No co complies fully with IFRSs (7.2.1)	10.7
16	Tensions present : each views report from own perspective preparers : competitive advantage (9.3.1) regulators: rules followed (9.3.3) auditors: true & fair view (9.3.4) analysts: full information (9.3.2) shareholders: few read reports (9.3.4)	FASB (1978) questioned Radebaugh&G ('97) supp Agency theory supported Agency theory supported Agency theory supported Agency theory supported Decoupling supported	2.5.1 2.5.1 2.5.1 2.5.1 2.5.1 2.5.1 2.5.6
17	Kenyan analysts view annual report as vital (9.4.2)	Chang & M. (1985), Vergoossen (1993)	2.4.3, 2.4.3
18	Kenyan auditors assist in improving quality (9.5.1)	AICPA (1997) Teoh & Wong (1993)	2.2.2 2.6.4
19	Kenyan preparers view their own annual report as HQ: "quality" is subjective (9.5.1)	Supports Crowther ('96), legitimacy theory	2.2.3, 2.5.4
20	Auditor rates one annual report low quality but analysts rate it high quality: "quality" is context dependent (9.5.6)	Supports Crowther ('96), legitimacy theory, & institutional theory	2.2.3, 2.5.4, 2.5.6
21	Annual report difficult to understand rated low quality (9.5.6)	FASB (2005)	2.2.6
22	Earnings perceived to have been managed: annual report rated low quality (9.5.6)	Richardson (2003)	2.6.1
23	Kenyan preparers reluctant to name low quality annual reports (9.5.6)	Supports legitimacy & institutional theories	2.5.4, 2.5.6
24	Kenyan preparers claim their knowledge of IFRS is improving (9.5.1)	Supports institutional theory (2.5.6)	10.7
25	Nos. 12 & 13 contradicted: preparers over-reliant on auditors in Kenya (9.3.4)	Supports agency theory, quantitative results	2.5.1. 7.2.1&5

No.	Issue re High Quality Fin. Reporting -HQFR	Dealt with in earlier chapters by:	Discuss-ed in
26	Timeliness sometimes prevented by lack of timeliness on the part of other companies (9.5.1)	Contradicts stakeholder & institutional theories	2.5.5, 2.5.6
27	Greater discussion of annual report with knowledgeable people would improve quality: better to have a team than a single individual (9.5.7)	Supported by FiRe but contradicted by IFRS & S&P regressions	8.4.3.1, 8.4.1.3, 8.4.2.1
28	Arriving at HQFR difficult work (9.5.7)	Supports signalling theory	2.5.2
29	Preparers may not be aware that they are judged from what they put into the annual report (9.4.3)	Supports agency & signalling theory	2.5.1, 2.5.2
30	Analysts claim annual report low quality because discrepancy between management report & figures (9.5.6)	Supports signalling & stakeholder theory Contradicts agency theory	2.5.2, 2.5.5 2.5.1
31	Central Bank regulation too stultified (9.5.5)	Contradicts stakeholder theory (2.5.5)	10.4.3
32	No connection between share price & HQFR (9.3.1-4)	FiRe Award regression contradicts this	8.4.3.1
33	Lack of investor & media-personnel financial literacy makes communication difficult (9.5.1)	Supports World Bank (2000) and Radebaugh & Gray (1997)	3.8.9, 2.5.1
34	Banks able to obtain international ratings using standard annual reports showing they are HQ (9.5.1)	FiRe Award scores positively assoc with banks: univar support	8.3.8, 8.4.3.1
35	Kenyan auditors prevent forms of earnings management: regulator rates earnings quality good (9.5.3, 9.5.4)	Contradicts finding that audit firm E (in particular) unable to ensure IFRS compliance	Future research 10.7
36	Interim reporting IAS compliance very variable 3 regulators undecided about "publishing" Auditor: interim reports useful only if audited (9.5.5) Central bank: quarterly reporting but not IAS (9.5.5) Analysts: reporting useful only if HQ (9.5.5) Regulators indecisive (9.5.5)	Supports decoupling. World Bank (2000). Supports agency theory. Implications of this research. Herring&Santomero ('99) World Bank (2004a)	7.2.5, 4.13.3.1, 2.5.1, 10.4.3, 2.3, 4.1
37	Demand for shares on the Nairobi Stock Exchange exceeds supply & results in lower quality reporting (9.6.2)	Supports Haniffa and Cooke's (2002) finding & quantitative results	2.2.3, 7.2.1, 7.2.5
38	Preparers do not under-report profits to avoid political costs or taxation charges (9.5.6)	Supports political cost, legitimacy & stakeholder theories	2.5.3, 2.5.4, 2.5.5
39	Kenyan companies do not take compliance as seriously as London listed companies (9.6.3)	Supports decoupling by Kenyan regulators	2.5.6
40	Kenya does not punish non-compliance as severely as London (9.6.3)	Supports decoupling by Kenyan regulators	2.5.6
41	Some use annual report as marketing tool (9.4.1)	Implications of research	10.4.3
42	Controllers should examine how companies in their industry report on other stock exchanges (9.6.2-3)	Implications of this research	10.4.3
43	Interviewees became more aware of High Quality Financial Reporting as interview progressed (9.3.1)	Implications of this research	10.7

Table 9-9 summarizes the findings of the interview research on financial reporting by NSE companies in Kenya. The interview research provides some of the reasons why full compliance with IFRSs is not achieved by the NSE companies: it also confirms the regressions' findings of a positive association between FiRe Award

scores and company size, and the univariate association between Fire Award scores and banking companies. It also confirms the World Bank's finding (WB 2001) that the change to IFRSs improved the quality of financial reporting in Kenya (1.1). The views that there is no connection between high quality disclosure and the share price of the company is contradicted by the positive association of FiRe Award scores with share price increases reported in section 8.4.3.1.

The interview research also confirms some of the expectations formed by disclosure theories. Agency theory is confirmed in the finding that preparers, auditors, regulators and analysts each view the annual report from their own perspective and care little about the concerns of the other persons involved. Preparers, audit staff, regulators and even individual shareholders engage in decoupling as predicted by institutional theory. Preparers do not understate profits to avoid political costs and for legitimacy reasons – they avoid at all costs the scandal that would occur if they were discovered. But the banks minimize political costs by including a substantial amount of social responsibility disclosure, especially after the Donde Act was passed and their prices of their shares dropped on the NSE.

A large number of findings which support or are contradicted by prior research or the quantitative research is included in Table 9-9.

The other findings of the interview research will be used in arriving at the implications of this study in section 10.4 and topics for future research in 10.7.

CHAPTER 10
Summary, Implications, Contribution, Limitations and Suggestions for Further Research

10.1 Introduction

The purpose of this chapter is to summarize the objectives, questions and approach (10.2) and the main research results and conclusions (10.3). The main implications of the research are explained (10.4). The main contributions, implied by meeting the objectives of the research, are presented (10.5), together with the associated limitations (10.6): this enables an assessment to be made of this study. Matters of particular interest for further research are suggested (10.7).

10.2 Summary of objectives, questions and research methods

This section summarizes the general research objectives, the empirical research questions and the research methods used in this study.

10.2.1 General research objectives

The general research objective, as presented in section 1.3, was to make a contribution to understanding how preparers of financial statements that will be used in capital markets in developing economies can be assisted in achieving "high quality financial reporting", and how regulators and other intermediaries can help them to do so.

This general objective was divided into three sub-objectives (1.3), which were:

1. To contribute to an understanding of the meaning of the phrase "high quality financial reporting", to clarify the distinction between "high quality disclosure" and "high quality measurement" in financial statements, and to develop a tentative definition of "high quality disclosure" for this study.

2. To contribute to understanding the applicability of disclosure theories to a capital market in a developing country with particular reference to high quality disclosure.

3. To contribute to understanding the relevance of International Financial Reporting Standards in achieving high quality disclosure in financial reporting to investors in a developing country.

The approaches adopted to meet these objectives were as follows:

1. The meaning of "high quality financial reporting" was investigated by analysing the academic literature (chapter 2), examining the use of the phrase by regulators, practitioners, professional bodies and users (chapter 3) and probing the opinions of

accounting experts in Kenya (chapter 9). The distinction between "high quality disclosure" and "high quality measurement" was examined in each of these contexts.

2. Relevant theories of disclosure were summarized (chapter 2). Kenyan institutional characteristics related to "high quality financial reporting disclosure" were examined (chapter 4). Theories and empirical findings were used to formulate hypotheses (chapter 6). "High quality financial reporting disclosure" by quoted companies in Kenya was measured (chapter 7). The hypotheses were tested using univariate and multivariate analysis (chapter 8).

3. The relevance of International Financial Reporting Standards in achieving high quality disclosure was examined in the academic literature (chapter 2), in the deliberations of regulatory and accounting standards setting bodies (chapter 3), in the context of accounting in Kenya (chapter 4), in assessing elements of high quality financial reporting disclosure (chapter 7) and by accounting experts in Kenya (chapter 9).

10.2.2 Empirical research questions

The three general research objectives (1.3) were used to develop three general research questions (1.5.1), which in turn were used to develop three empirical research questions (1.5.2). The links in Figure 1-2 indicate that the general research question, $\mathbf{GQ_1}$, was answered first in a tentative way in order that the remainder of the research could be carried out. The findings of the empirical research questions were then used in providing a more definitive answer to $\mathbf{GQ_1}$ in 10.4.1. The empirical research questions were examined in chapters 7, 8 and 9.

10.2.3 Research methods

The main research methods employed by this study were:

(1) the creation and application of an International Financial Reporting Standard (IFRS) compliance disclosure index, using an un-weighted scoring method;

(2) the application of Standard and Poor's Transparency and Disclosure Survey 2003 (S&P survey) index, using an un-weighted scoring method;

(3) the comparison of the results of the IFRS compliance and the S&P survey scores with a study undertaken independently in Kenya, the Financial Reporting (FiRe) Award for Excellence 2003;

(3) univariate and multivariate analysis to test hypotheses;

(4) semi-structured interviews.

10.3 Main research results and conclusions

The main research findings and conclusions are presented in four sections as follows:

(1) The meaning of the phrase "high quality financial reporting" and the clarification of the distinction between "high quality disclosure" and "high quality measurement" in financial statements (10.3.1), in answer to $\mathbf{GQ_1}$.

(2) The extent of high quality disclosure among companies quoted on the Nairobi Stock Exchange (10.3.2), in answer to $\mathbf{EQ_1}$.

(3) Associations between company characteristics and high quality disclosure (10.3.3), in answer to $\mathbf{EQ_2}$.

(4) Perceptions of accounting experts on high quality financial reporting (10.3.4), in answer to $\mathbf{EQ_3}$.

10.3.1 Meaning of the phrase "high quality financial reporting"

The use of the phrase "high quality financial reporting" was investigated in an attempt to clarify its meaning. Practitioners want to develop a framework so that a common understanding of the meaning of "quality" is achieved (2.2.5). The framework developed is multidimensional and is difficult to deal with in a research setting (2.2.4). Academic researchers study elements included in this framework, but they do not show how their studies relate to taking forward the framework as a whole.

Academic researchers have used the phrase "high quality financial reporting" when investigating a variety of elements that are part of the financial reporting process, including audit quality, the quality of accounting standards, "earnings" or measurement quality, and "disclosure" quality (2.1, 2.2.1). This study briefly examined the financial reporting process (2.2.2, Fig. 2-1) so that the distinction between "earnings quality" and "disclosure quality" was clarified. It then examined the literature; it finds that no real attempt to define "disclosure quality" has been made (2.4) but a number of definitions of "earnings quality" have been proposed (2.6). In an attempt to operationalize the concept for the purposes of this study (2.8), and to supplement FASB's definition of "high quality financial reporting" (2.2.6), this study proposes a definition of "high quality disclosure" (which requires full compliance with high quality accounting standards, and a high rating by an international and a national disclosure index): because all three measure different aspects of disclosure quality, a combination of the three indices was used to arrive at the definition (2.8). This study shows that the US SEC has come to accept International

Financial Reporting Standards (IFRSs) as "high quality", but possibly on a provisional basis (3.9.5): this acceptance is important because FASB has stated that, without this acceptance, "a global standard-setting process is impossible", and IFRSs will not be truly "international", in that they would not be acceptable in US capital markets, possibly the most important in the world (3.6): if a Form 20-F reconciliation is required when companies using IFRSs report in US markets, IFRSs are no better than the national accounting standards of the country of domicile of the foreign company (3.10).

10.3.2 Extent of high quality disclosure among companies

A number of researchers have used IFRS compliance (2.4.5) and S&P survey (2.4.3) scores as measures of high quality disclosure. The Institute of Certified Public Accountants of Kenya, the Nairobi Stock Exchange (NSE) and the Kenya Capital Markets Authority claim that the FiRe Award measures "excellence in Financial Reporting" (4.11). These three measures were used to gauge the quality of disclosure of NSE companies to test associations between each of the measures and company and market independent variables. None of the three can be claimed to be the "best" in measuring the quality of disclosure in NSE company annual reports, because each measures a different aspect of disclosure quality. IFRS compliance ensures complete width of coverage - ensures that the report embraces all the material financial activities of the company – it provides a universal benchmark to ensure that financial disclosure is as complete as it need be; the S&P survey index covers the sort of information that a rating agency would use to decide the credit worthiness of the company and further disclosures judged by S&P to be important; the FiRe Award has a bias towards what accountants in Kenya perceive to be important in annual reports in Kenya – although the annual competition is now run by the three institutions mentioned above, it is dominated by ICPAK because ICPAK members are ready to do the work required: it suffers from a lack of input from analysts (4.11).

Using the definition of "high quality disclosure" tentatively developed by this study (2.8), it was found that no annual report of companies listed on the Nairobi Stock Exchange (NSE) achieved "high quality disclosure" (7.5). However, a large proportion (80.86% - 7.2.1) of NSE quoted companies has a level of compliance of 95% or more with the disclosure requirements of IFRSs: full compliance can be achieved with effort and perseverance (7.2.2, Appendix 7-3). Full compliance with

the disclosure requirements of the Kenya Capital Markets Authority would ensure that companies achieve the score set on the S&P survey to be rated high quality (2.8).

The interim financial report of only one company (company 39, appendix 7-1) achieved full compliance with IAS 34. At the present time, there are no established disclosure indices which are internationally or nationally recognized to gauge whether this company's interim financial report achieved "high quality disclosure" as defined in section 2.8. From IASB's standpoint, the disclosure in the interim report of company 39 was "high quality".

It was also found that there was no correlation between mandatory and voluntary disclosure for NSE companies (hence mandatory and voluntary disclosure can be studied independently in this market); nor between the different scoring systems (different managers stress different areas of disclosure); and that IFRS compliance and S&P scores in the annual report are not higher (at the 5% level of significance) for companies that entered the FiRe Award (managers who enter their annual reports for this competition probably think that their disclosure is superior to those that do not, whereas in reality this is not true: their perceptions of the disclosure quality of their annual reports are rather biased, a finding that was confirmed by interview research, section 9.5.1). However, FiRe Award entrants' interim report scores are higher (keener managers tend to disclose better when they do so unaided by their auditors) (7.6.1).

10.3.3 Associations between company characteristics and high quality disclosure

Associations between 15 company characteristics and "high quality disclosure" were tested.

It would be expected that "high quality disclosure" would have been found to be associated with company size, in keeping with many other disclosure studies (6.3.1). However, both univariate and multivariate analysis found size to be associated only with annual report high quality disclosure measured by FiRe Award scores; reasons for the absence of positive associations between company size and IFRS and S&P survey scores are discussed in 8.5. Univariate analysis found interim report IAS 34 compliance scores associated with size, but multivariate analysis failed to confirm this, possibly for the same reasons but in a less pronounced way, since interim report preparation is perfunctory by NSE companies: many cling to past practices as if IFRSs did not exist (8.4.5.1). Univariate and multivariate analysis found the number of shareholders (used as a proxy for shareholding

diffusion - 6.3.2) associated with S&P survey and FiRe Award scores, but all the other associations were found to be unique to each different scoring system, some of which are found in few prior studies, as discussed in sections 6.3.2 to 6.3.4, and 6.3.6 to 6.3.8 for annual reports and 6.4.2 and 6.4.3 for interim reports. These associations are sections 8.4.1.3, 8.4.2.1 and 8.4.3.1 for annual reports and in section 8.4.5.1 for interim reports. The overall conclusion of this analysis was that there are systematic associations between particular company and market characteristics and "high quality disclosure" in annual reports, and interim financial reports as measured by compliance with IAS 34.

10.3.4 Perceptions of accounting experts on high quality financial reporting

Interview research was conducted with preparers, auditors, regulators and buy-side analysts to obtain insights into matters pertaining to high quality reporting.

One finding was that the interviews were something of a learning process for many of the interviewees (9.3.1). It was clear that very few actually went through the questionnaire in detail before the interview. During the interview, the questions made them think of ideas which had not occurred to them earlier. They became a lot more aware of what constituted "high quality financial reporting" as the interviews progressed (9.5.7). It was not as if answers were being fed to them; it was more that they spontaneously began to grapple with ideas which enabled them to clarify those ideas for themselves (9.3.1).

Interviewees' perceptions were that "high quality reporting" was a multi-dimensional construct which portrayed faithfully the economic realities of the company (9.3.5). Both disclosure and reported earnings had to be high quality for a set of financial statements to be high quality. The quality of financial reporting could be increased by ensuring compliance with IFRSs, by providing more information (provided it was relevant and focused), by including a management review and key performance indicators relevant to the company business, by including forward projections, and by auditors ensuring that best practice was followed. Some preparers perceived that IFRSs compliance on its own was sufficient for "high quality reporting". No preparer, regulator, auditor or analyst thought that there was any connection between the price of the company's shares on the exchange and the quality of the financial report (9.3.5) – contrary to the finding reported in section 8.4.3.1.

Kenyan analysts viewed the annual report as a vital means of communication and used interim reports for profit projections and confirmations (9.4.3). They used annual reports to

assess the quality of management, especially if there was any discrepancy between the narrative report and the figures. Preparers stated that reports were a means of conveying information to investors but did not seem to be aware that their ability was being assessed by the market from the quality of their reports (9.4.3).

The vast majority of interviewees were of the view that the introduction of IFRSs in Kenya improved the quality of financial reporting, although a small minority were critical of the requirements of some of the IFRSs (9.7.4). One reason why the changeover from Kenyan to International Standards had brought about an improvement was that the amount of information in annual reports had increased. Another benefit of adopting IFRSs was that preparers took them more seriously than their Kenyan equivalents (9.7.4). Preparers invariably were of the view that the annual reports prepared by them were "high quality" and that their auditors had assisted them in achieving "high quality" (9.5.7). All interviewees who had examined annual reports of companies quoted on more developed markets agreed that much more detail was included in those reports than in Kenyan annual reports; the majority of analysts, auditors and regulators claimed that overseas annual reports were "higher quality"; many preparers thought those annual reports were superior in their level of detail but not in relation to disclosures required by IFRSs (9.6.4).

Preparers stated that they did not under-report profits to avoid political costs; but the banks, which were seen to earn profits even when the rest of the economy was suffering from the effects of shortages of rain, increased the reporting of their involvement in social projects (9.5.6). Some banks were able to obtain international ratings using their annual reports without making any adjustments: they viewed this as confirmation that their financial statements were high quality (9.5.1). A number of the banks thought that Central Bank was over-regulating and required information in a format different to that dictated by IFRSs, increasing unnecessarily reporting costs (9.5.5).

Interim reporting compliance was very variable. One agricultural company was fully compliant with IAS 34. The majority of companies had made no change in their interim reporting when IFRSs were introduced. Regulators lacked focus (4.13.3.1); the Central Bank laid down a quarterly reporting format that was not compliant with IAS 34 (9.5.5). Banks often paid little attention to ensuring that interim reports reflected the economic position of the bank (9.5.5) with the result that they were of little use to analysts (9.5.5). The other regulators did nothing to address the problem (9.5.5). Interim reports were not

audited; auditors' assistance in complying with IAS 34 was therefore not present and this became evident in the extremely low scores achieved for compliance.

Interview research revealed a factor for non compliance with IFRSs that the quantitative research did not reveal – the major constraint on IFRS compliance revealed by interview research seems to be the lack of detailed knowledge of IFRSs on the part of the majority of preparers and audit staff (9.3.4, 9.7.3): unless this deficiency is tackled, high quality financial reporting will remain an impossibility by quoted companies in Kenya. An auditor stated that disclosure checklists were seldom used by preparers or auditors (9.7.3).

Interview research revealed that analysts need a focused and relevant management review in the annual report of a quoted company (9.3.2); key performance indicators for the industry in which the company operates should be included; forward projections should be included whenever possible (9.3.2). Interim reports need to be prepared with more attention so that they become more useful to analysts.

Interview research also clarified that regulators need to lay down rules which make compliance with IFRSs as simple as possible (9.3.1). They should not require disclosures which are different to those required by IFRSs. Different regulators have to work together to ensure that there is unity amongst the requirements they each lay down (9.3.1).

10.3.5 Applicability of Disclosure Theories

Disclosure theories were outlined in chapter 2. They were used to formulate hypotheses (chapter 6) tested by statistical analysis (chapter 9). Disclosure theories were not used in formulating hypotheses 7, 12 and 13. For hypothesis 4 (H_4), both stakeholder and institutional theory predicted that younger companies would have relatively better disclosure (6.3.4), which was confirmed by the S&P scores using univariate analysis (8.3.4): the hypothesis was framed in the opposite direction, on the basis of Owusu-Ansah's (1998) arguments and findings.

Tables 10-1 and 10-2 indicate that there is support for all the theories of disclosure, depending on which disclosure index is chosen in relation to each hypothesis. Agency, signalling and political cost theories explain part of the variability of annual report and interim report IFRS compliance variability, with legitimacy also explaining the latter. Interviews revealed that institutional theory is also relevant in explaining IFRS compliance variability: decoupling occurs in IFRS compliance: preparers thought the reports they prepared "high quality" (9.5.1), whereas auditors claim that preparers do little to ensure

Table 10-1: Annual report: prior expectations, theories and research findings

Hyp-oth-eses	Prior expectations: There is a significant association between high quality disclosure and:	Theories	Research findings
H_1	positive: company size	Agency, signalling, political cost	IFRS, S&P: not supported FiRe Award: supported
H_2	positive: the number of shareholders	Agency, political cost	IFRS: not supported S&P, FiRe Award: supported
H_3	positive: higher shareholding owned by a holding/investing company	Agency, political cost, stakeholder	IFRS, S&P: not supported FiRe Award: supported
H_4	positive: age of the company	Stakeholder, institutional	IFRS, FiRe Award: not supported S&P: contradicted
H_5	positive: leverage of the company	Agency, signalling, stakeholder	IFRS, FiRe Award: not supported S&P: contradicted (univar. only)
H_6	positive: dividend pay out ratio	Agency, signalling, political cost	IFRS: supported S&P, FiRe Award: not supported
H_8	positive: affiliate of a multinational	Political cost, legitimacy, stakeholder	IFRS: not supported S&P: supported. FiRe Award: supported (univariate only)
H_9	uncertain: type of industry	Agency, political cost, signalling, legitimacy	IFRS: not supported S&P, FiRe Award: supported (univariate only)

Table 10-2: Interim report: prior expectations, theories and research findings

Hyp-oth-eses	Prior expectations: There is a significant association between high quality disclosure and:	Theories	Research findings
H_{10}	positive: company size	Agency, signalling, political cost	IFRS – IAS 34 – supported (univariate only)
H_{11}	type of industry		IFRS – IAS 34:
	positive: agricultural sector company	Signalling, political cost, legitimacy	supported
	positive: banking & invest. company	Agency, legitimacy, political cost, signalling	supported
	negative: industrial & allied company	N/A	supported (univariate only)

compliance with IFRS (9.3.4), which is confirmed by low quality interim reports (7.3.6), where auditors are not involved (9.5.5); preparers are ready to admit that auditors assist them in achieving "high quality disclosure" (9.5.1) but auditors have to do far more than should be required of them (9.3.4). Preparer IFRS compliance is not the result of coercive, mimetic or normative isomorphism: stakeholders do not demand high levels of IFRS compliance because they tend not to understand them and are unaware of their contents (9.7.1, 9.3.4, 9.7.3), and in spite of preparers perceiving that enforcement of IFRSs being better than of Kenyan Accounting Standards (9.7.1), in fact regulation is ineffective (9.3.1) and non-compliance is punished less severely than in London (9.6.3). Preparers do not understate profits to reduce the tax charge for fear of penalties but also to avoid political costs (9.5.6).

Agency, political cost, legitimacy, institutional and stakeholder theories explain part of the variability in S&P survey scores. Interviews again confirmed these findings. Preparers agree that more information improves the quality of disclosure, that focused and pertinent information is essential for high quality disclosure (9.3.1), which should include a management review and key performance indicators (9.3.1), but fail to include this additional information, except in affiliates of multinationals (8.3.8), which did so to avoid agency and political costs, for greater legitimacy, and to satisfy different stakeholders using mimetic isomorphism – they follow their parent company's accounting (9.6.1).

Similarly, agency, signalling, political cost, stakeholder and legitimacy theories explain part of the variability of FiRe Award scores.

It can be concluded that disclosure theories do explain part of the variability of disclosure quality of reporting by Nairobi Stock Exchange companies. Interview research brought to light a number of explanations that disclosure theories overlooked: the fact that IFRS knowledge is wanting in varying degrees on the part of preparers and audit staff; that there is sometimes a discrepancy between the narrative and the numbers in the annual report; the absence of the use of checklists to ensure compliance; that regulation is ineffective; that the interim reports produced by banks seem to be prepared almost entirely to satisfy the Central Bank of Kenya's regulations but with little regard for users – even though the disclosure in banks' interim reports tended to be higher quality than non-banking companies.

10.3.6 Influences that enable companies achieve high quality disclosure

The empirical research suggests that companies with high quality auditors and managers who try to minimize agency costs by having a higher dividend payout ratio tend to achieve higher IFRS compliance. Younger companies which are subsidiaries or associates of multinationals and have larger numbers of shareholders tend to achieve higher S&P survey scores; other NSE companies cannot change their age, nor can they become associated with a multinational, nor increase the number of shareholders, but they can indulge in mimetic isomorphism. Larger companies, with larger numbers of shareholders and which have a larger proportion of shares owned by holding or investing companies tend to have higher FiRe Award scores: smaller companies will find it hard to mimic larger companies because smaller companies do not have the same resources available. Agricultural and banking companies, and companies with a 31 December year end, tend to have better interim reporting. Interview research suggests that superior knowledge of the IFRSs on the part of

preparers and the company's auditors, and the use of disclosure checklists, enable companies to achieve better IFRS compliance: this finding is common sense, but it reinforces the fact to companies that do not achieve a high level of compliance: IFRS compliance does not come easily: it is achieved by painstaking attention to detail. Interview research suggests that there is over-reliance on auditors to achieve compliance: to change this, preparers must assume ownership of the financial reports and ICPAK should reinforce this outlook, by taking action against preparers in addition to taking action against auditors when compliance is not achieved. Interview research also suggests that better corporate governance disclosure, a better management review, key performance indicators, and 5-10 reviews are required of companies: these would automatically achieve higher scores on the S&P survey and the FiRe Award, which would enable companies to move towards "high quality disclosure".

10.4 Implications of research findings

The findings of this study are useful for a number of different groups which are enumerated below.

10.4.1 The meaning of high quality disclosure

This study developed a working definition of "high quality disclosure" at the end of chapter 2 in section 2.8. As the empirical part of the study progressed, it became clear that the definition required expansion to capture a number of aspects of financial reporting that contribute to "high quality disclosure".

Capital market regulators all over the world increasingly demand full compliance with a set of "high quality accounting standards": the SEC accepts US GAAP and IFRSs as "high quality accounting standards" (3.9.5). Given the importance of the SEC in the US, the world's largest, and possibly most important capital markets, and in IOSCO, full compliance with either US GAAP or IFRSs is a necessary condition for "high quality disclosure".

S&P is an internationally recognized rating agency: it is US based, which adds credibility in the US to its disclosure and transparency disclosure index. It captures some voluntary disclosures which are universally absent from US companies' reporting (Bushee 2004): S&P use this checklist in its interactive corporate governance scoring service (S&P 2003, p.4). Since UK companies score more highly than US ones, the overall UK mean score (73%, section 7.3.2) should be adopted as the measure of "high quality" for this index.

A score of 73% or more on a nationally recognized disclosure index, similar in breadth to the FiRe Award disclosure index (see Appendix 5-2), is also a necessary condition for "high quality disclosure": this index of this type captures the main cultural influences particular to the domicile of the companies whose disclosures are being measured.

An element in financial statements that is necessary for buy-side analysts (whose importance was stressed by Sutton, M. (2002) in section 3.9.2) is a management review which gives a clear explanation of the figures and a good overview of the business (9.3.5), "in a manner that non-finance professionals can understand" (9.3.2). This management review should include "forward looking statements on plans" (9.3.2). Buy-side analysts' needs in developing countries are not inferior to buy-side analysts' needs in more developed markets. All listed companies need to come up to world standards: that is the reason why comparisons are made. The persons who should judge whether management reviews are rated highly (i.e., are "high quality") are analysts in the jurisdiction of the listed companies; as reported in section 9.6.2, all the private sector buy-side analysts in Kenya examine annual reports of companies quoted on stock markets around the world and have a good idea of the content required and the way this content should be presented.

Timely disclosures are essential for buy-side analysts (9.3.2) and other investors. I propose that the annual report should be published within three months of the year end, and that the interim report should be published within one month of the end of the period, as necessary conditions for "high quality disclosure"..

On the basis of these necessary elements, the proposed definition of "high quality is as follows:

Table 10-3: Proposed definition of "high quality disclosure"

A financial report exhibits "high quality disclosure" if it receives a clean audit report, is in full compliance with high quality Accounting Standards, is rated highly using an internationally recognized disclosure index, is rated highly using a nationally recognized disclosure index in the country in which it is incorporated, contains a management review which is rated highly by private sector buy-side analysts in the country in which it is incorporated, and which is published within one month of the end of the period if it is an interim report and three months of the end of the year if it is an annual report.

It is clear that this study is only a beginning. The proposed definition is a first step. Academic researchers can certainly improve upon the definition presented above. But in

their quest to develop a much more sophisticated definition and examine ways by which disclosure in financial reporting can be enhanced, precision in terminology is of utmost importance. The phrase "high quality financial reporting" is bandied about by regulators, standard-setters and consultants whenever they wish to stress the importance of what they are trying to communicate. Academics have to avoid the temptation to do the same when they are arguing how their study contributes new thought to the world of accounting ideas: Miller and Bahnson (2002) devote a whole book to "Quality Financial Reporting" but agree that they do not really know what comprises "Quality Financial Reporting". Although they manage to record a quote from Warren Buffet that "This book is a step toward restoring its (accounting's) usefulness", accountants who read the book would wonder what the step consists of, other than an exhortation to managers to reveal the true position of the company. Rather, academics, like managers, have to lead by example (Deming 1982). If a study contributes a single point which enhances "disclosure quality" or "financial reporting quality", the researcher should be honest enough to state this fact rather than claim that this improvement is critical to "high quality financial reporting". In addition, much greater care has to be made in choosing proxies for "high quality disclosure": there is serious doubt whether a single proxy portrays the totality of "high quality financial reporting": academic researchers should have the honesty to acknowledge this fact and tailor their studies and claims appropriately, rather than climbing onto the bandwagon by using a phrase which happens to be in fashion at the time, and which therefore will enhance the publication prospects of their study.

This precision must distinguish between "quality earnings", "quality disclosure" and "quality financial reporting". Just as ensuring "quality disclosure" is necessary but not sufficient to ensure "quality financial reporting", so too "quality earnings" on its own is not a guarantee of "quality financial reporting". If academics demand precision from the practitioners' world, the message may eventually be communicated to practitioners: at present, it appears that academics accept the lack of precision as if they were being swept along by the tide, attempting to use it to their own advantage. Lack of precision serves to create confusion; confusion is a lot more difficult to deal with than a well ordered set of ideas.

Finding "disclosure" to be associated with a number of company and market variables is a useful practice in so far as it identifies what factors can predict the variability of

"disclosure" in a market; generalizations are sometimes made by politicians and by journalists based on a single example – if problems had not been found in a number of US companies in 2002, Enron would have been a good example. Academics are able to give much more balanced views, which are closer to the truth, when they make statements based on findings derived from random samples, or from the total population, as has been done for two measures of disclosure in this study. However, as this study has shown, far more care has to be taken in arriving at valid "measuring instruments". As Marston and Shrives (1991) point out, the usefulness of the disclosure index as a measure of disclosure depends critically on the selection of the items for inclusion. The findings of this study provide empirical proof of the validity of this statement. The abstract concept "disclosure", measured in the multitude of ways that it can be measured, could possibly be found to vary with almost any company or market variable by choosing a suitable set of items to be designated as the "disclosure index". Beattie et al (2004) note that researchers investigating the determinants and consequences of disclosure quality could be wasting their efforts if the primary variable of interest is not measured with sufficient accuracy: they conclude that measures that equate absolute quantity with quality are questionable. Greater study needs to be conducted to examine whether more objective selections of items can be made to arrive at better measures of "disclosure".

10.4.2 Implications for standard setters, regulators and practitioners

Just as academics should use the term "high quality financial reporting" more judiciously, so too standards setters, regulators and practitioners should use the phrase to mean what FASB and IASB have defined it to mean (section 2.2.6). FASB and IASB have said that "high quality" does not describe attributes of decision useful financial information distinct from other qualitative characteristics and should not be added as a separate qualitative characteristic in the FASB/IASB converged framework (FASB 2005c); the SEC speaks of "high quality global accounting standards" (Erhardt 2006) soon after the definition has been decided upon, without any reference to FASB/IASB's definition. Does the SEC mean by the phrase "high quality" what FASB and IASB have defined it to mean? While the answer could be yes, there is some possibility that it could be no; what was the point of FASB and IASB struggling to agree on a definition of "high quality" if the US regulator uses the phrase as if it was unaware of the change in the status of the phrase? Or is the audience being addressed so aware of the changes in the nuances of the phrase that they do not need to

be cautioned in understanding the phrase in a slightly different sense from what was previously the case? There is little wonder that the US General Accounting Office states that SEC oversight of FASB has been sporadic (GAO 1996, p.21) and that more progress could be achieved in resolving the major issues facing the standard setters if the SEC would exert more of a leadership role in working with the standard setters (ibid., p.124).

10.4.3 Implications for regulators in Kenya and in developing countries

It seems that Kenya is a country much studied by the World Bank, judging from the number of its publications in which Kenya is mentioned. As a result, there have been many proposals given to the authorities in Kenya. The World Bank reports that, in Kenya, "*(t)he ICA (Investment Climate Assessment) and FIAS (Foreign Investment Advisory Services) findings indicate that business regulation and inspections are principally an opportunity for low-level public officials to extract bribes from firms, and that these bribes represent a significant portion of revenue*" (WB 2004a, p. 95). The World Bank goes on to propose that administrative procedures for on-going businesses "*be simplified and streamlined*", but some of the more specific suggestions go counter to the principle of simplification. The department in the World Bank that produced the Report on the Observance of Standards and Codes (ROSC) (WB 2001) was probably unaware of this principle. It proposed: "*revise the Accountants Act, the Companies Act, and related regulations . .*"; "*make IASs legally mandatory for large enterprises and financial institutions . .*"; "*strengthen the institutional framework of the profession*"; "*strengthen ICPAK*"; "*review and upgrade the accounting curriculum*"; "*address CPA licensing issues*"; "*deliver effective and high quality training*"; and "*strengthen the enforcement mechanisms*" (WB 2001, pp. 11-12): in other words, almost, start all over again. In just one area, the accounting curriculum, all four financial accounting papers and the two auditing papers in the CPA syllabus in Kenya had been examining candidates in IASs and ISAs since 1997 (KASNEB 2000, Foreword): was the World Bank aware of this fact? Many of the "facts" stated in the ROSC seem to have been established by seeking the views of disenchanted parties rather than from the persons involved in accounting in the country. Some of the proposals of the ROSC have been put into practice: but those that could be said to have been effected would probably have been put into practice anyway. The ROSC did have a positive effect in Kenya, in that it made Kenyan accountants more aware of their deficiencies. If the World Bank had made a single, well thought-out suggestion, and had stated that it would be back in five years to

repeat its study, its ROSC may have carried greater weight: the World Bank is held in great awe in Kenya, and pleasing this institution is regarded to be of utmost importance by Government and private sector alike.

Following the principle of simplification, specific suggestions from this study are as follows: the first three proposals would apply, mutatis mutandis, to all developing countries. (1) Make accounting regulations as simple as possible: eg., the Capital Markets Authority Regulations 2002 (CMA 2002a) should be revised to state that the financial reports of NSE companies should comply with the International Financial Reporting Standards *full stop* (section 4.13.3): further regulations, although (supposed to be) identical to parts of IFRSs when the CMA Regulations were published, will become outdated and be a source of confusion – in fact, they already are because of imprecise wording (4.13.3.2): the NSE is to be congratulated on its approach to its "Continuing Listing Obligations applicable to all Market Segments" (section 4.12.2) – it reproduces the Fifth Schedule of "The Capital Markets Regulations 2002" and *states that this is the case*: it would be even better if reference was made to the CMA Regulations without reproducing them. (2) The Central Bank of Kenya should change banks' reporting requirements to make them identical to IFRSs: if additional disclosures are required, and these should be kept to the absolute minimum, they can be specified as additional to IFRSs. (3) ICPAK, CMA and NSE should coordinate their tasks of regulating disclosure by companies quoted on the Nairobi Stock Exchange (4.13.3.1). (4) ICPAK should ensure that the interim and the annual reports of all the companies quoted on the NSE are examined each year as part of the FiRe Award, using a comprehensive IFRS checklist as opposed to the method now in use: the CMA could drop its present examination of the reports of NSE companies and rely on ICPAK for this function. (5) ICPAK, CMA and NSE should specify that interim reports in accordance with IAS 34 are sent to all the shareholders of NSE companies.

A significant advantage of the simplification process is that it is easier for staff in regulatory bodies to know what their own guidelines advocate. Staff of the CMA are sometimes not aware of what is contained in their own guidelines (section 4.13.3.1). But regulators should ensure that proposed regulations are not promulgated unless they have been vetted by a lawyer who is has an extremely sound knowledge of English: some CMA regulations are ineffectual because they are badly worded (sections 4.13.3.2-3): the US SEC Deputy Accountant Erhardt's words ring true: "To be applied well and applied

consistently IFRS needs to be understood by all these people in the same manner. One set of standards does not guarantee uniform application of those standards. Are the education opportunities there for all these people? Are education curriculums changing, and keeping up? Are these opportunities predominantly in English, which is not the native language for everyone?" (Erhardt 2006).

10.4.3 Implications for CFOs of NSE companies

Accounting systems are in place in all the NSE companies. The importance of doing the ordinary, day-to-day tasks well cannot be over-stressed in Africa, where more money can be spent on a graduation ceremony than purchasing up to date books for the University's library (Owuor 2006). Ensuring compliance with IFRS enables financial reports to fulfil their function: accounts that fail to communicate accurate information are as much part of the "dilapidated infrastructure" of a country as pot-holed roads, telephone lines whose wires have been stolen and electricity supplies that fail frequently.

This study reveals that CFOs think that disclosure in the reports they prepare are of "high quality" whereas this study has found them not to be so. The IFRS compliance disclosure checklist used in this study is similar to that produced by Pricewaterhouse-Coopers, and probably by other Big 4 audit firms; these disclosure checklists are updated annually. Although it is a tedious and tiring task to ensure full disclosure, it is not complex. Some companies may not be willing to make certain disclosures, eg., interest paid to overseas related parties by some of the larger banks; compliance in these areas may be more difficult. CFOs need to have a copy of this checklist at hand when they prepare reports for their companies. In addition, they need a checklist similar to that in Appendix 4-3 to ensure compliance with disclosure of Corporate Governance Practices, as laid down by the Capital Markets Authority. Full compliance with these requirements would result in substantially better S&P Survey scores, but more importantly, bring Kenyan disclosure more in line with that of companies listed on advanced exchanges.

This study also reveals that analysts require a Management Review. Guidance needs to be given as to what should be included in this review. Adoption of this as best practice should be started immediately by those companies that do not presently include a Management Review in the annual report.

CFOs should familiarize themselves with reporting practices by leading companies quoted on Stock Exchanges around the world. Many of these companies have their annual

and interim reports on their websites. CFOs should make full use of the internet for this purpose. They should also move their companies to imitate best practice by having the interim and annual reports of their companies available on their websites.

A number of companies quoted on the NSE use the annual report as a marketing tool to advertise the products of the company. All financial controllers should give serious thought as to how this document can be a real advertising tool, so that there is a financial return earned by producing high quality interim and annual reports.

10.4.4 Implications for auditors of NSE companies

This study reveals analytically that financial statements examined by some auditors and certified as complying with IFRS are closer to doing so than others. Those firms which do less well need to take action to ensure that their staff have and use an IFRS checklist.

This study also reveals that excessive reliance is placed on auditors by NSE companies. All the audit firms need to emphasize that the duty of producing financial statements lies with the directors of the company (section 4.7.4): it is the directors' and the CFO's responsibility to ensure that the financial statements are in accordance with IFRSs; if they are not, the auditor is to blame for not having detected the fact: but the directors and the company staff are to blame for not ensuring that compliance is achieved. If audit firms, backed by ICPAK, take a common approach to this problem, it is more likely to be eased.

10.5 Contribution to knowledge

By achieving the objectives enumerated in section 1.3 of this study, contributions to the literature are made as stated below.

A comprehensive analysis of the literature related to "high quality financial reporting" as used by academics and by standard setters, regulators and practitioners, and an investigation of the difference between "high quality disclosure" and "high quality measurement (or earnings)" provides insights into the meaning of the different phrases and contributes to a clearer understanding of the phrases (chapters 2 and 3). Evidence from financial reporting disclosure practices (chapters 7 and 8) and perceptions of individuals who are responsible for the preparation and examination of financial statements (chapter 9) provide explanations as to why "high quality disclosure" varies in a capital market in a developing country. The use of three different disclosure indices to measure "high quality disclosure" reveals that each index measures a different underlying construct and is associated with different company and market independent variables. This implies that

researchers should be cautious in asserting associations between disclosure scores using a particular index and company and market variables, because each disclosure index is associated with different company variables. It also reveals that much more care needs to be taken in constructing more "objective" disclosure indices.

A tentative operational definition of "high quality disclosure" was proposed by this study at the completion of the review of the literature so as to provide a way by which the empirical study could be carried out (2.8). After the completion of the empirical study, it was clear that the definition needed expansion. An enhanced definition was presented in Table 10-3. Buy side analysts, regarded as important users of interim and annual reports, attach importance to a management review, which should deal with what the business does, key risks and challenges, important cost and market drivers, and the link between performance and strategy – and what managers have done to overcome the problems they have encountered in running the business; they require forward looking statements; they require 5-10 year performance summaries; they look for a coherent story from the narratives and from the numbers in an annual report; they seek greater timeliness in reporting; in short, buy side analysts in a developing country need the type of information that is the norm for world class companies. Part of the FiRe Award score deals with a number of these factors but not in sufficient detail to arrive at a more comprehensive view of "high quality disclosure". These factors are incorporated in the definition proposed by this study. This study has established that "high quality disclosure" is a rich concept, with many facets to be examined. Future studies will undoubtedly establish further aspects of "high quality disclosure" which will need to be incorporated in "higher quality" definitions of "high quality disclosure".

This study also contributes to understanding the applicability of disclosure theories to a capital market in a developing country with particular reference to "high quality disclosure". It is found that disclosure theories, tested in regression studies, do explain part of the variability of high quality disclosure in the developing country studied, but interview research brought out a number of factors that also explain this variability, which would have been overlooked if interview research had not been undertaken.

Finally, this study contributes to understanding the relevance of International Financial Reporting Standards (IFRSs) in achieving high quality disclosure in financial reporting to investors in a developing country setting. It was shown that there is almost universal

agreement that IFRSs are high quality accounting standards, albeit this agreement is reluctant on the part of the US SEC (section 3.9.5). 95% of controllers and 100% of regulators, auditors and analysts are of the opinion that switching from national accounting standards to international ones improved financial reporting disclosure by companies quoted on the Nairobi Stock Exchange. The use of IFRSs is a vital factor in assisting companies move towards "high quality disclosure".

10.6 Limitations of this study

There are several limitations to this study.

There are conceptual problems when disclosure quality is measured by using a disclosure index. The quality of disclosure is equated to the quantity of disclosure on the basis that more is better. Although several researchers have used this method (eg., Botosan 1997, Barton and Waymire 2004), Marston and Shrives (1991) have emphasized that the index score "can give a measure of the extent of disclosure but not *necessarily* the quality of disclosure (emphasis added)". Botosan (1997) constructed her own index and awarded additional points for quantified information. This study modified the simple binary coding system used in a number of studies by awarding the score 1 to items disclosed only if they were expressed in a way that a knowledgeable layman would be able to understand. In this way, when an item involved narrative, part of the quality of the narrative was captured by the disclosure score. Beattie et al. (2004) argue that a primary dimension of disclosure quality is likely to be the actual amount of disclosure: all other things being equal, companies that disclose more make higher quality disclosure. They go to explain that another dimension is the spread of disclosures across topics. Both the IFRS compliance and the S&P survey scores cover the primary dimension of quality in this study, from different perspectives; the FiRe Award scores do too: the definition of "high quality disclosure" developed by this study attempts to capture the second dimension. However, an element of subjectivity is introduced by judging whether the disclosure has really been made on the basis of the expression used. A second element of subjectivity is introduced by defining "high quality disclosure" in the way it has been defined in this study: there may be many who would not agree with this definition. Beattie et al. (2004) emphasize that no *definitive* (emphasis added) set of quality attributes and weightings of these attributes exists because quality is subjective and context-dependent. This limitation is present in this study.

This study has arrived at disclosure scores on the basis that if no mention was made of an item by a company, and other information in the annual and interim report did not reveal that this item was applicable to the company, that item need not be disclosed by the company. However, only persons with intimate knowledge of the whole operation of the company know with a high degree of certainty whether an item should be disclosed or not. Sometimes, even the CFO of the company may not be aware that the item should, in fact, be disclosed: some CFOs are much more observant and know, and feel, what is going on around them much better than others. This factor again introduces subjectivity in scoring disclosure, and also in the CFO replies elicited by the interview questions. This same factor also applies in the replies obtained from auditors, regulators and buy-side analysts.

The IFRS disclosure index used in this study was developed by this researcher combing through all the IASs and SIC interpretations extant between 30 June 2002 and 31 March 2003 in the *IFRS 2003 Handbook* published by IASB (IASB 2003). It was then reconciled against a similar checklist produced by PricewaterhouseCoopers. However, this does not give assurance that it would be identical to one developed by the International Accounting Standards Board. In addition, when using both the IFRS compliance and the S&P survey indices, IASB and S&P may have arrived at different disclosure scores to the one arrived at by this study. Here again an element of subjectivity is present.

This study examines annual and interim reports of the companies quoted on the Nairobi Stock Exchange. It does not examine directors' briefings to media representatives, radio and television broadcasts, newspaper and magazine reports, newspaper supplements produced when annual general meetings are held and a variety of other ways that NSE companies use to communicate their results and financial position to interested parties. To obtain a comprehensive view of NSE companies' reporting, all these different methods of communication would need to be examined. The result is that the conclusions arrived at by this study have to be treated with caution, and should not be extrapolated beyond the interim and annual reports of this companies.

The views expressed by CFOs, auditors, regulators and buy-side analysts may be different to those that would have been expressed by both more junior managers and by more senior managers in the companies and firms in which interviews were carried out. Caution again needs to be exercised in treating the conclusions arrived at.

Because there are only 47 companies listed on the Nairobi Stock Exchange, in a cross-sectional study the number of regressors in a regression equation should be limited to nine to satisfy Hebden's (1981) rule of thumb (8.4): because a number of control variables needed to be included in the regression equations, this rule was not always complied with, which could adversely affect the validity of the deductions. Whenever more than 9 regressors were included, a second regression was run in which non-significant variables with the highest correlation coefficients with other independent variables were eliminated from the regression equation, and the new results were compared with those previously obtained. Invariably, no differences were obtained. However, other statisticians would question the validity of drawing inferences from these regressions (eg., Stevens 1996, Tabachnick and Fidell 2001).

Finally, bias is inevitably present in interview research despite the researcher being aware of the problem and doing all that he can to avoid it.

10.7 Suggestions for future research

The main suggestions for further research are as stated below.

Development of operational definitions of quality. This study's definition of disclosure quality is a first step in trying to develop a definition that captures more dimensions of quality that a simple binary disclosure index. Core's (2001) suggestion that new definitions need to be developed are echoed by this study. Practitioners want to arrive at a common understanding of the concept of financial reporting quality. More thought, assisted by empirical investigation, is needed to develop and refine the way accountants understand each aspect of "quality financial reporting", especially "quality disclosure", so that standards of reporting to capital markets can be improved.

Investigate the validity of using different disclosure indices. Marston and Shrives (1991) mention that disclosure indices have proved to be a valuable research tool and will be used as long as research into accounting disclosure is continued. Research into the use of different disclosure indices on given samples of annual and interim financial reports, and indeed on the other means of communicating financial information, such as internet sites, conference calls, radio and television broadcasts, press briefings, etc., needs to be carried out to see whether one, or several, capture the abstract concept "disclosure" better than others.

Measure different aspects of quality in annual and interim reports of companies in this market. This study has not investigated a wide variety of facets which contribute to

"high quality financial reporting". There is a need to examine all these aspects of financial reporting by companies quoted on the Nairobi Stock Exchange to establish whether these companies compare with those on longer established and more sophisticated markets. The readability of reports and the degree of obfuscation in them (Jones and Shoemaker 1994; Courtis 1995; Courtis 2004), the variability of annual report narratives measured using the indexical approach in Sydserff and Weetman (1999), and impression management in the annual report narratives of poorer performing companies tested using the transitivity index and the use of DICTION scores elaborated in Sydserff and Weetman (2002) are all aspects of the quality of disclosure not tackled by this study. Impression management in the use of graphs and the quality of graphs (Beattie and Jones 1992 & 2000; Frownfelter-Lohrke and Fulkerson 2001; Mather et al. 2005), the use of colour in presenting graphical information (So and Smith 2002; Lohse and Rosen 2001), and the ways by which photographs (Rivelli 1984; Graves, Flesher and Jordan 1996) and financial ratios (Watson, Shrives and Marston 2002) can enhance the quality of financial reports are other aspects of "quality financial reporting" that need to be investigated. Although the FiRe Award allocates scores for the use of graphs and ratios, these topics need to be studied in greater depth in the annual reports of NSE companies. The inclusion of non-financial (Robb, Single and Zarzeski 2001) and forward looking (Kent and Ung 2003) information and the quality of the management review (Barron, Kile and O'Keefe 1999), as required by analysts (9.3.2, 9.5.2, 9.6.2), also need to be studied. Another aspect of accounting quality that needs to be investigated in relation to the financial reports of NSE companies is earnings quality (Schipper and Vincent 2003: Picur 2004).

Carry out a time-series studies. IFRSs are new in Kenya: this presents a number of opportunities to examine changes in disclosure quality over time. The introduction of IFRSs increased the amount of disclosure and from one point of view therefore improved the quality of disclosure (9.7.1). Longitudinal studies could examine whether disclosure quality not only increased in amount but in clarity and precision. In addition, longitudinal studies will show whether the perceived improvement continues or whether IFRS compliance and disclosure quality generally decline when the novelty of IFRSs wears off.

Investigate whether preparers understand the purpose of published financial statements. Interview research (9.4.3) reveals that preparers may not understand the real import of financial statements prepared by quoted companies. Fundamental to preparing

"high quality financial reports" is the understanding of why the financial reports are prepared. In a society where a stranger is regarded as a threat until s/he has proved otherwise, because of the prevalence of corruption, if it was found that shareholders were regarded as one more intruder in the well functioning of the business, a real reason to explain a lack of desire to achieve "high quality reporting" would have been established - which can then be corrected. In addition, it would be important to investigate whether preparers are aware that they are judged by analysts by what they say in the annual report (9.4.3). If preparers were more aware of this fact, they may make greater efforts to produce annual reports of higher quality.

Investigate why preparers perceive IFRSs to be better enforced. Interview research (9.7.1) reveals that preparers perceive that IFRSs are better enforced, and are taken more seriously, than Kenyan Accounting Standards. If the factors that lead to these perceptions are established, they can be used to ensure that information which is not presently in the annual reports of NSE companies, but which is sought after by analysts, is included in the future.

Examine whether cost constraints really do reduce the amount of information included in the annual report and the amount of time audit staff spend on the audit. Interview research finds that companies do not include as much information as they would like due to costs constraints (9.3.1) and audit staff spend less time than is required to ensure that full compliance with IFRSs is achieved (9.7.3). Wider use of disclosure checklists by preparers and better knowledge of the disclosure requirements of IFRSs by both preparers and audit staff would alleviate this problem. But empirical investigation into annual report publication costs and audit fees, and the IFRS compliance of different companies could establish whether these claims are supported by the evidence obtained.

Investigate whether preparers' knowledge of IFRSs is really improving. Kenyan preparers claim that their knowledge is improving (9.5.1), but auditors claim that their knowledge of IFRSs is poor (9.7.3). Although it would be difficult to establish this ex post, if it is found that their knowledge is improving, the causes of the improvement can be sought, so as to establish ways by which further improvement can be achieved.

Investigate ways by which discussions among experts can be promoted so that understanding of the importance of high quality financial reporting can be enhanced. This researcher found a step-function increase in the understanding of the meaning of "high quality financial reporting" on the part of the majority of CFOs interviewed. It is clearly

beneficial that discussions of this nature are engaged in with the aim of improving financial reporting in Kenya. This finding warrants further study so that it, together with other possible findings, can be incorporated into a series of measures by which financial reporting in Kenya can be brought closer to "high quality financial reporting".

Appendix 2-1: Areas of accounting in relation to which "quality" is used: because of constraints of space these articles are not listed in the references but can be obtained from the author.

Area	Studies
Accounting information	Moriarity (2005), Brown & Howieson (1998), Lee (1994)
Accounting processes	Dull & Tegarden (2004)
Accounting reports	Brown & Howieson (1998)
Analysts' forecasts	Fried & Givoly (1982)
Annual reports	Nelson, Banks & Fisher (2003)
Asset	Gilbert & Vaughan (2001), Mayes (2000)
Audit	Nagy (2005), O'Sullivan (2000), DeAngelo (1981), Becker et al. (1998), Carcello et al. (2002b)
Audit committee	Krishnan (2005a), Carcello et al. (2002b)
Audit decision making	Bedard (1993)
Auditor	O'Sullivan (2000)
Bank	Mayes (2000), Boldin & Leggett (1995)
Board of directors	Carcello et al. (2002b)
Board oversight	Carcello et al. (2002b)
Brand	Ittner & Larcker (1998)
Candidates	Howieson (2003)
Competition	Krishnan (2005b), Howieson (2003)
Control systems	Ratnatunga et al. (1989)
Corporate communication	Holland (1998)
Corporate governance	Altamuro, Beatty and Weber (2005), Mayes (2000)
Data	Ahmed & Courtis (1999), Brown & Howieson (1998), Gray et al. (1995b)
Decisions	Mayes (2000)
Delivery of services	Ogden & Clarke (2005)
Disclosure	Appendix 2-2
Earnings	Appendix 2.2: includes Nagy (2005), Carcello et al. (2002a), Brown & Howieson (1998)
Education	Parker (2001a)
Employment	Gray et al. (1995a)
Environment	Woodward et al. (2001)
Environmental disclosure	Hasseldine, Salama & Toms (2005), Holland & Foo (2003)
Evidence	Gwilliam, Macve & Meeks (2005)
Expert services	Bedard (2001)
Financial information	Oyelere, Laswad & Fisher (2003), Walker & Jones (2003)
Financial reporting	Krishnan (2005a), Nagy (2005), Raghunandan et al. (2003), Carcello et al. (2002a&b), Abbott et al. (2000), O'Sullivan (2000), Street & Gray (1999), Ahmed & Courtis (1999),
Financial statements	O'Sullivan (2000)
Firms	Meek et al. (1995)
Footnote disclosure	Brown & Howieson (1998)
Governance	O'Sullivan (2000)
Information	Jones & Xiao (2004), Parker (2001a), O'Sullivan (2000), Brown & Howieson (1998), Hermann et al. (1996), Adams et al. (1993)
Inputs into research process	Brown & Howieson (1998)
Institutions	Bazley & Nikolai (1975)
Internal audit	Abbott et al. (2000)
Internal control	Krishnan (2005a)
Job (satisfaction)	Brinn, Jones & Pendlebury (2001)
Journal	Jones & Roberts (2005), Milne (2002), Brown & Howieson (1998), Parker et al. (1998), Brinn, Jones & Pendlebury (1996), Howard & Nikolai (1983)
Life	Holland & Foo (2003), Woodward et al. (2001), Gray (1989)

Area	Studies
Loan portfolios	Gilbert & Vaughan (2001)
Management	Toms (2002), Parker (2001a), Beattie (1999), Oliver & Qu (1999), Holland (1998), Gray et al. (1995a)
Management of risks	Mayes (2000)
Marketing-accounting interface	Ratnatunga et al. (1989)
MD&A	Barron, Kile & O'Keefe (1999)
Monitoring	Abbott et al. (2000)
Moral behaviour	Gray & Collison (2002)
Narrative reporting	Beattie et al. (2004)
New entrants	Mayes (2000)
Outcomes	Parker (2001a)
Performance	Gurd et al. (2002), Woodward et al. (2001)
Private voluntary disclosure	Holland (1998)
Planning	Ratnatunga et al. (1989)
Product(s)	Gwilliam, Macve & Meeks (2005), Oliver & Qu (1999), Vaivio (1999), Ittner & Larcker (1998)
Publications/publishing	Otley (2002), Parker et al. (1998)
Referee	Parker et al. (1998)
Reporting	Lee (1994)
Research	Jones & Roberts (2005), Amernic (2004), Milne (2002), Otley (2002), Brinn, Jones & Pendlebury (2001), Parker et al. (1998), Brinn, Jones & Pendlebury (1996)
Research training	Brown & Howieson (1998)
Scholarship	Brinn, Jones & Pendlebury (2001)
Service	Krishnan (2005b), Oliver & Qu (1999), Ittner & Larcker (1998)
Signals	Hasseldine, Salama & Toms (2005), Toms (2002)
Social reporting	Thompson and Cowton (2004)
Standards	Street & Gray (2002), Street et al. (2000), Adams et al. (1999), Street & Gray (1999), Adams et al. (1993)
Strategy	Holland (1998)
Students	Brinn, Jones & Pendlebury (2001), Parker (2001a)
Suppliers	Vaivio (1999)
Suppliers of professional training	Howieson (2003)
Teaching	Howieson (2003), Brinn, Jones & Pendlebury (2001), Parker et al. (1998)
Understanding	Gray (2002)
US capital markets	Adams et al. (1999)
Water	Mayes (2000)
Work produced	Otley (2002)

Appendix 2-2 Number of articles in which "quality" is used to designate some aspect of financial reporting: the period covered by this table is from the inception of the Journal cited to mid-2006.

	Accounting	Audit	Audit Committee	Decision Making	Disclosure	Earnings	Financial Reports	Information	Internal Control System	Judgement	Measurement	Narratives	OFR or MD&A	Standards	TOTAL
Abacus	1	1						1						3	6
Accounting & Business Research		2			1						2				5
Accounting & Finance		2		1	1	1	2	1						1	9
Accounting, Auditing & Accountability Journal							1								1
Accounting Forum							1					1		1	3
Accounting Horizons		4				4	3							7	18
Accounting Organisations & Society				2	1		1			1				1	6
Accounting Review		11	2		8	15	3	2	1	1					43
Applied Financial Economics								1							1
Behavioral Research in Accounting	1														1
British Accounting Review		6			2	2	1								11
British Journal of Management		1													1
Contemporary Accounting Research		3				1	3						1		8
CPA Journal							1								1
European Accounting Review		9			1	1									11
GS						1									1
Industrial Management & Data Systems	1														1
Insights								1							1
International Journal of Accounting		6			2		5							1	14
International Journal of Auditing		4													4
Issues in Accounting Education						1									1
Journal of Accountancy		1													1
Journal of Accounting, Auditing & Finance						1									1
Journal of Accounting & Economics		5				4	2	3							14
Journal of Accounting & Public Policy	1	2			1		1							1	6
Journal of Accounting Literature		1					1								2
Journal of Accounting Research		2			2	1	4	1							10
Journal of Banking & Finance							1								1
Journal of American Academy of Business					1										1
Journal of Business Ethics					1										1

	Accounting	Audit	Audit Committee	Decision Making	Disclosure	Earnings	Financial Reports	Information	Internal Control System	Judgement	Measurement	Narratives	OFR or MD&A	Standards	TOTAL
Journal of Business Finance & Accounting		1													1
Journal of Business Research					1										1
Journal of Business Strategies					1										1
Journal of Financial Economics						1									1
Journal of International Accounting					1										1
Journal of International Accounting Auditing & Taxation					1	1									2
Journal of International Accounting Research		1													1
Journal of International Financial Management & Accounting							1							1	2
Managerial Auditing Journal		1													1
Managerial Finance						1		1							2
Review of Accounting Studies					1										1
Spanish Economic Review					1										1
Strategic Finance							1								1
TOTAL	4	63	2	3	27	35	32	11	1	2	2	1	1	16	200

	Accounting	Audit	Audit Committee	Decision Making	Disclosure	Earnings	Financial Reports	Information	Internal Control System	Judgement	Measurement	Narratives	OFR or MD&A	Standards	TOTAL

Appendix 4-1: Summary of the requirements of the Sixth Schedule (p. = paragraph) to the Kenya Companies Act & Sections 197 & 198 of the Act

Balance Sheet:
The following items must be shown:
Share Capital:
Authorised Share Capital: p. 2
Issued Share Capital: p. 2
Redeemable Preference Shares & earliest date when they can be redeemed: p. 2(a)
Share Premium: p.2(c)
Total Capital (non-distributable) Reserves : p. 6 & a schedule of year's movements: p. 7
Dividend proposed: p. 8(e)
Total Revenue (distributable) Reserves: p. 6 & a schedule of movements for the year: p. 7
Any debentures redeemed which the company can reissue: p. 2(d)
Property, plant & equipment (fixed assets):
Cost or valuation:
total for each class of asset: p. 5(1)(a) &
overall total: p. 5(3)(a)
Accumulated depreciation since purchase or valuation:
total for each class of asset: p. 5(1)(b) &
overall total: p. 5(3)(b)
Net book value for each class of asset: p. 4(3) & overall total: p.4(1)
Goodwill: net book value: p. 8(1)(b)
Patents & trade marks: p. 8(1)(b)
Investments:
Total of trade investments: p. 8(1)(a)
Investments other than trade:
Total of quoted: p. 8(1)(a) & market value: p. 11 (8)
Total of unquoted: p. 8(1)(a)
Total of loans to any officers of the company: s. 198
Total of loans to employees to buy shares in the company: p. 8(1)(c)
Total of current assets: p. 4(1)
Aggregate amount of bank loans & overdraft: p. 8(d)
Tax liability to balance sheet date & basis of computation: p. 11(10)
Total of current liabilities: p. 4(1)
Comparative amounts for each item as at the end of the preceding year: p. 11(11)
Disclose at least by way of note:
Where any liability is secured, the fact that the liability is secured: p.9
The number, description & amount of any shares in the company which any person has an option to subscribe for & the period during which it is exercisable & the price to be paid for the shares: p. 11(2)
The amount of any arrears of fixed cumulative dividends & the period for which they are in arrears: p. 11(3)
Particulars of any charge on the assets of the company to secure the liabilities of any other person & the amount secured: p. 11(4).
The general nature of any contingent liabilities & the estimated amount of those liabilities: p. 11(5).
The aggregate amount of contracts for capital expenditure which have not been provided for: p. 11(6).
The bases for which items denominated in foreign currencies are converted to Kenya currency: p. 11(9).
Profit and Loss Account:
The following items must be shown:
Income from investments: Trade: p. 12(1)(g)
Other than trade: p. 12(1)(g)
Depreciation charge for the year: p. 12(1)(a)
Interest on debentures & fixed loans:
p. 12(1)(b)
Auditors' remuneration (including expenses): p. 13
Directors' remuneration:
For services as management: s. 197(2)(a)
For services as directors: s. 197(2)(b)
Subtotal: s. 197 (1)(a)
Pension contributions for directors:
For services as management: s. 197(3)(a)
For services as directors: s. 197(3)(b)
Subtotal: s.197 (1)(b)
Directors' compensation for loss of office
For services as management: s. 197(4)(a)
For services as directors: s. 197 (4)(b)
Subtotal: s. 197(1)(c)
Income tax charge for the year: p. 12(1)(c)
Aggregate amount of dividends paid & proposed: p. 12(1)(h)
Provisions for redemption of share capital &/or debentures: p. 12(1)(d)
Transfers to/from reserves: p. 12(1)(e)
Comparative amounts for each item for the preceding year: p. 14(5)
Disclose at least by way of note:
The basis on which the amount payable for tax is computed: p. 14(3)
Whether the dividend paid & proposed is subject to income tax: p. 14(4)
Any exceptional items: p. 14(6)(a)
Any changes in the basis of accounting: p. 14(6)(b)

Appendix 4-2(a): Kenyan Accounting Standards
Operative in Kenya from 1 January 1983 to 31 December 1998

No	Title	Equiv IAS	Effective date
1	Disclosure of Accounting Policies	1	1 January 1983
2	Extraordinary and Prior Period Items	8	1 January 1985
3	Accounting for Contingencies	10	1 October 1984
4	Accounting for Post Balance Events	10	1 October 1984
5	Depreciation Accounting	4	1 January 1985
6	Valuation & Presentation of Inventories in the Context of the Historical Cost System	2	1 January 1985
7	Statements of Changes in Financial Position: revised to: Cash Flow Statements	7 7	1 January 1985 1 January 1995
8	Accounting for Leases	17	1 January 1987
9	Accounting for the effects of changes in Foreign Exchange Rates	21	1 January 1989
10	Accounting for Income Tax	12	1 January 1989
11	Group Accounts: Part 1: Accounting for Subsidiary Companies	3	1 January 1989
12	Group Accounts: Part 2: Accounting for Associated Companies	3	1 July 1988
13	Accounting for Goodwill	22	1 January 1989
14	Accounting for Investments	25	1 January 1989
15	Related Party Transactions	24	1 January 1990
16	Revenue Recognition	18	1 January 1990
17	Accounting for property, plant & equipment	16	1 January 1990
18	Disclosures in the Financial Statements of Banks, Mortgage Finance Companies & Other Financial Institutions	30	1 January 1996

Kenya Accounting Guideline: Accounting & Reporting Practices of Short Term Insurers
The recommendations of the Accounting Guideline represented what ICPAK considered to be best accounting practice: the recommendations had to be applied to all relevant material items in the financial statements of short term insurers with effect from 1 August 1997.

Appendix 4-2(b): Best Presented Accounts of the Year Award: Companies quoted on the Nairobi Stock Exchange: accounting years 1985 - 1998

Year	No	Winner	Second	Third
1985	30	Kakuzi Ltd.	Mercat Ltd.	Credit Finance Corporation (CFC) Ltd.
1986	23	Kenya National Mills Ltd.	Brooke Bond Kenya Ltd.	A. Baumann & Co. Ltd.
1987	16	Barclays Bank of Kenya Ltd.	Kakuzi Ltd.	Unga Group Ltd.
1988	16	Car & General Kenya Ltd.	Kenya National Mills Ltd.	Carbacid Investments Ltd.
1989	21	Sasini Tea & Coffee Co. Ltd.	Kakuzi Ltd.	Carbacid Investments Ltd.
1990	16	BAT Kenya Ltd.	Brooke Bond Kenya Ltd.	Motor Mart Group
1991	19	Kenya Breweries Ltd.	Sasini Tea & Coffee Co. Ltd.	Total Kenya Ltd
1992	18	Total Kenya Ltd.	Kakuzi Ltd.	Standard Chartered Bank Kenya Ltd.
1993	14	Brooke Bond Kenya Ltd	Standard Chartered Bank Kenya Ltd.	Sasini Tea & Coffee Co. Ltd.
1994	19	Firestone East Africa Ltd.	NIC Ltd.	Barclays Bank of Kenya Ltd.

Year	No	Winner	Second	Third
1995	23	Total Kenya Ltd.	Sasini Tea & Coffee Co. Ltd.	Nation Printers & Publishers Ltd.
1996	16	Kakuzi Ltd.	Total Kenya Ltd.	Standard Chartered Bank Kenya Ltd.
1997	17	George Williamson Kenya Ltd.	Jubilee Insurance Co. Ltd.	Firestone East Africa Ltd.
1998	6	Jubilee Insurance Co. Ltd.	Kenya Power & Lighting Co. Ltd.	Brooke Bond Kenya Ltd.

Best Presented Accounts of the Year Award: accounting year 1999
Quoted non-financial companies:
1. Nation Media Group Ltd. 2. Bamburi Cement Co. Ltd. 3. BAT (K) Ltd.

Quoted financial companies:
1. Barclays Bank of Kenya Ltd. 2. Jubilee Insurance Co. Ltd. 3. National Industrial Credit (NIC) Bank Ltd.

Non-quoted entities:
1. Commercial Bank of Africa Ltd. 2. East Africa Reinsurance Ltd. 3. Imperial Bank Ltd.

Best Presented Accounts of the Year Award: accounting year 2000
Quoted non-financial companies:
1. Brooke Bond Kenya Ltd. 2. Bamburi Cement Co. Ltd. 3. East African Breweries Ltd.

Quoted financial companies:
1. Barclays Bank of Kenya Ltd. 2. Pan Africa Insurance Co. Ltd. 3. Jubilee Insurance Co. Ltd.

Non-quoted companies:
1. East Africa Reinsurance Co. Ltd. 2. UAP Insurance Co. Ltd. 3. Imperial Bank Ltd.

Financial Reporting (FiRe) Award for Excellence 2001: accounting year 2001
Overall awards: 61 entries
1. Imperial Bank Ltd. 2. Brooke Bond Kenya Ltd. 3. Nation Media Group Ltd.

Banks: 25 entries
1. Imperial Bank Ltd. 2. Barclays Bank of Kenya Ltd. 3. Standard Chartered Bank Kenya Ltd.

Insurance companies: 20 entries
1. East Africa Reinsurance Co. Ltd. 2. UAP Provincial Insurance Co. Ltd. 3. Pan Africa Insurance Co. Ltd.

Listed non-financial entities: 16 entries
1. Brooke Bond Kenya Ltd. 2. Nation Media Group Ltd. 3. British American Tobacco Kenya Ltd

There was no Financial Reporting Award for Excellence 2002 competition: up to 2001, the year related to the calendar year for which the accounts were prepared; the FiRe Award 2003 competition was held in 2003 (prizes were awarded on 26 September 2003) for companies with year ends between 30 June 2002 and 31 March 2003.

Financial Reporting (FiRe) Award for Excellence 2003
Overall awards: 69 entries
1. Imperial Bank Ltd. 2. Brooke Bond Kenya Ltd. 3. NIC Bank Ltd.

Banking institutions: 22 entries
1. Imperial Bank Ltd. 2. NIC Bank Ltd. 3. Standard Chartered Bank Kenya Ltd.

Insurance companies: 17 entries
1. Pan Africa Insurance Holdings Ltd. 2. UAP Provincial Insurance Co. Ltd. 3. Jubilee Insurance Co. Ltd.

Listed non-financial companies: 26 entries
1. Brooke Bond Kenya Ltd. 2. BOC Gases Kenya Ltd. 3. Williamson Tea Kenya Ltd.

Non-listed non-financial institutions: 4 entries
No winner declared since all accounts below the requisite standard.

Corporate Citizenship: recognises corporate citizenship disclosures among participating companies:
1. NIC Bank Ltd. 2. Barclays Bank of Kenya Ltd. 3. Standard Chartered Bank Kenya Ltd.

Appendix 4-3: Summary of the disclosure requirements of Gazette Notice No. 3362, 14 May 2002, The Capital Markets Act (Cap.485A): Guidelines on Governance Practices by Public Listed Companies in Kenya.

Disclosure should be made of:

(a) the extent of compliance: "*it is important that the extent of compliance with these guidelines should form an **essential** part of (the) disclosure obligations in ... corporate annual reports*" (emphasis added);
(b) the extent of non-compliance: "*it is equally important (that) the extent of non-compliance be also disclosed*";
(c) the reasons for non-compliance;
(d) the steps being taken to become compliant;
(e) "ten major shareholders of the company" – this could be satisfied by revealing any 10 large shareholders – "the 2002 Regulations" require disclosure of the "10 largest shareholders";
(f) whether the company has an audit committee;
(g) the mandate of the audit committee;
(h) details of the activities of the audit committee;
(i) the number of audit committee meetings held in the year;
(j) the details of attendance of each member of the audit committee at the meetings of that committee;
(k) an objective and understandable assessment of the company's operating position and prospects, which should include highlights of the operation of the company;
(l) highlights of the company's financial performance;
(m) information related to major disposals of the company's assets, acquisitions, mergers, takeovers, reorganization or restructuring;
(n) whether one third of the board is made up of independent and non-executive directors and whether the minority shareholders are represented;
(o) a review by the nominating committee of the board's required mix of skills and expertise and how this mix is achieved with the present executive and independent non-executive directors;
(p) the company's policies for remuneration (including incentives) of the board and senior management;
(q) the total of the executive directors' fees;
(r) the total of the executive directors' emoluments (distinguishing between cash payments, benefits and share options);
(s) the total remuneration for executive directors;
(t) the total of non-executive directors' fees;
(u) the total of non-executive directors' emoluments (distinguishing between cash payments, benefits and share options);
(v) the consolidated total remuneration of the directors;
(w) the aggregate of the directors' loans granted by the company;
(x) the resignation of a serving director and why he or she resigned;
(y) the reasons why the chairman of the Board is the chief executive, if this is the case;
(z) the name of any director who will attain the age of 70 in the year following the Annual General Meeting.

Appendix 5-1: Companies included in the Nairobi Stock Exchange Handbook 2002 Edition (published 2003); NSE company year ends; companies de-listed, placements and public offerings in the period 1989 – 2003.

MAIN INVESTMENT MARKET SEGMENT

AGRICULTURE
Brooke Bond Kenya Limited
Kakuzi Limited
Rea Vipingo Plantations Limited
Sasini Tea and Coffee Limited

COMMERCIAL AND SERVICES
African Lakes Corporation Plc-
(the listing of the ordinary shares was cancelled on the Nairobi Stock Exchange on 1 March 2003 and on the London Stock Exchange on 3 March 2003. See note 1 below.)
Car and General (Kenya) Limited
CMC Holdings Limited
Hutchings Biemer Limited – *(suspended in February 2001 for failing to comply with the continuous reporting obligations of companies listed on the Nairobi Stock Exchange. See note 2 below.)*
Kenya Airways Limited
Marshalls (East Africa) Limited
Nation Media Group Limited
Tourism Promotion Services Limited
Uchumi Supermarkets Limited

FINANCE AND INVESTMENT
Barclays Bank of Kenya Limited
CFC Bank Limited
Diamond Trust Bank (Kenya) Limited
Housing Finance Company of Kenya Limited
ICDC Investment Company Limited
Jubilee Insurance Company Limited
Kenya Commercial Bank Limited
National Bank of Kenya Limited
NIC Bank Limited
Pan Africa Insurance Company Limited
Standard Chartered Bank Kenya Limited

INDUSTRIAL AND ALLIED
Athi River Mining Limited
Bamburi Cement Company Limited
British American Tobacco Kenya Limited
BOC Kenya Limited
Carbacid Investments Limited
Crown-Berger Kenya Limited
Dunlop Kenya Limited
East African Cables Limited
East African Portland Cement Company Limited
East African Breweries Limited
Firestone (E.A) Limited
Kenya Oil Company Limited
Mumias Sugar Company Limited
Kenya Power and Lighting Company Limited
Total Kenya Limited
Unga Group Limited

ALTERNATIVE INVESTMENT MARKET SEGMENT
A. Baumann & Company Limited
City Trust Limited
Eaagads Limited
Express Kenya Limited
Kapchorua Tea Company Limited
Kenya Orchards Limited
Limuru Tea Company Limited
Standard Newspapers Group Limited
Williamson Tea Kenya Limited

PREFERENCE SHARES
Kenya Hotels Limited – *(de-listed in February 2001 for non-compliance with minimum listing requirements. See note 2 below.)*

Note No. 1: The African Lakes Corporation plc.
On 17 March 2000, The African Lakes Corporation plc, a technology company listed on the London Stock Exchange, issued four million shares on the NSE, and as result, secured a secondary listing there. The company de-listed its shares on the NSE on 1 March 2003 and on the London Stock Exchange on 3 March 2003. During the whole of the period March 2000 to March 2003, the company prepared its accounts in accordance with United Kingdom Generally Accepted Accounting Principles and not in accordance with International Financial Reporting Standards. The latest sets of financial reports that were available for The African Lakes

Corporation plc were for the quarters ended 31 December 2001, 31 March and 30 June 2002 and the year ended 30 September 2002. However, since these sets of financial statements had been prepared in accordance with UK GAAP, and not in accordance with the International Financial Reporting Standards, the scores I would obtain for my examination of these accounts could vary markedly from those of other companies, producing outlier figures which would be excluded as unrepresentative of the general position amongst companies on the NSE. I decided to exclude these financial statements.

Note No. 2: Hutchings Biemer Limited & Kenya Hotels Limited.

Hutchings Biemer Limited had been suspended from the NSE in February 2001 for failing to comply with the continuing reporting obligations of the Exchange; the company was included in the 2002 Edition of the NSE Handbook but the latest accounting numbers included therein relate to the financial year ended 31 December 1997. When I visited the premises of the company, the finance director told me that the latest set of accounts available on the date of my visit (30 June 2003) was for the year ended 31 December 2000. However these had not been submitted to the Exchange.

Kenya Hotels Limited had been suspended for the same reason in February 2001. It had only preference shares listed on the Exchange.

I was forced to exclude the financial statements of these two companies from this study.

Financial year ends in the year ended 31 March 2003 of 47 companies listed on the Nairobi Stock Exchange as at 31 March 2003.

	30-June-2002	7	Crown Berger Limited
1	E. A. Portland Cement Limited	8	Diamond Trust Bank Kenya Ltd.
2	East African Breweries Limited	9	Dunlop Kenya Limited
3	I.C.D.C Investments Co Limited	10	E.A.Cables Limited
4	Kenya Power & Lighting Limited	11	Express Kenya Limited
5	Mumias Sugar Co. Limited	12	Firestone East Africa Limited
6	Uchumi Supermarket Limited	13	Housing Finance Company Ltd.
7	Unga Group Limited	14	Jubilee Insurance Company Ltd.
	31-July-2002	15	Kakuzi Limited
1	Carbacid Investments Limited	16	Kenya Commercial Bank Ltd.
2	City Trust Limited	17	Kenya Orchards Limited
	30-September-2002	18	Limuru Tea Co. Limited
1	B.O.C Kenya Limited	19	Nation Media Group Limited
2	Car & General (K) Limited	20	National Bank of Kenya Limited
3	CMC Holdings Limited	21	NIC Bank Limited
4	Kenya Oil Co Limited	22	Pan Africa Insurance Limited
5	Rea Vipingo Plantations Limited	23	Standard Chartered Bank Limited
6	Sasini Tea & Coffee Limited	24	Total Kenya Limited
7	Standard Newspapers Group	25	Tourism Promotion Services Ltd.
	31-December-2002		**31-March-2003**
1	Athi River Mining Limited	1	A. Baumann & Co. Limited
2	Bamburi Cement Limited	2	Eaagads Limited
3	Barclays Bank Limited	3	Kapchorua Tea Company Limited
4	British- American Tobacco K. Ltd.	4	Kenya Airways Limited
5	Brooke Bond Limited	5	Marshalls (E.A.) Limited
6	C.F.C Bank Limited	6	Williamson Tea Kenya Limited

Source: Annual reports of companies.

Companies de-listed in the period 1989 – 2003

Company	Reason	Year
Kenya Co-operative Creameries Ltd.	De-registered.	1989
Kulia & Company Limited	Taken over by Bensilla Ltd	1989
Timsales Limited	Capital reduction; company went private.	1989
E.A Road Services (OTC) Limited	Placed under receivership.	1990
Kilombero Sugar Company Limited	Takeover by Tanzania government.	1990
Elliots Bakeries Limited	Wound up	1993
Kenya Finance Bank Limited	Placed under receivership.	1996
African Tours & Hotels Limited	Placed under receivership.	1998
Kingfisher Properties Limited	Placed under receivership.	1998
Ol Pejeta Ranching Limited	Voluntary winding up	2000
Regent Limited	Suspended	2000
Kenstock Loans Limited	Suspended	2000
Lonrho Motors Limited	Suspended	2000
Pearl Dry Cleaners Limited	Non-compliance with listing requirements.	2001
Regent Undervalued Assets	Non-compliance with listing requirements.	2001
Theta Group	Non-compliance with listing requirements.	2001
East African Packaging Industries Limited	Taken over by Canadian Overseas Packaging Industries Limited	2003 Feb

Source: Market Intelligence 2002, as amended.

Placements and Public Offerings in the period 1989 – 2003

Year	Company	Reason	Shsm
1990	Kenya Commercial Bank Limited.	Raising additional capital	297
1991	Kenya Finance Corporation Limited	Raising additional capital	40.8
1992	Housing Finance Company of Kenya Ltd.	Raising additional capital	126
1992	Uchumi Supermarkets Limited.	Raising additional capital	232
1992	Crown-Berger Kenya Limited.	Raising additional capital	138
1993	EA Oxygen (BOC Kenya Limited)	Divestiture by Government of Kenya	42.4
1993	Cooper Motor Corporation (CMC) Ltd.	Divestiture by Government of Kenya	20
1994	NIC Bank Limited	Raising additional capital	936
1994	Firestone (East Africa) Limited.	Raising additional capital	1,420
1994	National Bank of Kenya Limited.	Raising additional capital	400
1995	Rea Vipingo Plantations Limited	Private placement	102
1996	Rea Vipingo Plantations Limited	Raising additional capital	84
1996	Kenya Airways Limited.	Divestiture by Government of Kenya	2,664
1996	East African Portland Cement Co.Ltd.	Rights issue	1,008
1996	National Bank of Kenya Limited	Raising additional capital	600
1996	Kenya Commercial Bank Limited	Privatization	594
1997	Tourism Promotion Services Limited	Raising additional capital	168
1997	Athi River Mining Limited	Raising additional capital	282
1998	Kenya Commercial Bank Limited	Raising additional capital	1,823
1999	Housing Finance Company of Kenya Ltd.	Privatization	420
2000	African Lakes Corporation Plc.	Raising additional capital	378
2001	Mumias Sugar Company Limited	Divestiture by Government of Kenya	1,125

Source: Nairobi Stock Exchange Handbook 2002; Capital Markets Authority Annual Report 1994/95 and 1995/96

Appendix 5-2: Financial Reporting Excellence Award 2003

COMPANY_____			Evaluator_____		
	Criteria	Areas & Marks Allocation.	Max. Mark	Marks	Comments & findings.
1	Compliance with IFRS & Other Technical Pronouncements.		**75**		
2	Compliance with Accounting Requirements of the Companies Act.		**15**		
3	Clarity of Statement of Accounting Policies.		**10**		
4	Clarity of notes to Financial Statements.		**20**		
5	Design, layout & visual appearance of the annual report including typeface.		**5**		
6	Board & Management reports	6.1 Review of the External Operating Environment	5		
		6.2 Review of performance	4		
		6.3 Review of operations and management	3		
		6.4 Review of Risk.	4		
		6.5 Future developments.	4		
		Sub-total.	**20**		
7	Presentation of performance data including use of graphs, bar charts, pie charts, ratios & trends.	7.1 E.P.S. Basic & Diluted	2		
		7.2 Dividend per share	1		
		7.3. Trends as presented through bar-charts, pie charts & graphs	5		
		7.3. Any other relevant tool e.g. value added statements	2		
		Sub-total.	**10**		
8	Corporate Governance	8.01 A statement on compliance with any of the following codes of best practice: OECD, CACG, CCG or other.	1		
		8.02 A statement on separation and distribution of powers between Chair and Chief Executive.	1		
		8.03 Board composition, showing the size of the Board. Appropriate Board size should be 7-11 members.	1		
		8.04 A statement on mix of skills and competencies of directors.	1		
		8.05 A statement on the number of Executive, Non-Executive and Independent Directors. About 70% of the directors should be composed of non-executive and independent directors.	1		

	Corporate Governance	8.06 Regularity of meetings - within the context of the relevant legal framework.	1		
		8.07 Statement of the duties & responsibilities of directors.	1		
		8.08 Establishment of board committees, their composition, powers delegated to them &/or terms of reference.	3		
		Specific issues relevant to directors:			
		8.09 Supply of information to directors & freedom to seek independent professional advice.	1		
		8.10 Statement showing how directors are Inducted and developed.	1		
		8.11 A statement on directors' compensation.	1		
		8.12 A statement on directors' shareholdings.	1		
		8.13 Statement showing succession plans for directors & management	1		
		8.14 Statement showing how conflicts of interest & disclosure are dealt with.	1		
		8.15 Acounting to shareholders & protection of shareholders' rights.	2		
		8.16 Statement on human resource development practices.	1		
		8.17 A statement on the "solvency test".	1		
		Sub-total.	**20**		
9	Social Responsibilities & Environmental Reporting	9.1 Statement acknowledging responsibility to society.	2		
		9.2 Specific disclosure of actions taken depending on extent of disclosure	4		
		9.3 Policy towards the environment.	2		
		9.4 Specific actions towards safeguarding & improving the environment.	4		
		9.5 Contribution towards staff welfare beyond salary	4		
		9.6 Responsible corporate conduct in the market place.	4		
		Sub-total.	**20**		
10	Principal shareholding disclosure		**5**		
TOTAL SCORE			**200**		
Signature_____			**Date**_____		

Appendix 5-3: Interview questionnaire

Financial reporting by Nairobi Stock Exchange companies

I. High quality financial reporting (for all respondents)

1. (a) Do you think the accounts of any company in Kenya are of particularly high quality?
   (b) Are there any accounts which you think are of particularly low quality?
   (c) What factors make a set of accounts high quality?
   (d) What makes a set of accounts low quality?
2. (a) Have you examined the financial statements of companies listed on any other stock exchange?
   (b) If so, which companies and which exchanges ?
   (c) Again, if so, how would you rate the financial statements that you prepare/examine against the financial statements of those companies?
3. (a) Do you think the introduction of international accounting standards in Kenya wef 1 Jan 1999 brought about an improvement in the quality of financial reporting in Kenya?
   (b) If so, in what way? If not, why not?
4. If a set of accounts disclosed all the information that it should disclose under International Accounting Standards and Company Law and yet did not report the earnings and financial position correctly, would you say that the accounts are of high quality?

II Transparency of the financial statements (for all respondents)

1. (a) Do you think that putting a greater amount of information into the financial statements necessarily improves their quality?
   (b) If so, what information? (Examples could include: a value-added statement, a five or ten year review of the results and financial position, management discussion and analysis of financial condition and results of operations).
   (c) If not, why do you think that the quality of the financial statements is not improved by putting in additional information?
2. (a) Has there ever been difficulties in reporting the results of some activity or event because user reaction would have been adverse or for any other reason?
   (b) If so, how have you dealt with the difficulties that you have been confronted with?
   (c) Do you know of any other companies that have been faced with difficulties of this nature? Do you know how they solved these problems?
3. (a) Do you feel that giving information in the annual accounts puts the company at a disadvantage from a trading point of view in that non-quoted companies, and even other quoted companies, obtain information from your accounts which you would prefer not to give away?
   (b) Is this particularly the case in relation to segment reporting?
   (c) If this is the case, how do you minimise the disadvantages that arise because of this?
   (d) Do you examine the accounts of your competitors to see if they contain information that could help you run your company more efficiently or more effectively, or enter a market which is more profitable than your current areas of operation?
   (e) In the case of non-quoted companies which are your competitors, do you try to get information about their operations and finances and if so how do you obtain this information?
4. (a) Does the company report information voluntarily so as to achieve advantages of any kind?
   (b) If so, what information does the company report voluntarily?
   (c) What advantages do you think this reporting gives the company?
   (d) If the company does not report additional information voluntarily, have you ever thought about doing so in the past and decided against it? What were the factors that made you decide against doing so?
5. What do you mean by the word "transparent" when it is used in connection with financial reporting?

III: Preparing financial statements for users: investors, creditors, lenders and regulators (The Nairobi Stock Exchange and The Capital Markets Authority (for preparers only)

1. (a) When the financial statements of the company are prepared, what do you aim to achieve with that set of accounts?
   (b) Who is your principal target audience?

(c) Do you have other users in mind when you prepare the accounts?

2. (a) Is there ever a worry in your mind that if you report that the company is doing extremely well, new competitors may enter your market?

(b) Are you aware of any companies that under-report their performance, results and financial position for this motive? Do you suspect any of doing so?

3. (a) Do you find that the Kenya Revenue Authority question your tax computation or your accounts unnecessarily?

(b) In what areas do you have differences of opinion with the Tax Department?

4. Do you find that preparing your financial statements become more burdensome because different regulators demand information:

(a) of a different nature;

(b) in as different format;

(c) of a more sensitive nature vis-à-vis competitors?

5. Does your company have to prepare accounts in a different format or using different figures because of bank covenants entered into when the company reported under different accounting standards?

6. (a) Do you think that the value of the shares of the company on the Stock Exchange is increased by raising the quality of financial reporting by the company?

(b) Why do you think that this is the case?

7. Is the value of the shares on the Stock Exchange of concern to you in any way?

8. (a) Does your company have an audit committee?

(b) If so, do you find the audit committee useful in raising the quality of financial reporting?

(c) In what way is the audit committee useful in raising the quality of financial reporting?

IV: Reporting profits (for preparers only)

1. (a) How does your company arrive at the figures for inventories, prepayments, accruals and provisions in its accounts ?

(b) Has your company ever had difficulties in arriving at the amounts to include in the accounts for inventories, prepayments, accruals and provisions in its accounts? Does it have a laid down policy as to how to arrive at these figures or are they computed using the best estimate that can be arrived at each year?

(c) Are these figures examined by a committee of persons: if so who make up this committee?

2. Do any directors in the company receive bonuses based on the level of profits reported by the company?

3. Are you under pressure to report lower profits so as to avoid having the Government question the level of profit?

4. (a) Are you under pressure to report a lower level of profit so as to reduce the tax liability of the company?

(b) Are you of the opinion that the level of corporation tax is higher than it should be in Kenya? If so, why? If not, why not?

5. Are you under pressure to report lower profits for any other reason?

6. Are you ever under pressure to report higher profits?

7. Do you think the financial statements you prepare are of high quality?

Appendix 7-1: Nairobi Stock Exchange Companies' Scores (DNE = did not enter)

Co. No.	CAR IFRS Compliance		S&P Survey Methodology		FiRe Award 2003 Score		IAS34: Interim Report	
	%	Rank	%	Rank	%	Rank	%	Rank
1	96.77	4	36.15	44	DNE	N/A	22.2	34
2	95.31	35	38.88	40	72.00	19	33.3	11
3	90.43	46	59.82	8	82.00	3	22.2	34
4	96.44	17	47.96	29	75.50	12	22.2	34
5	96.00	25	48.92	28	80.50	5	35.3	7
6	96.92	3	64.54	3	77.50	10	25.0	20
7	95.73	29	50.10	25	83.50	1	68.4	3
8	96.58	13	44.04	38	71.50	22	42.1	6
9	93.77	43	50.36	24	67.00	30	22.2	34
10	96.48	15	61.92	5	62.50	31	22.2	34
11	96.69	6	35.74	45	54.00	35	25.0	20
12	96.30	19	46.47	32	69.00	28	77.8	2
13	96.30	19	50.88	23	DNE	N/A	25.0	20
14	95.78	28	50.91	21	71.00	24	47.1	4
15	94.96	39	55.87	12	DNE	N/A	22.2	34
16	96.60	9	56.81	9	70.50	27	25.0	20
17	94.56	40	37.23	43	DNE	N/A	22.2	34
18	94.44	41	49.38	27	61.50	32	25.0	20
19	93.95	42	47.67	30	77.00	11	22.2	34
20	96.14	24	35.15	47	DNE	N/A	22.2	34
21	97.11	1	54.57	15	72.00	19	31.3	15
22	96.60	12	55.44	13	78.50	7	31.6	13
23	96.26	23	56.33	10	73.50	14	27.8	17
24	95.24	37	60.83	7	78.25	8	27.8	17
25	91.04	45	65.11	2	72.50	16	31.8	12
26	96.63	7	50.90	22	DNE	N/A	25.0	20
27	95.60	32	71.43	1	61.00	34	22.2	34
28	93.37	44	44.71	36	73.25	15	29.4	16
29	95.59	33	54.08	17	DNE	N/A	22.2	34
30	97.11	1	35.66	46	DNE	N/A	25.0	20
31	95.06	38	41.53	39	72.50	16	25.0	20
32	96.60	9	54.19	16	DNE	N/A	25.0	20
33	96.60	9	38.78	41	DNE	N/A	25.0	20
34	96.62	8	46.35	33	67.50	29	25.0	20
35	95.31	35	47.49	31	71.00	24	31.6	13
36	96.52	14	44.64	37	72.00	19	35.3	7
37	95.72	30	56.18	11	81.00	4	35.3	7
38	95.64	31	61.70	6	79.25	6	27.8	17
39	96.31	18	64.52	4	DNE	N/A	100.0	1
40	88.79	47	54.95	14	74.00	13	42.9	5
41	95.99	26	53.73	18	82.25	2	35.3	7
42	95.38	34	38.78	41	61.50	32	22.2	34
43	95.99	27	44.85	35	DNE	N/A	25.0	20
44	96.30	19	45.45	34	71.50	22	25.0	20
45	96.30	19	52.44	20	72.50	16	25.0	20
46	96.45	16	49.75	26	71.00	24	22.2	34
47	96.77	4	53.50	19	78.00	9	22.2	34

Appendix 7-2: Standard & Poor's Transparency and Disclosure Survey 2003		%
	Block 1: Ownership Structure and Investor Rights: Mean for Block	**55.76**
	Component 1: Transparency of ownership: Mean for Component	**63.69**
1	The number of issued and ordinary shares?	95.74
2	The number of issued and outstanding other shares (preferred, nonvoting)?	100.00
3	The par value of each ordinary share?	100.00
4	The par value of each other share (preferred, non-voting)?	100.00
5	The number of authorized but un-issued and outstanding ordinary shares?	91.30
6	The number of authorized but un-issued and outstanding other shares?	100.00
7	The par value of authorized but un-issued and outstanding ordinary shares?	100.00
8	The par value of authorized but un-issued and outstanding other shares?	100.00
9	The identity of the largest shareholder?	70.21
10	The identity of the 3 largest shareholders?	55.32
11	The identity of the 5 largest shareholders?	53.19
12	The identity of the 10 largest shareholders?	48.94
13	The description of share classes provided?	63.64
14	A review of shareholders by type?	8.51
15	The number & identity of shareholders holding more than 3% of the shares?	53.19
16	The number & identity of shareholders holding more than 5% of the shares?	55.32
17	The number & identity of shareholders holding more than 10% of the shares?	55.32
18	The percentage of cross-ownership?	26.09
	Component 2: Shareholder rights: Mean for Component	**40.43**
19	The existence of a corporate charter or code of best practice?	70.21
20	The contents of any corporate charter or code of best practice?	55.32
21	The provision of details about the company's articles of association, such as changes?	59.57
22	The existence of voting rights for each voting or nonvoting share?	12.77
23	The transparency of the way that shareholders nominate directors to the board?	0.00
24	The transparency of the way shareholders convene an extraordinary general meeting?	0.00
25	The transparency of the procedure for putting inquiry rights to the board?	100.00
26	The transparency of the procedure for putting proposals at shareholders meetings?	100.00
27	The existence of a review of last shareholders meeting, including minutes?	0.00
28	The existence of a calendar of important shareholders dates?	6.38
	Block 2: Financial and Operational Information: Mean for Block	**69.90**
	Component 3: Financial Information: Mean for Component	**78.43**
29	The form of the company's accounting policy?	100.00
30	The accounting standards it uses for its accounts?	100.00
31	Whether the accounts meet local accounting standards?	100.00
32	Whether the accounts meet IAS/ US GAAP?	100.00
33	Whether the company's balance sheet is according to IAS/US GAAP?	100.00
34	Whether the company's income statement is according to IAS/US GAAP?	100.00
35	Whether the company's cash flow statement is according to IAS/US GAAP?	100.00
36	Whether there is a basic earnings forecast of any kind?	19.15
37	Whether there is a detailed earnings forecast?	0.00
38	Whether there is financial information on a quarterly basis?	17.02
39	Whether there is a segment analysis -results broken down by business line?	88.00
40	The name of the company's auditing firm?	100.00
41	Whether there is a reproduction of the auditor's report?	100.00
42	How much the company pays in audit fees to the auditor?	100.00
43	Whether there are any nonaudit fees paid to the auditor?	0.00
44	Whether audited consolidated financial financial statements are presented?	97.87
45	Whether there are methods of asset valuation?	100.00
46	Is there information about the method of calculating fixed-asset depreciation?	100.00
47	Whether there is a list of affiliates in which the company holds a minority stake?	94.12
48	Whether there are notes to IAS or US GAAP financial statements?	100.00
49	The ownership structure of affiliates?	94.12

50	Whether there is a list or register of related-party transactions?	91.11
51	Whether there is a list or register of group transactions?	6.06
	Component 4: Operational & non-financial information: Mean for comp.	**53.60**
52	Details of the kind of business the company engages in?	100.00
53	Details of the products or services the company produces or provides?	100.00
54	Whether there is a measure of output in physical terms, such as number of users?	46.34
55	The characteristics of the assets employed?	100.00
56	Efficiency indicators, such as ROA or ROE?	6.38
57	Whether there are any industry-specific ratios?	4.26
58	Whether there is a discussion of corporate strategy?	59.57
59	Whether there are any plans for investment in the coming years?	100.00
60	Detailed information about investment plans in the coming year?	4.26
61	Whether there is an output forecast of any kind?	13.04
62	Whether there is an overview of trends in its industry?	97.87
63	The company's market share for any or all of its business?	10.64
	Block 3: Board and Management Structure and Process: Mean for Block	**26.49**
	Component 5: Board & management information: Mean for component	**27.20**
64	Whether there is a list of the names of the board members?	100.00
65	Details about directors other than their name and title?	17.02
66	Details about the current employment and position of directors?	17.02
67	Details about the directors' previous employment and positions?	10.64
68	When each director joined the board?	14.89
69	Whether there is identification of the directors' arrangement with the company?	2.13
70	Whether there is a named chairman listed?	97.87
71	Details about the chairman, other than name and title?	17.02
72	Details about the role of the board of directors at the company?	89.36
73	Whether there is a list of matters reserved for the board?	2.13
74	Whether there is a list of board committees?	55.32
75	Whether there is an audit committee?	74.47
76	The names of the members of the audit committee?	19.15
77	Whether there is a remuneration and compensation committee?	44.68
78	The names of the members of the remuneration and compensation committee?	12.77
79	Whether there is a nomination committee?	23.40
80	The names of the members of the nomination committee?	10.64
81	Whether there are internal audit functions besides the audit committee?	46.81
82	Whether there is a strategy, investment, and/or finance committee?	21.28
83	The number of shares in the company held by directors?	12.77
84	Whether there is a review of the last board meeting, such as minutes?	0.00
85	The list of senior managers not on the Board of Directors?	10.64
86	The backgrounds of senior managers?	2.13
87	The details of the CEO's contract?	2.13
88	The number of shares held by the senior managers?	0.00
89	The number of shares held in other affiliated companies by managers?	0.00
	Component 6: Board and management remuneration: Mean for comp.	**24.40**
90	Whether director training is provided?	4.26
91	The decision-making process of directors' pay?	74.47
92	The specifics of directors' pay, including the salary levels?	2.13
93	The form of directors' salaries, such as whether they are in cash or shares?	97.87
94	The specifics of performance-related pay for directors?	0.00
95	The decision-making process for determining managerial (not Board) pay?	23.91
96	The specifics of managers' (not Board) pay, such as salary levels?	2.17
97	The form of managers' (not Board) pay?	13.04
98	The specifics of performance-related pay for managers?	0.00
	OVERALL MEAN	**50.35**

Appendix 7-3: Areas of IFRS annual report non-compliance

Selected areas of IFRS annual report non-compliance are detailed below. The purpose of listing these deficiencies is to make a practical contribution to enable companies quoted on the Nairobi Stock Exchange to be aware of these areas of non-compliance.

A7.3.1Contingent Liabilities

Company 3 included in its contingent liabilities note that "the company is party to some legal proceedings but the directors believe that such litigation will be disposed of without material effect on the net asset position as shown in these statements". The financial statements for the year ended 30 September 2002 were approved at a meeting of the Board of Directors on 11 November 2002 but the notice of the Annual General Meeting (which is normally included as part of the annual report of companies in Kenya) was signed by the company Secretary on 4 January 2003. On 15 January 2003, it was reported in the *East African Standard* that the Managing Director and two senior employees of the company were found guilty of having prevented a competitor from trading, by holding 601 containers in October 2000 belonging to the competitor; the three employees were fined Shs.1.7 million each, a total of Shs.5.1 million; the profit after tax for the year ended 30 September 2002 was Shs.105 million. The company paid the fines for the employees. The company did not make proper disclosure of this event nor did it disclose an estimate of its financial effect as required by paragraph 20 of IAS 10: *Events after the Balance Sheet Date*, even if the event was deemed to be a non-adjusting event.

When companies 27, 38 and 45 did not quantify the amounts of some of their contingent liabilities, they did not state that such an estimate could not be made, as is required by the same paragraph of IAS 10. From the nature of all of these contingent liabilities, it would seem that an estimate could have been made. The companies were given the benefit of the doubt but the point is recorded to emphasize full disclosure.

A7.3.2 Capital commitments

Company 5 did not state the amount of commitments for the acquisition of property and equipment as at 31 December 2002, as required by paragraph 61 (d) IAS 16: *Property, Plant and Equipment.* In the year ended 31 December 2002, the company spent KShs.229 million purchasing property and equipment, which represented approximately 7% of the net cash from operating activities; the previous year, it had spent KShs.361 million, 228% of the net cash flow from operating activities of KShs.158 million. From the 2003 annual

report (i.e., the one after that examined in this study), expenditure on property and equipment turned out to be KShs.298 million, 3.5% of the cash flow from operating activities of KShs.8,462 million, which was an exceptionally good year for the company both in terms of profit and cash flow. A similar situation pertained to companies 6, 9 and 14. Companies 33, 39 and 44 had no capital commitments at the end of its financial year; this fact is clearly stated in the notes to the accounts. The company was again given the benefit of the doubt but the point is recorded to emphasize full disclosure.

A7.3.3 Impairment reviews.

Company 40 did not state whether property, plant and equipment were periodically reviewed for impairment, whereas all the other companies in its sector clearly stated that they did this. Although no company in the sector recognised any impairment loss, it would provide confidence to users of the annual report of company 40 to know that the possibility of an impairment loss had been considered. Company 40 incurred a loss in the year. The two other companies that traded in coffee (the principal commodity of company 40) also incurred losses. The value of the fixed assets could be have been adversely affected by the fact that the world coffee market price had dropped to a figure which made the growing and selling of coffee unprofitable in Kenya. One stated that "prices at the Nairobi coffee auction remained below our cost of production for much of the year" after pointing out that "our rigorous cost cutting measures continued during 2002"; this company, for which the sales proceeds from coffee made up 28.5% of turnover in the year ended 31 December 2001 and 17.3% of turnover in 2002, ceased the production and sale of coffee in 2003 because of this fact. Another of these three companies pointed out that "Vietnam and China are now growing both tea and coffee in abundance at much lower costs of production than ours" and "the large volumes being produced are ....exerting further downward pressure on international market prices". As a consequence, a user of the financial statements could think that company 40 likely overstated not only the value of the property, plant and equipment dedicated to this market but also either overstated deferred tax assets or understated deferred tax liabilities. Reassurance is given to investors if disclosure is made of regular reviews of the value of property, plant and equipment.

A7.3.4 Leasehold land shown as prepaid operating leases

Two companies included leasehold land under property, plant and equipment based on valuations performed by external independent valuers rather than as prepaid operating

leases at cost less amortization, as required by IAS 17: Leases. Firm A, the auditors of company 18 (which has a 31 December 2002 year end in the period studied), qualified its report to the members of the company as a result of this. Firm D did not qualify its report to the members of company 19: company 19's year end was 30 June 2002. Company 19 had a strict reporting deadline to meet so that its accounts could be incorporated into the holding company's consolidated accounts in London. ICPAK had issued a "Discussion Paper" in April 2002 inviting members of the Institute to give their views, by 30 June 2002, as to whether leasehold land should no longer be shown as part of property, plant and equipment, but as a prepaid operating lease at cost, which should be amortised over the period of the lease (ICPAK 2002d). However, the final communication from ICPAK took place one year later in April 2003, which settled the matter (ICPAK 2003a). All the big 4 firms in Nairobi have representatives on the Professional Standards Committee of ICPAK (some more active than others) which dealt with the issue and were probably aware that a change was needed in the financial statements of many companies in Kenya. But those companies which had a 30 June 2002 year end were clearly at a disadvantage, since the matter had not been concluded at the time their financial statements were being audited. The result was that company 19's financial statements did not comply with IAS 17 in this point. All the other companies quoted on the NSE complied with the requirement that leasehold land should be carried as a pre-paid operating lease at cost less accumulated amortisation, although a number of CFOs did not agree with this treatment (interviews chapter 9).

A7.3.5 Revalued property, plant and equipment.

Company 40 was one of 38 companies (81% of the companies on the exchange) that carried property, plant and equipment at revalued amounts, but did not show items carried at cost and items carried at revalued amounts as separate line items, as required by IAS 1 paragraph 71; in addition, this batch of companies did not show the carrying amount of each class of property, plant and equipment that would have been included in the financial statements had the assets been carried at cost less any accumulated depreciation and any impairment losses; some showed the breakdown of the "Cost or valuation" amounts into "cost" and "at valuation" but did not show a similar breakdown for the accumulated depreciation figure.

17 of these companies had not kept the revaluation of property, plant and equipment up to date; I treated any revaluation which is more than 9 years old at the end of the year examined as meaning that the carrying amount would differ materially from that which would be determined using fair value at the balance sheet date. The reason why I chose the period of 9 years was that when company 7 had its land, buildings and tea development revalued on 1st January 2000 by named independent valuers on the basis of open market value, the valuation amounts were comparable to the net book amounts on that date, which represented the 1993 revaluation by named independent valuers on the same basis (i.e. 9 years previous to the year ended 31 December 2002) less accumulated depreciation.

Company 31 carried property, plant and equipment at historical cost or at a revalued amount. However, the basis used to revalue the assets, the effective date of the revaluation, whether an independent valuer was involved and the nature of any indices used to determine replacement cost, as required by paragraph 64 of IAS 16: *Property, Plant and Equipment* were all omitted.

Company 28 carried "certain properties" included under "Freehold and leasehold premises" at a revalued amount, on the basis of open market value; no explanation was made as to why the entire class was not revalued, as required by paragraph 34 of IAS 16.

The 8 companies (17% of the companies on the exchange – one company had no fixed assets) which carried property, plant and equipment at historical cost without a revaluation did not face these problems. It would seem that company 5 carried its property, plant and equipment at historical cost, as stated in the accounting policy note; the property and equipment note in the financial statements indicated that property was carried at "Cost or valuation" but there is no other reference to these assets being revalued nor is there any revaluation surplus.

A7.3.6 Lack of clarity in the deferred tax note to the accounts

All the companies which revalued property, plant and equipment upwards created a deferred tax liability in accordance with IAS 12: *Income Taxes*, paragraphs 15 and 20, except company 22, which had deferred tax assets but no deferred tax liabilities. Paragraphs 15 and 20 of IAS 12 state that a deferred tax liability should be recognised for all taxable temporary differences, that is differences between the carrying amounts of assets and the tax carrying amounts (or the tax bases) which result in a tax charge in a future year being greater than the tax rate applied to the accounting profit in that future

year – when property, plant and equipment are revalued in Kenya the tax base remains unchanged.

Because of the creation of this deferred tax liability on the revaluation of property, plant and equipment, the amount that is credited to the revaluation surplus is the revaluation figure less the amount of the deferred tax liability. All the companies which have revalued property, plant and equipment follow the concept that the surplus is realized as the asset is used by the company. Hence, a transfer is made of this surplus depreciation from the revaluation surplus to retained profit, in accordance with paragraph 39 of IAS 16: *Property, Plant and Equipment.* But since the amount that was credited to the Revaluation Surplus was the revaluation amount less the deferred tax, the amount that should be transferred each year to the retained profit out of the revaluation surplus is the surplus depreciation for the year less the deferred taxation for the year- this could be described as "Transfer of excess depreciation net of taxation". The corresponding deferred tax should be removed from the deferred tax account and used to create a liability to current tax, through the Profit and Loss Account for the year.

In the Statement of Changes in Equity, all companies showed the "Transfer (from revaluation surplus to retained earnings) of excess depreciation" gross, and showed a corresponding "Deferred tax on transfer" (also from revaluation reserve to retained earnings, but opposite in sign). In the Deferred Tax note, the companies stated that "Deferred tax of Shs. x was transferred within shareholders' equity from revaluation reserves to retained earnings. This represents deferred tax on the difference between the actual depreciation on the property and the equivalent depreciation based on the historical cost of the property". However, in reality, no deferred tax has been transferred and, for users, this must be a very difficult entry to follow.

For companies audited by Firm E, the amount removed from the deferred tax account (in respect of deferred tax on revaluation surpluses) and credited to the current taxation account was equal for companies 14 and 44 but was not equal for companies 7, 35 and 44; companies 12 and 25 did not make this statement in their deferred tax note and released the deferred tax element to the Revaluation Reserve, rather than to the current tax liability account, both in the year 2002 and in the preceding year for company 25 but only for 2002 in the case of company 12. The figures in the deferred taxation note of company 40, audited by Firm B, are unintelligible. Part of the movement in the deferred tax account for

the year is stated as a credit to the "Minority interest share", which is possible when excess depreciation is dealt with gross in a subsidiary company. The figures did not agree in the case of company 9, a company audited by Firm A. Company 22, which was audited by Firm D, carried a deferred tax asset in respect of "Plant and equipment". Neither in the preceding year's Consolidated Statement of Changes in Equity nor in the current year's is there any mention of a transfer from the Revaluation Reserve. Dealing with the transfer out of revaluation reserve to retained profits as a net figure in all circumstances would simplify the figures for users.

In addition, there needs to be a careful reconciliation of the deferred tax accounts of all the companies quoted on the NSE; it is probable that many of them are overstated or understated. There is no simple check that can be applied to the balances on the deferred tax accounts even though the component elements are stated on the balance sheets of all the companies; when depreciable assets are revalued upwards, a deferred tax liability is created; when freehold land is revalued upwards, no deferred tax liability is created. It is not possible to establish the revaluation amounts from the accounts of most of the companies.

A7.3.7 Further points related to Deferred Taxation.

Note 7 to the accounts of company 15 for the year ended 31 December 2002 dealt with taxation; four figures in part (b) of this note are not properly aligned in their appropriate columns, with the result that a user of the accounts will have to spend a considerable amount of time studying the figures to make out what they mean. An examination of the components of the net deferred tax liability as at 31 December 2002 indicates that the deferred tax on the revaluation surplus has increased in the year while the surplus revaluation has decreased in the year. The closing deferred tax liability of KShs.6.712 million on the revaluation surplus is 30% (the current rate of corporation tax in Kenya) of the grossed up revaluation surplus, namely KShs.15.663 million divided by 70%, or KShs.22.376 million. The opening deferred tax liability of KShs.5.532 million on the revaluation surplus is *not* 30% of the grossed up revaluation surplus of KShs.17.184 million divided by 70%, or KShs.24.549 million. The reduction in the revaluation surplus in the year was due to the realization of the revaluation surplus on the disposal of a property and on the transfer of excess depreciation on revalued assets.

A7.3.8 Concurrence with a departure from an IAS

In the case of company 27, the auditors pointed out that the company did not follow IAS 21: *The Effects of Changes in Foreign Exchange Rates* in relation to aircraft which were financed wholly or partly in foreign currency (almost wholly US Dollar) borrowings. IAS 21 specifies that the foreign currency cost of these aircraft should have been translated into Kenya Shillings (the reporting currency) using the exchange rate at the date the aircraft were purchased. The loan drawn down to finance the purchase should also have been translated at this rate. In subsequent balance sheets under the historical cost system, the aircraft should have remained at the Kenya Shilling cost but the loans outstanding should have been translated at the exchange rate ruling at that subsequent balance sheet date; any change in the loan amount due to a change in the exchange rate between the Shilling and the foreign currency should have been charged or credited in the Profit and Loss Account for the period. At 31 March 2003, the company's fleet was comprised of 14 Boeing aircraft, 2 SAAB 340B turboprop and one Beechcraft-1900C airplanes; the Beechcraft airplane is referred to in the "Three Year Operating Statistics" on page 27 of the annual report but not in the Directors' Report on page 31 (where the number of aircraft is specified), nor on page 40 in the "Summary of Significant Accounting Policies" of the annual report (where the aircraft are again specified). The Kenya Shilling has generally depreciated against the US Dollar in the past, as can be seen from Table A7.1 below (exchange rates are stated at 31 March each year, the balance sheet date for company 27): the Kenya Shilling gained against the US Dollar in early 2003 after the election of the National Alliance Rainbow Coalition in place of the Kenya African National Union (KANU) which had been headed by President Moi.

Table A7-1: Exchange rate between the Kenya Shilling and the US Dollar.

31 March	1998	1999	2000	2001	2002	2003	2004
K Shillings per US$	59.88	64.87	74.92	77.82	78.06	76.65	77.76

Source: Central Bank of Kenya.

Company 27 translated the US Dollar cost of the aircraft together with the related foreign currency liabilities into Kenya Shillings at the exchange rate ruling at the balance sheet date; the difference between this net figure and the previous year's figure less the depreciation charge for the year was taken to reserves, since the directors were "of the opinion that these borrowings provide a hedge against the exchange risk associated with the investments". In keeping with paragraph 13(a) of IAS 1: *Presentation of Financial Statements*, the company disclosed that the directors had concluded that the financial

statements fairly presented the company's financial position, financial performance and cash flows. The financial statements for the year ended 31 March 2003 pointed out that the departure from the IAS has resulted in a decrease of net profit of KShs.165 million for the year and an increase in the preceding year of Shs.55 million, and a cumulative increase of assets of KShs.945 million at 31 March 2003 and KShs.1,365 million at 31 March 2002. They did not point out in the same note what the cumulative increase in liabilities had been, nor the fact that the exchange movements were debits of KShs.255 million and KShs.202 million for the year and the preceding year respectively, and that there was an exchange debit of KShs.900 million in the preceding year on the disposal of aircraft; these facts were displayed in note 21, thirteen pages later. Also there was no explicit statement as to why the treatment required by IAS 21 would have been misleading.

A7.3.9 Segment reporting

22 companies had reportable segments in the period studied. Companies 3, 17 and 40 did not disclose segment revenue, companies 3, 9, 17 and 40 segment result, 3, 9, 17, 25 and 40 the total carrying amount of segment assets for each reportable segment, and 3, 9, 25 and 40 segment liabilities; 10 companies did not disclose the total cost incurred during the period to acquire segment property, plant and equipment and 11 did not disclose depreciation of segment property, plant and equipment. There were numerous other items that were not disclosed in this area.

A7.3.10 Cash Flow Statements

Company 9 showed hire purchase (or finance lease) financing as a source of cash from financing activities. IAS 7: *Cash Flow Statements*, paragraph 17 (e) states that cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease is an example of a cash flow; however, when the asset is purchased using hire-purchase finance, no flow of cash is involved, and so a cash flow should not be reported.

A7.3.11 Banks

Banks 8 and 14 did not disclose the aggregate amount included in the balance sheet for loans and advances on which interest is not being accrued and the basis used to determine this amount. Bank 5 did not disclose its fee and commission income separately and banks 5, 14 and 36 did not disclose their fee and commission expenses separately.

Banks 28 and 41 did not disclose significant concentrations of their assets, and banks 28, 36, 37 and 41 did not disclose significant concentrations of their off balance sheet

items. Bank 28 did not disclose the amount of significant net foreign currency exposure at the balance sheet date.

Banks 22 and 28 did not disclose the bank's lending policy to related parties: banks 5, 8, 14, 28, 37 and 41 did not disclose each of the principal types of income, interest expense and commissions to related parties; banks 14, 28 and 37 did not disclose advances, deposits, repayments and other changes on related parties' balances; bank 28 did not disclose the amount of the expenses recognized in the period for losses on related parties' loans and advances and the amount provided at the balance sheet date, and bank 37 did not disclose the aggregate amounts due to and from related parties at the beginning of the period.

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