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Effect of IFRS Adoption on Reporting Quality in Kenya

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Abstract: *IASB states that the main objective of financial reporting is to provide information that is useful to investors, creditors and others in making investment, credit and similar resource allocation decisions. This study sought to find out if the adoption of IFRS had affected the financial reporting quality of listed firms in Kenya. Sample selection consisted of all companies listed in the Nairobi Stock Exchange (NSE) between 1994 and 2003 excluding banking and insurance companies. The study shows that the value relevance of reported earnings was incrementally higher for listed companies during the post-IFRS convergence period than in the pre-IFRS convergence period.*
Keywords: *IFRS, Kenya, Nairobi Securities Exchange*

I. Introduction

International convergence of accounting standards first arose in the late 1950s in response to post World War II economic integration and related increases in cross-border capital flows. Initial efforts focused on harmonization - reducing differences among the accounting principles used in major capital markets around the world. By the 1990s, the notion of harmonization was replaced by the concept of convergence - the development of a unified set of high-quality, international accounting standards that would be used in at least all major capital markets. The International Accounting Standards Committee (IASC), formed in 1973, was the first international standards-setting body. It began releasing International Accounting Standards (IAS) in that same year. The primary purpose of these standards was to unify the financial reporting requirements of European firms. In 2001, the International Accounting Standards Board (IASB) was established to develop International Financial Reporting Standards (IFRS). A year later, European Union (EU) member states committed to requiring IFRS for all listed corporations in their jurisdictions effective year 2005 (EC, 2002). Over time, the majority of developed countries have adopted IFRS requirements as a means of standardizing accounting practices internationally (PWC, 2011). The main holdout among developed economies is the United States, which continues to practice its own set of Generally Accepted Accounting Principles (GAAP).

IFRS was set to be the accounting standard in Kenya in 1998 by the Council of the Institute of Certified Public Accountants of Kenya (ICPAK) effective for financial statement covering periods beginning 1 January 1999. IFRS, including IFRS for small and medium enterprises (SMEs) are the Kenya national accounting standards. Companies whose securities are not publicly traded may choose the IFRS for SMEs or full IFRS. Requirements to use IFRS have been incorporated into Regulations issued by various governmental regulatory bodies, including the Central Bank of Kenya's prudential guidelines and regulatory guidelines issued by the Insurance Regulatory Authority of Kenya (IRA), the Capital Markets Authority of Kenya (CMA), and the Retirement Benefits Authority. Also IFRS are required by the Nairobi Securities Exchange (NSE) listing rules.

One of the main arguments in favour of IFRSs is that it helps eliminate barriers to cross-border trading in securities by ensuring that company accounts across jurisdictions are more reliable and transparent and that they can be more easily compared. This in turn increases market efficiency and reduces the cost of raising capital for companies, ultimately improving competitiveness and helping boost growth. Arguments against IFRS are its complexity, especially as regards the small and medium enterprises. Rather than reducing administrative burdens, IFRSs increase them, and increase the cost of preparation and audit of individual company accounts. The extensive disclosure requirements are also seen as potentially creating a competitive disadvantage vis-à-vis companies that follow less stringent rules. Opponents have also questioned the actual benefits that IFRS bring to companies operating only locally and having a limited number of shareholders.

This study seeks to answer the following overall research question: Has the adoption of IFRS affected the financial reporting quality of listed firms in Kenya? The significance of this study is that it is expected to be able to confirm the one of the rationale for adopting IFRS in Kenya. In this regard, this study could clarify whether single set of accounting standards fits all countries.

II. Measurement Of Financial Reporting Quality

According to IASB (2010), the two primary qualitative characteristics of information in financial statements are relevance and faithful representation. Information in financial statements is relevant when it is capable of making a difference to a financial statement user's decisions. Relevant information has confirmatory or predictive value. Faithful representation means that the information reflects the real-world economic

phenomena that it purports to represent. Relevance and faithful representation make financial statements useful to the reader

Usefulness of financial reporting underlies the IASB's conceptual framework. In fact, IASB (2010) states that the main objective of financial reporting is to provide information that is useful to investors, creditors and others in making investment, credit and similar resource allocation decisions. However, although financial reporting users include a large numbers of subjects, IASB focuses on the needs of participants in capital markets. More specifically, investors are considered those who are most in need of information from financial reports, given that they cannot usually request information directly from the firm. Moreover, as investors provide risk capital to firms, the financial statements which meet their needs also meet most of the needs of other users. Investors' needs are therefore considered as highly representative of the needs of a wide range of users (IASB 2010). Accordingly, in the last decades, empirical research has long been focusing on the relation between different accounting standards and share prices, or returns, with the purpose of choosing the best accounting policies.

The research stream that compares different accounting policies for standard setting purposes by examining their association with securities prices is also called "value relevance" research (Holthausen and Watts, 2001). In the last decades, value-relevance research has been the prevalent way to address accounting standard-setting issues. As outlined by Barth et al. (2001), in the accounting literature an accounting number is defined as value-relevant if it has a predicted association with share prices. This, in turn, happens only if the amount reflects information relevant to investors in valuing a firm and is measured reliably enough to be reflected in share prices. Equity values therefore reflect an accounting amount only if the two are correlated.

III. Data And Methodology

This study evaluates the impact of IFRS adoption in Kenya on financial reporting quality among listed firms on the Nairobi Securities Exchange through value relevance tests. Sample selection consisted of all companies listed in the Nairobi Stock Exchange (NSE) between 1994 and 2003 excluding banking and insurance companies owing to the differences between the accounting measurement used in these companies and the one used in other industries. Only firms for which valid data could be obtained are included in the sample, to enable calculation of the test variables required in the empirical analyses. There were 210 observations of 21 companies listed in the Nairobi Stock Exchange (NSE) between 1994 and 2003.

Table 1 presents summary statistics on the sample selected. The years 1994 to 1998 are classified as the pre-IFRS adoption period and the years 1999 to 2003 as the post-IFRS adoption period. Financial statements up to 31 December 1998 were prepare in accordance with the Kenya Accounting Standards from 1999 they were prepared in accordance with IFRS.

Table 1: Summary Statistics

	Pre-IFRS adoption period 1994-8						Post-IFRS adoption period1999-2000					
	Obs.	Mean	25th pct	50th pct	75th pct	Std	Obs.	Mean	25th pct	50th pct	75th pct	Std
P	105	0.165	3.030	5.330	9.490	5.711	105	11	6.940	9.250	15.870	6.673
EPS	105	0.138	0.020	0.140	0.290	0.250	105	0.251	0.040	0.190	0.459	0.319
BVPS	105	2.477	1.483	2.879	3.631	1.170	105	2.758	1.660	2.710	3.967	1.416

Specifically, the following regression model is used in the evaluation:

$$P_{i,t} = \alpha_0 + \alpha_1 BVPS_{i,t} + \alpha_2 EPS_{i,t} + \alpha_3 Post + \alpha_4 Post \times BVPS_{i,t} + \alpha_5 Post \times EPS_{i,t} + \varepsilon_{i,t}$$

where for firm i in year t,

$P_{i,t}$ = share price 3 months after fiscal year-end

$BVPS_{i,t}$ = book value per share

$EPS_{i,t}$ = earnings per share

Post = a dummy variable set equal to 1 for the post-IFRS period and 0 otherwise.

α_1 and α_2 = sensitivity of share price to book value per share and earnings per share in the pre-IFRS period

This model focuses on the extent to which share price can be explained by earnings per share and book value per share. For the post-IFRS convergence period, the model controls for the interactions of both book value and earnings per share with the Post dummy variable. For example, the interaction term Post x $EPS_{i,t}$ indicates the difference in value relevance of reported earnings before and after the IFRS convergence. If the coefficient α_5 is significantly positive, this indicates that the equity value of firms becomes more sensitive to reported earnings IFRS than under the previous Kenya Accounting Standards. This implies that earnings reported by NSE listed firms become more informative to equity investors in determining the value of firms following adoption of IFRS.

IV. Results And Discussion

Table 2 presents the findings of the first value-relevance test through the regression analyses based on the regression model.

	Treatment group	
	Coefficient	t-test
Intercept	6.439	(3.88)
BVPS	1.022	(15.354)
EPS	3.848	(14.355)
Post	3.365	(15.867)
Post x BVPS	0.078	(1.161)
Post x EPS	0.559	(1.71)
Firm fixed effect	YES	
Observations	210	
Adjusted R^2	0.686	

All variables except Post are winsorised at the 5% and 95% levels.

It can be observed that the coefficients for BVPS and EPS are both significantly positive, i.e. 1.022 (t-stat = 15.354) and 3.848 (t-stat = 14.355) respectively. This indicates that both book value and earnings were value-relevant before IFRS adoption in Kenya. The coefficients for the interaction terms Post×BVPS and Post×EPS are 0.078 (t-stat = 1.161) and 0.559 (t-stat = 1.71) respectively. This suggests that the value relevance of reported earnings was incrementally higher for listed companies during the post-IFRS convergence period than in the pre-IFRS convergence period. The observation that the value relevance of reported earnings significantly increases for the listed companies strengthens the argument that the observed effect is attributable to IFRS adoption in Kenya.

V. Conclusion

One of the most important functions of the capital market is to allocate financial resources efficiently. To achieve this function, the information efficiency of the capital market is paramount. The analyses prove that adoption of IFRS in Kenya in 1999 has positively affected reporting quality. The evidence reported above shows that IFRS adoption increased the value relevance of earnings of companies since during the study period most firms listed on the Nairobi Securities Exchange neded to attract capital from external investors. This is consistent with the argument that firms with demand for external capital experience a greater increase in the value relevance of their accounting earnings after IFRS adoption.

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