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Testing Applicability of International Financial Reporting Standards by Firms Listed at Nairobi Securities Exchange

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Abstract— **International Financial Reporting Standards (IFRS) have increasingly become global accounting standards. About 120 countries recognize IFRS as standards used in preparation of financial statements. However it is unclear as to whether firms operating in these countries can claim to be IFRS compliant. This study looks at what factors are likely to influence the compliance with IFRS by listed firms in Nairobi Securities Exchange as at 31st December 2016.There were 64 listed firms at this time. The study takes census approach. Secondary data covers the study for a period of five years from 2012 to 2016 both inclusive. The dependent variable is disclosure index. Independent variables included: firm size, profitability, leverage and age of the firm. Results reveal that there is negative but significant relationship between firm size and disclosure index. On profitability there is negative and insignificant relationship with disclosure index. On the other hand the study finds that the relationship between leverage and disclosure index is positive but insignificant. However in the case age of firm and disclosure index there is positive and significant relationship. The study concludes that the key factors that influence the compliance of IFRS by firms are age of firms and firm size.**

Index Terms— **Firm age, Firm Leverage, Firm Size, IFRS, Profitability.**

I. INTRODUCTION

International Financial Reporting Standards (IFRS) are important in defining ways in which accounting numbers are presented in financial statements to avoid subjectivity of information presented. They are a set of guidelines and rules that are applied by those who prepare financial statements (Katselas & Rosov, 2017)[ ]. The objectives of IFRS are to ensure that entities have high quality information; that information is transparent to users and are comparable in all periods presented and can be generated at a cost that does not exceed the benefits to users (IAS, 2006) This development has arisen due globalization of world trade where investors are able to invest in any part of the world. Globalization in trade has created need to standardize information especially those that appear in financial statements for the benefits of potential users such as investors, employees, lenders, suppliers, customers, governments, their agencies and public at large. The application of IFRS is aimed at reducing information asymmetry and agency problems that face many publicly quoted enterprises (Sun & Rath, 2008)[ ]. Chee Haat, Rahman and Mahenthiran (2008)[ ] state that the integrity of financial reporting is highly dependent on the performance and conduct of those involved in the financial reporting ecosystem, particularly directors, management and auditors. Despite this objective, several studies show that that IFRS still offer many options and require important estimates (Nobes, 2006) [ ]. Thus although IFRS have been largely recognized in over 100 countries their use have not been widely applied. For example Mulyadi, Soeyriyanto and Anwar (2012) [ ]) on the applicability of IFRS in four African countries; namely South Africa, Nigeria, Tunisia and Libya find that these countries still use local generally accepted accounting principles as a basis for taxation.

Stigler (1971) [ ] posits that regulation is one means by which state power can be exercised to benefit specific groups. Interest groups demand certain levels of regulation in order to provide for control. Private interest theory demonstrates common regulatory framework put in place for the good of a group. This group in respect to IFRS is identified as; potential investors, employees, lenders, suppliers, customers, governments, their agencies and public at large. The regulators have the responsibility of following sound governance practices in their operations to maintain credibility and moral authority in their oversight responsibility (Das & Quinty, 2002) [ ]. For full applicability of IFRS there may be need for government intervention. Cascino and Gassen (2012) [ ]) confirm this notion by emphasizing that firm, region and country incentives may promote diverse IFRS compliance. In Kenya Certified Public Accountants of Kenya adopted the use of IAS in 1998, the forerunner of IFRS. It requires that all listed companies to comply with IFRS even though there is no legal backing. Since 2001, Capital Markets Authority has made it mandatory for all listed companies to comply with IFRS (Outa, 2011[ ]; World Bank, 2001 [ ]).

This study is motivated by two factors. First the regulatory bodies and accountancy profession suffer from structural weakness and often fail to implement the rules in certain cases leading to collapse of firms listed in Stock Exchanges (Ali; Ahmed & Henry; 2004) [ ]. Secondly studies so far done on compliance with IFRS by firms listed in Stock Exchanges have given conflicting results. For example: On profitability Ali et al., (2004) [11] state that compliance levels are positively related to profitability. But the other two studies by Mutawaa and Hewaidy (2010) [ ] and Demira and Bahadir (2014) [ ] state that profitability has no significant association with level of compliance. On Leverage there are also conflicting results. Ali et al., (2004) [11] state that leverage is

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insignificant in explaining the compliance level. Palmer (2013) [ ] and Demir & Bahadir (2014) [13] posit that compliance is significantly associated with the level of leverage. Bonson & Escobar (2006) [ ] and Gorgan and Gorgan (2012 [ ] find positive correlation between auditor reputation. But a study by Wallace and Naser (1995) [ ] find negative correlation. Ballas and Tzovas (2010) [ ]; Joshi & Ramadhan (2002) [ ]; Ali, Ahmed & Henry (2004) [11]; Bonson & Escober (2001) [15] find significant positive relationship between company size and level of compliance. But Street & Gray (2001) [20]; Street & Bryant (2000) [22] find no evidence of association. Bonson & Escober (2006) [15], Gorgan & Gorgan (2012) [16] find positive correlation between company size and level of compliance. However, Street & Gray (2001) [ ] and Street & Bryant (2000) [ ] find no evidence of association. Bonson & Escober (2006) [15]; Gorgan & Gorgan (2012) [16] find positive correlation between auditors reputation and compliance with IFRS while Wallace & Nasser (1995) [18] find negative correlation. Al Shamir (2011) [ ] finds positive association with IFRS with internationality, industry type and leverage. However Adjei-Mensah (2012) [ ], Ali et al., (2004) [11] and Wallace &Nasser (1995)[17] find no association with leverage. These conflicting results call for further study in this area.

There are three main theories that govern the use of IFRS. These are; the agency theory, the normative theory and the signaling theory. Major corporate governance problems arise from the separation between ownership and management which is referred to as agency problems (Thomsen & Conyon, 2012 [ ]; Jensen & Meckling, 1976) [ ]. These corporate governance problems can partly be solved when financial reports are presented in standard forms where management is limited in subjecting the reports to personal latitude. IFRS do not limit managers in excising their professional views but give guidance on the mode of reporting. Appiah, Awunyo, Mireka and Ahiagbah (2016) [ ] argue that in agency theory, firms with higher agency cost generally comply with IFRS requirements to minimize information asymmetry between management and shareholders. Appiah et al., (2016) [26] point out that agency problem is more pronounced in developing economies because of weak capital markets. Variations in firm compliance with IFRS however may be linked with many factors. These include industrial sector (Street and Bryant, 2000) [21], profitability Tower et al., (1999)[ ], firm age Al Shammari, (2008) [ ] liquidity, Street and Gray, (2001)[20], firm size Glaum & Street, (2003) [ ].

Signaling theory argues that managers whose firms are profitable are likely to take advantage of benefits that are associated with the quality of accounting reporting because the firm is proud to share the success with prospective investors and shareholders. In Kenya this was noted when Uchumi Super market Ltd which had virtually collapsed in 2001 was revived by a new chief executive. In the next few years he was proud to give lectures at every opportunity of how he revived a firm which had collapsed.

A number of scholars have discussed the need for uniformity in presentation of financial statements Cole, Branson & Breesch (2007) [ ], Sunder (2010) [ ], and Hope (2004) [ ] in order to have comparability when using the financial statements. There are two approaches commonly used to measure the comparability, these are by use of indices and statistical models. Users of indices tend to prefer uniformity claiming that maximum comparability would exist when all companies use the same accounting methods (Taplin, 2009) [ ].The users of statistical models however prefer flexibility and claim that maximum comparability exists when companies are able to use the most appropriate accounting methods regardless of the country they belong (Jaafar & MCleay, 2007)[ ]. Jaafar and MCleay (2007) [34] posit that even though international exposure and firm size may be significant factors in IFRS applicability, county effects may be very important thus leading to inconsistency with harmonized accounting. Sunder (2010) [31], argues that written standards discourage thoughtful disclosure on alternatives which develop professional judgment and standards also drive away talent from accounting programs.

International Financial Reporting Standards are based on normative accounting theories. Normative accounting theory seeks to suggest the basis of accounting measurements, particular accounting procedures and contents of financial reports. It has been observed that there are constrains in constructing the relevant information in form which would be meaningful in normative framework (Mattessich, 2006 [ ]).

The rest of the paper is structured as follows: Section 2 reviews the empirical literature, section 3 covers data and methodology, section 4 presents results and discussion; finally section 5 concludes and suggests recommendations.

II. EMPIRICAL LITERATURE REVIEW

A number of studies have been done in regard to the level of compliance with IFRS by firms. These studies have been base on several firm attributes for example: size Atsunyo, Gatsi & Manso (2017) [ ], profitability, audit type , firm age, industry type, internationality, Country effect, Jaafar & MCley (2007) [32] and leverage Adjei-Mensah (2012) [23]; Ali et al.,(2004) [11] amongst others. Some studies are highlighted below.

Fekete, Matis and Lukas (2008) [ ] investigated whether Hungarian listed firms comply with IFRS disclosure requirements. The objective of the study was to establish to what extent quoted companies in Hungarian stock market comply with IFRS and if indeed they comply with IFRS then which specific characteristics are associated with level of disclosure? A sample of 22 blue chip companies was selected for year 2006. The study identified certain factors that could be associated with the level of compliance. These included company size, profitability, leverage, audit type, listing status, internationality, and industry type Fekete et al., (2008)[37].These formed the independent variables. The dependent variable was the disclosure index. A multi-regression model was used to analyze the data based on

the seven hypotheses. The study found that only company size and industry type were associated with the extent of compliance with IFRS disclosure requirements. Fekete et al., (2008) [37] concluded that there is evidence that significant number of firms do not comply with IFRS in their financial the reporting.

Outa (2011)[9] carried out a comparative study to establish if adoption of IFRS improved the quality of financial statements of listed companies in Nairobi Stock Exchange by having two periods pre and post adoption of IFRS in five years. The pre IFRS period ran from 1995-1999 and post IFRS 2000 to 2004. Outa (2011) [9] used eight metrics to measure the accounting quality for the selected sample of 54 companies listed in Nairobi Stock Exchange. This gave 320 firm year observations. The eight metric measures were; size based on market value of equity, growth based on annual percentage of change in sales, issue based on percentage of change in common stock, leverage, turnover sale divided by annual total assets, cash flow, quality of audit, duality in listing (Kenya and USA). Multi-regression analysis method was used for the study. Out of the eight measures only three gave positive prediction that adoption of IFRS improved quality of accounting but with low or insignificant measures. The only metrics which improved were earnings, timely loss recognition and value relevance. Outa (2011) [9] concluded that quality of accounting may have remained the same in the pre and post adoption periods.

Yigit (2014)[ ] investigated the determinants of voluntary adoption of IFRS by listed companies in Borsa, Istanbul. A sample of 206 firms for year 2003 were selected and tested. The objective of the study was to understand the determinants for voluntary IFRS adoption. The study used the following firm attributes; auditor type, export shares of sales, leverage, firm size, and industry type. These attributes were translated into five hypotheses; voluntary IFRS adoption is a function of an audit type, voluntary IFRS adoption is a function of export share of sales, voluntary IFRS adoption is a function of leverage, voluntary IFRS adoption is a function of firm size and voluntary IFRS adoption is a function of industry. The study found that firm size, type of auditors and export were the major drivers for the use of IFRS whereas leverage and industry type had insignificant effect on voluntary adoption of IFRS.

A similar study was undertaken by Demir and Bahadir (2014) [13] in Turkey. The objective was similar to that of Yigit (2014) [38] but with a fewer sample of 168 companies drawn from year 2011. The study used linear regression analysis. Compliance ranged between 64% and 92%. One outstanding finding was that compliance was found to be positively related to firms that were audited by the big 4 auditing firms. However compliance was negatively related to leverage. Other company characteristics such as profitability, company size and age were statistically insignificant in explaining the level of disclosure compliant with IFRS.

Appiah et al., (2016)[26] examined the association between seven firm-specifics (firm size, profitability, leverage, quality of auditors, firm age, listing, industry effects) and how these relate to level of compliance with IFRS by companies listed on Ghana Stock Exchange. Data was obtained from 31 listed companies. The study covered five years from 2008-2012. Random effect model was used to examine the influence of predictive variables on the level of IFRS corporate compliance. The results revealed a positive significant relationship between the level of compliance with firm size and quality of audit services. Positive association between firm size and firm compliance suggested that firm with larger total assets comply with the IFRS. A positive association between auditor type and IFRS mandatory disclosure suggest that firms audited by the big 4 are more likely to subscribe to the use of IFRS. There was positive association with cross listing and compliance with IFRS suggesting enhancement of investor confidence. There was negative insignificant association between leverage, firm age and profitability in terms of compliance with IFRS.

Tsegba, Semberfan and Tyokoso (2017) [ ] investigated level of compliance with IFRS by listed financial services companies in Nigeria. The study had three objectives one was to ascertain the level of compliance with IFRS by the selected companies, second was to examine the effect of firm characteristics on IFRS compliance and lastly to determine whether compliance with IFRS by deposit money bank (DMB) is significantly different from that of Insurance companies (INC). Secondary data was extracted from annual financial statements of the 57 financial services companies in Nigeria Stock Exchange. The independent variables collected included firm size, profitability, leverage, and internationality and auditor type. The dependent variable was corporate compliance index for each company. Data was analyzed using multiple regression technique and Wilcoxon Rank Test based on five hypotheses; profitability is positive and significant with IFRS, firm size is positively but insignificant to IFRS, audit type is positively associated with compliance, leverage and internationality is positively related with IFRS compliance. Results of the study showed that listed financial service companies in Nigeria have a higher rate of compliance. Secondly, profitability has a significant effect on compliance with IFRS. Thirdly size, leverage and internationality have no significant effect on IFRS compliance. Lastly, it was found that insignificant differences existed in the level of compliance with IFRS between DMB and INC.

Atsunya et al., (2017) [36] carried a comparative study on the success of IFRS application between Ghana and Kenya. The study was based on the following hypotheses; size, profitability, auditor type, industry type, internationality and leverage. A sample of 31 companies listed on Ghana Stock Exchange and 50 companies listed in Nairobi Securities Exchange as at 31st January 2011. Data was obtained from 2010 financial statement using checklist developed by Deloitte (2010) [ ]. The checklist was developed for each o f the selected standards (IAS 1, IAS 7 IAS 12, IAS 16, IAS 18 and IAS 19). Pearson product moment correlation was used in analyzing the data. Results of the study showed that company attributes; size, profitability, auditor type, industry

type and internationality have statistical significant positive relationship with companies' rate of IFRS compliance in Ghana but leverage was not related significantly. In Kenya auditor type, industry type and internationality were statistically significant with IFRS compliance. The study revealed a significant difference in compliance rate with IFRS between Ghana and Kenya. The study concluded that Kenya recorded a higher level of IFRS compliance than Ghana.

Based on review of literature above, the study tested the following four main null hypotheses:

1. H1: Firm size has no significant influence on applicability of IFRS

Because large firms have reputation and would like to attract viable investments they are more likely to comply with IFRS. Jumani (2012) [ ], Al -Shammari and Al-Sultan (2010) [ ], find positive link between firm size and compliance with IFRS.

2. H2: Profitability has no significant influence on applicability of IFRS

The influence of profits on the level of compliance with IFRS may be associated with several empirical arguments. For example Street and Bryant (2000)[21]; Street & Gray (2001)[20] find no positive relation for level of compliance. Moreover Glaum & Street (2003)[29] and Juhmani (2012)[41] state that profitability is not significantly related to level of compliance with IFRS.

3. H3: Leverage has no significant influence in applicability of IFRS.

Al-Shammari (2011) [22] argues that firms reduce shareholders and debt holders conflict where there is compliance with IFRS. This is based on an assumption that high-levered firms are expected have less information asymmetry. This enhances funding from their creditors which suggests that there is positive relation between compliance and leverage.

4. H4: Firm age has no significant influence in applicability of IFRS.

Demir and Bahadir (2014) Jumani (2012) [41] Glaum and street (2003) [29] have argued that firm age influences firm information on disclosure. These arguments have been based on the fact that old firms are exposed to these standards than new firms. They have reputation to protect as well as investor goodwill hence is more likely to comply with these standards. Older firms are expected to have a large asset base therefore would recruit professionals as their staff members.

III. DTA AND METHODOLOGY

The study used secondary data. The population of the study was all firms that were listed in Nairobi Securities Exchange numbering 64 from 1st January 2012 to 31st December 2016 covering 5 calendar years. Out of the 64 firms picked, only 60 firms responded and formed the sample for our study. Four attributes were used for the study these included firm size, profitability, leverage, and age of the firms. The dependent variable was the compliance. Compliance with IFRS was measured using Beest, Braam and Boelus (2009) [i] disclosure index.

A. *MODEL*

The disclosure index is determined as follows:

$$D1 = \frac{\sum_{i=1}^{m} di}{\sum_{i=1}^{n} di}$$

DI= Disclosure index.

m = Number of items, actually presented.

n = Number of total possible items that apply.

di =Index item i, 1 if the information (item) is supplied (disclosed) and 0 otherwise.

1 =If the information (item) is disclosed.

0 =If the information is not disclosed

A multiple regression analysis was used to determine the effect of each of the independent variables on the compliance with IFRS. The model is shown below:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Y = Compliance with IFRS.

β_0 = Constant

β_1- β_4 are coefficients

X_1=Firm size in total value of assets owned

X_2= Profitability (Return on Assets)

X_3= Leverage in terms of debt/ asset ratio

X_4= Firm age in years

B. *DATA ANALYSIS*

Table 1: Descriptive statistics

	Firm Size	ROA	Leverage	Firm Age	Disclosure index
N	300	300	300	300	300
Mean	16.51	.044	.124	58.13	2.69
Standard Deviation	2.05	.106	.143	27.47	.33

Skewness	.009	-1.35	1.22	.366	-.610
Kurtosis	-.47	.83	.71	-.439	-.45
Minimum	12.13	-.056	.00	8.00	1.880
Maximum	22.09	.39	.57	114.00	3.13

The following summary is made on descriptive statistics. The maximum and minimum value of firm size is 22.90 and 12.130 with mean value at 16.51. Return on asset has a mean of 0.04377 and a minimum and a maximum return of -0.056 and 0.390 respectively. On leverage, the study revealed a mean of 0.12427 with minimum and maximum leverage of 0.000 and 0.570 respectively. Mean age of firms was 58.33 while the minimum age and maximum ages were 8 and 114 respectively. The disclosure index had a mean of 2.687 with a minimum and maximum value of 1.880 and 3.130 respectively. Results from DI indicate that the mean disclosure is 2.687, minimum and maximum values are 1.880 and 3.130 respectively. The skewness and kurtosis results show that all the values lay within the negative and positive level hence the data is normally distributed.

Table 2: Correlation Analysis

	Firm Size	ROA	Leverage	Firm Age	DI
Firm Size	1				
ROA	-.033	1			
Leverage	.008	-.081	1		
Firm Age	-.281**	.151**	-.072	1	
DI	-.046	.074	.095	.147*	1

** Correlation is significant at the 0.01 level (2-tailed)

*Correlation is significant at the 0.05 level (2-tailed)

Table 3: Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficient	Sig	Co linearity Statistics	
		Std. error	*t.* statistics	sign.	Tolerance	VIF
Constant	.952	0.069	- 13.791	.000		
Firm Size	-.031	0.009	-.021 - 3.444	.006	.921	1.086
ROA	-.122	0.070	-.100 -1.743	.084	.972	1.029
Leverage	.070	.038	.105 1.842	.068	.990	1.010
Firm Age	.001	.000353	.170 2.828	.005	.898	1.114

Regression coefficients show that there is negative and significant relationship between firm size, and disclosure index of firms listed at the NSE. On the other hand there is a negative and insignificant relationship between return on asset and disclosure index. In the case of leverage, there is positive relationship with disclosure index but this relationship is insignificant. Firm age shows positive and significant relationship with disclosure index. This can be shown in the following model

$Y=.952-.\ 031X_1-.122X_2+.070X_3+.001X_4+ \varepsilon$

The entire independent variables show high tolerance factor which suggests that very low level of dependent variable is explained by the independent variables. The Variance inflation factor is less than 10 suggesting that there is no co linearity problem.

Table 4: Regression Analysis Model summary

Model	R	R^2	Adjusted R^2	Std error	Durbin Watson
1	.215	.046	.033	.12752	1.478

Predictors: Constant, Firm Age, Leverage, ROA, Firm Size.
Dependent Variable: Disclosure Index

The regression summary results show that R^2 statistic value is 0.046. This indicates that only 4.6% of variation is explained by independent variables. Adjusted R^2 is only 3.3%. All these suggest a small strength of relationship (Cohen, 1988) [ii]. The Durbin Watson d statistic is 1.478. This lies within the recommended range of 1.25 and 2.5 indicating that there is no autocorrelation.

Table 5: Analysis of Variance

Model	Sum of Squares	df	Mean Square	F	Sig
Regression	.232	4	.058	3.565	.007
Residual	4.797	295	.016		
Total	5.029	299			

Dependent Variable: Disclosure Index

Predictors: Constant, Firm Age, Leverage, ROA. Firm Size

The results of ANOVA indicate that the adopted regression model is significant and coefficients are jointly equal to zero or at least one coefficient is significantly not equal to zero. This is indicated by a p-value of .007 which is less than .05.The F-Statistics of 3.565 is significant at 5% level (.007). This means that the model is fit to be used to explain the relationship between firm characteristics and compliance with IFRS of the sampled companies.

IV. RESULTS AND DISCUSSION

This section present the results obtained from the statistical tests. The results are in respect of descriptive statistics, correlation analysis regression coefficients, regression analysis and analysis of variance.

Table III shows the results of the hypotheses tests on companies attributes. Hypothesis one firm size has no significant influence on applicability of IFRS is rejected because firm size has p-value of. 006 which is p- value .05. This shows that there is enough evidence to reject hypothesis one. Firm size has statistically significant though negative influence on compliance with IFRS. This finding is consistent with results of Ballas &Tzovas, 2010[18]; Ali et al., 2004[11]; Bonson & Escober (2006) [15] and Gorgan & Gorgan (2012) [16].

The second hypothesis states that profitability has no significant influence on applicability of IFRS. This is acceptable because it has a p-value .068 which is greater than p-value of .05. Thus profitability measured by ROA has no statistical significant relationship between it and IFRS compliance. This result is consistent with studies done by [36]; but is contradicted by Agyei-Mensah (2013) [ ].

The third hypothesis that states 'leverage has no significant influence in applicability of IFRS' is confirmed. Table 3 indicates there are non-statistically significant relationships

between leverage and level of company compliance with IFRS. It has p-value 0.068, this >p-0.05 thus return on assets does not relate to compliance with IFRS. This result is consistent with results from other studies, [11]; [23]; [36], and[13]

The last hypothesis tested was that 'firm age has no significant influence in applicability of IFRS.' This hypothesis is rejected. Indeed firm age has significant and positive relationship with IFRS compliance. Table III shows there is statistically significant influence in applicability of IFRS and firm age. The p-value is .005 which is<pvalue .05. The result is consistent with studies done by Glaum & Street (2003) [29] and Juhmani (2012) [41].

V. CONCLUSION AND RECOMMENDATION

This study investigated the compliance rate of IFRS by firms that are listed in Nairobi Securities Exchange for period covering 1st January 2012 to 31st December 2016. The study used possible factors that could influence the compliance rate of IFRS. These were identified as; firm age, firm leverage, firm size and profitability. The compliance rate was measured using disclosure index. Our evidence confirm results done in other studies by; Appiah et al., (2016 [26]), Yigit (2014)[38] Fekete et al., (2008)[37] that the level of compliance by firms on IFRS depends mainly on firm size and age. Large firms are able to hire competent managers, they are able to establish sound internal controls and even establish good governance. The study also found that profitability and leverage do not have influence on compliance with IFRS.

The study has a few advantages over other studies done to date. It is more recent study in Kenyan market in terms of data tested for example Atsunya et al., (2017)[36] used data that was of 2012. The study has several sensitivity checks. However there are a few short comings. First, not many variables were tested such as internationality, audit type, industry type export sales. Inclusion of these other variables could probably have added more light to the study. Secondly the study did not consider indirect costs that may be associated with adoption of IFRS. These costs may contribute to non applicability of IFRS in their current state.

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