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REVIEW OF PRACTICAL IMPLEMENTATION ISSUES OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

Case study in Kenya

Executive Summary

In concluding its twenty-second session, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) agreed to conduct further reviews of the practical implementation challenges of International Financial Reporting Standards (IFRS) as well as ways to meet these challenges. It was also agreed that the further review could be conducted by preparing country case studies with a view to developing guidance on good practices in IFRS implementation. Accordingly, five country case studies covering Brazil, Germany, India, Jamaica and Kenya were prepared**.**

This report presents findings of the case study conducted in Kenya. In 1999, Kenya decided to adopt IFRS. This case study presents the financial reporting infrastructure, including the regulatory framework, enforcement, status of compliance with IFRS among Kenyan companies, capacity-building issues and lessons learned.

The main objectives of this case study are to draw lessons learned from the experience of Kenya in converging with IFRS and to discuss the findings with member States, with a view to facilitating sharing of experience among countries that are either implementing IFRS or that intend to do so in the coming years.

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I. Introduction and background*

1. This case study focuses on Kenya, which was one of the first countries to adopt the use of IFRS and IAS in 1999. Over the years, Kenya has developed a wealth of experiences in the use of IFRS which would provide useful insights in the development of strategies by ISAR to aid other countries in the implementation of IFRS.

2. There is one stock market in Kenya, the Nairobi Stock Exchange, in which the shares of about 50 companies are traded. In addition to these listed companies, there is also a sizeable number of companies which are either multinationals or owned privately by Kenyans, as well as a large number of small- and medium-sized enterprises (SMEs). In terms of financial reporting, all these companies are required to prepare financial statements based on International Financial Reporting Standards (IFRS). In most cases however, most SMEs would prepare financial statements for use by the tax authorities or by the banks for purposes of accessing credit.

3. Other public interest companies such as, among others, banks, insurance companies, cooperative societies, non-governmental organizations also prepare accounts in accordance with IFRS.

4. With respect to auditing, all companies are required to be audited in accordance with the International Standards on Auditing. In most cases though, it is the larger companies that would seek to be audited. SMEs are only audited when necessary for tax purposes or as a requirement to access credit. The auditing sector/industry in Kenya is fragmented with about 500 firms practising. Of these, four are considered as large with international linkages and they audit practically all the large multinationals, banks, insurance companies and the listed companies. There are about ten or so medium-sized firms with more than two partners and the rest of the audit firms are largely one or two-partner firms.

II. Regulatory framework governing financial reporting in Kenya

Statutory framework governing the accountancy profession in Kenya

5. The accounting profession in Kenya is regulated by the Accountants Act Chapter 531, Laws of Kenya which was enacted on 1 July 1977. The Accountants Act established three bodies, namely the:

    a. Kenya Accountants and Secretaries National Examinations Board (KASNEB), which was given the responsibility of administering examinations for persons intending to qualify for registration as accountants and company secretaries. The Board administers the Accounting Technicians examinations as well as the higher level Certified Public Accountants (CPA) examinations.

* This document was prepared and edited by the UNCTAD secretariat with substantive inputs from Caroline J. Kigen, Institute of Certified Public Accountants, Kenya.

b. Registration of Accountants Board (RAB), which was to be responsible for the registration of those who have attained the specified qualifications after passing the relevant examinations administered by KASNEB. Persons holding designated foreign accountancy qualifications are allowed to be registered with the RAB after passing the examinations in company law and taxation administered by KASNEB. The RAB also issues practicing certificates to those who have met the requirements prescribed for issuance of a practicing certificate. These requirements include prior registration and membership of ICPAK as an accountant, as well as relevant experience in auditing for a minimum period of two years.

c. Institute of Certified Public Accountants of Kenya (ICPAK), which is responsible for the oversight of the profession. Once someone is registered as an accountant by the RAB, he or she becomes eligible for membership of ICPAK. ICPAK is mandated by the Accountants Act to perform the following functions:

    i. to promote standards of professional competence and practice amongst members of the Institute;
    ii. to promote research into the subjects of accountancy and finance, and related matters, and the publication of books, periodicals, journals and articles in connection therewith;
    iii. to promote the international recognition of the Institute;
    iv. to advise the Examinations Board on matters relating to examination standards and policies;
    v. to carry out any other functions prescribed for it under any of the other provisions of this Act or under any other written law; and
    vi. to do anything incidental or conducive to the performance of any of the preceding functions.

6. Membership of ICPAK is voluntary. Currently the membership of ICPAK numbers about 3 500 whereas statistics available from KASNEB indicate that as at the end of 2005, there were a total of 10 500 persons who had completed the final level of Certified Public Accountants examinations.

7. The existing statutory framework described above provides for the regulation of the profession through three separate entities. This poses various challenges particularly when it comes to decisions that impact the whole spectrum of accounting profession. ICPAK is a member of the International Federation of Accountants (IFAC) and is responsible for the implementation of International Education Standards aimed at strengthening the CPA qualification process; the qualification process is, however, managed by KASNEB. There is need for the two institutions to work closely together and obviously the need for consensus-building means that there will be delays in undertaking any reforms impacting on the qualification process. There are also challenges in coordinating the work of ICPAK and RAB to ensure that quality standards are adhered to.

8. With respect to financial reporting and auditing, the Accountants Act is not explicit that the authority to issue standards of professional practice, including accounting and auditing standards which shall form the basis of accountancy practice in the preparation, verification and auditing of financial statements vests with ICPAK. Although financial

statements are currently prepared in accordance with standards prescribed by ICPAK, there are currently no legal requirements for companies to comply with the standards issued by ICPAK.

9. The weaknesses in the Accountants Act are being addressed through a revision of the Act that is being undertaken by a taskforce appointed by the Minister of Finance in 2004. The proposed changes that will impact on financial reporting include giving ICPAK the legal authority to issue standards for use in financial reporting and auditing.

Statutory framework governing financial reporting in Kenya

10. In Kenya, the main legislation governing companies, including the financial reporting is the Companies Act. However, there are other legislations that impact on financial reporting. These deal with specialized sectors such as the insurance sector, banks and listed companies.

The Companies Act (CAP 486)

11. The Companies Act requires all limited liability companies to prepare and keep proper books of account as are necessary to give a true and fair view of the state of the companies' affairs and to explain its transactions. The Act further requires companies to present a Profit and Loss Account and a Balance Sheet each year during the Annual General Meeting and prescribes in detail what should be included in the Profit and Loss Account and in the Balance Sheet.

12. The Kenyan Companies Act, borrowed from the U.K. Companies Act of 1948, does not reflect the requirements set out in the Accountants Act and neither does it recognize the Institute's authority to oversee and prescribe the financial reporting framework to be adhered to by companies in preparing financial statements. The "true and fair view" concept is not defined in the Act.

13. The Companies Act prescribes in detail what should be included in financial reports but some of the requirements of the Act fall short of those of International Financial Reporting Standards. For instance the Act does not require preparation of a Cash Flow Statement among others.

14. With respect to audits, the Act requires companies to appoint auditors who must be members of the Institute and who meet the criteria for an auditor as laid out in the Accountants Act. The Act further specifies that the auditors' report should appear as an annex to the profit and loss account and balance sheet and prescribes the contents of the auditors' report. However, the Act does not specifically require the auditor to conduct audits in accordance with International Standards of Auditing.

Industry specific legislation governing financial reporting

15. Various industries are governed by various specialized legislation and these make provisions with regard to financial reporting. Some of the legislation requires the use IFRS and International Standards on Auditing as the basis for preparation and auditing of financial statements. These include regulations issued by the Capital Markets Authority, governing the companies whose shares are listed and traded on the Nairobi Stock

Exchange as well as those issued by the Central Bank of Kenya governing banks operating in Kenya. Thus listed companies and banks are specifically required to use IFRS in the preparation and audit of their financial statements.

16. In the case of the insurance sector in Kenya, while the Insurance Act requires preparation and audit of accounts, the Act does not specify the basis of preparing these accounts. The Act further specifies various schedules that must be filled by the companies containing prescribed financial information. These should be filled with the Commissioner of Insurance annually. With the issue of IFRS 4 on Insurance Contracts, it emerged that the provisions of the schedules as contained in the Act were contrary to the provisions of the standard. There were conflicts that emerged regarding how insurance companies would prepare their financial statements and after extensive discussions between ICPAK and the Commissioner of Insurance in Kenya, it was agreed that companies would prepare one set of financial statements that are IFRS compliant and would also fill the schedules as provided in the Act and send them to the Commissioner of Insurance. However, where the figures in the schedules prescribed by the insurance act differed from those in the financial statements that are prepared in accordance with IFRS, then companies were to prepare appropriate reconciliations which were to be certified by the auditor. This of course poses a burden on insurance companies in Kenya.

17. Other regulations impacting on financial reporting include legislation dealing with retirement benefit schemes, cooperative societies and local authorities. In some cases the provisions of these laws hinder the implementation of IFRS.

18. To deal with these regulatory challenges, ICPAK has adopted a policy of working with various regulators to sensitize them on the importance and the need for IFRS and ultimately promote ICPAK's role as the authority governing financial reporting. ICPAK continues to lobby for the incorporation of IFRS as the reporting framework in various legislation governing financial reporting in Kenya. In this regard, ICPAK recognizes that regulators may not have the technical expertise on financial reporting aspects, and therefore works with them in revising legal provisions to align them with IFRS provisions.

III. Implementation status: accounting and auditing standards

19. In 1998, the Council of the Institute of Certified Public Accountants of Kenya (ICPAK) made a historic decision to adopt International Financial Reporting and Auditing Standards for use in Kenya. Accordingly therefore, all companies were required to prepare financial statements based on International Accounting Standards (IAS) for periods beginning 1 January 1999 while the audits of all financial statements for period ending 31 December 1999 were to be carried out based on International Standards on Auditing (ISA).

20. Prior to this, ICPAK had issued Kenyan Accounting and Auditing Standards that were largely adopted from the IAS and ISA modified to suit the Kenyan environment. The decision to adopt international reporting standards fully was made at a time when the Kenyan business scene was reeling from numerous bank failures in the 1980s and 1990s. These failures raised questions as to the reliability of audited financial information and

particularly the fact that the financial statements of these banks did not provide any early warning signs about these bank failures.

21. The 1990s were also characterized by privatization of companies that were previously wholly state-owned. Some of the privatization was through a sale of shares at the Nairobi Stock Exchange. There was beginning to be an interest in the capital markets and to sustain this interest there was a need to address the weak corporate governance practices that prevailed at the time.

22. ICPAK recognized that to promote confidence in the capital markets and in the business environment in general, the country needed a globally accepted reporting framework which would result in quality financial reporting that would address the expectation of the users of financial statements. Indeed, at this time there was pressure from various regulators including those charged with overseeing the capital markets and the Central Bank to adopt IAS as these reflected best global practices.

23. The Council also took into account the scarce resources available at the Institute. Rather than utilize these scarce resources in the development of standards, it was felt that it would be more useful to utilize these resources to interpret IAS and provide user support. In any event, most of the Kenyan standards that had been issued so far were to a large extent compliant with international standards, albeit with a few modifications. During this period, there were 18 Kenyan Accounting Standards and about 20 Kenyan Auditing Guidelines in use. At the time of adopting international standards, there were International Accounting Standards 1 to 39 and International Standards on Auditing numbers 100 to 930 and International Auditing Practice Statements numbers 100 to 1011. Of the Kenyan accounting standards, 6 of them had no material differences with the corresponding IAS, while the others had a few differences here and there. About 20 of the IASs had no corresponding or equivalent Kenyan standard.

24. Prior to adopting international accounting and auditing standards, the Institute through its Professional Standards Committee, undertook extensive consultations with ICPAK members, preparers as well as various regulators particularly those in charge of the stock exchange and the banks as well. The committee issued various technical guidelines aimed at educating members on the differences between the Kenyan standards that were in use at the time and the international standards. Various technical seminars were also held to prepare for the full-scale adoption of international standards. At the same time, a technical desk was set up to help deal with queries that may arise in the course of preparing financial statements. The Institute also made arrangements to avail the books on the standards at reasonable rates to members. Various videos on accounting and auditing standards were obtained and shared with members through joint video sessions, after which these videos were availed in a technical library. Members were free to borrow and make use of these videos amongst other resource materials that were assembled to aid in the adoption process.

25. Since the adoption of international standards, there have been various benefits. There has been enhanced comparability of financial statements and the provision of better financial information that facilitates analysis and decision-making by various users. The stock market has witnessed increased activity and there has also been increased cross border investments. The use of international reporting and auditing standards provides safeguards to the public and generally increases public confidence in financial reporting.

There has been increased reliance by the regulators on financial reports which provide them a fairly reliable oversight mechanism.

Status of compliance with IFRS among Kenyan companies

26. In a bid to entrench and encourage the use of International Financial Reporting Standards (IFRS), ICPAK established an award known as the Financial Reporting (*FiRe)* Award in 2002. This award involves the evaluation of financial statements which have been voluntarily submitted by companies, to gauge their compliance with the requirements of IFRS. In 2005, six years after implementation of the IFRS in Kenya, there was no single company which exhibited 100 per cent compliance with IFRS out of a total of 84 companies who submitted their financial statements for review. The 2005 compliance levels are as shown in the table below, where 100 per cent denotes full compliance with all the requirements of IFRS including disclosure requirements and vice versa.

Compliance with IFRS recognized in the 2005 *FiRe* awards[1]

Compliance levels achieved	Number of companies achieving the compliance levels				
	Insurance sector	Banking sector	All other companies	Total	
				No.	In per cent
Above 80 per cent	3	0	10	13	16
60 to 79 per cent	12	10	15	37	44
50 to 59 per cent	7	1	3	11	13
Below 50 per cent	3	15	5	23	27
Total No.	25	26	33	84	100

27. As can be seen from the above table, while Kenya adopted the use of IFRS in 1999, the levels of non-compliance are quite high. This is especially the case when you consider that the above companies were quite large and indeed about 45 of them are listed on the Nairobi Stock Exchange. These companies have the resources to recruit well-trained professionals and in the case of the listed ones are required to comply with IFRS when preparing financial statements. Given this, one can expect that the level of compliance among the other private companies and small and medium enterprises is likely to be quite low.

28. The *FiRe* Award helps ICPAK to understand the areas of weaknesses in financial reporting and to design mechanisms to address these weaknesses. In early 2006 for example, various training sessions were organized focusing on presentation of financial statements and disclosure requirements of IAS 1 and 8. This training attracted about 300 participants and was well received. However, it should be noted that ICPAK has adopted the approach to encourage compliance rather than institute disciplinary measures against those companies where there is non-compliance.

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[1] Based on data compiled by the Institute of Certified Public Accountants of Kenya.

Areas of non-compliance with IFRS among Kenyan companies

29. From the evaluation of the Annual reports submitted for the 2005 *FiRe* awards, the following were the key areas where there was non compliance with the best practices as promulgated in the IFRS in preparing the financial reports;

IAS 1: Presentation of financial Statements

30. **Offsetting**: IAS 1 provides that assets and liabilities, and income and expenses should not be offset unless required or permitted by a particular standard or an interpretation. Offsetting may inhibit users' understanding of the substance of transactions and events that have occurred and prevent them from accurately assessing the entity's future cash-flows. It was observed that some companies were netting off various items in the income statement even where this was not permitted by any standard contrary to the above requirements

Identification of the financial statements:

31. IAS 1 provides that financial statements as well as each component of financial statements should be identified clearly and distinguished from other information in the same published annual report or document. IFRS apply only to financial statements and it is therefore important that users are able to distinguish information prepared using IFRS from all other information presented in the annual reports that while useful to users is not subject to the requirements of IFRS. Annual reports should therefore clearly identify and distinguish what constitutes the financial statements either in the table of contents or elsewhere in the report. IAS 1 (p 46a) further provides that the name of the reporting entity or any other means of identification should be displayed prominently. It was observed that while companies generally included financial statements in the table of contents, it was not possible to distinguish these from other information in the annual report.

Information to be presented on the face of the balance sheet, income statement or in the notes and other disclosures:

32. The following was information that should have been presented but in some cases was not:

Provisions: IAS 1 provides that provisions made in the current period are one of the line items that as a minimum must be included on the face of the Balance Sheet.

Reserves: IAS provides that the nature and purpose of each reserve within equity should be disclosed either on the face of the balance sheet or in the notes to the accounts.

Gross revenue: IAS 1 requires that as a minimum the face of the income statement must include a line item presenting the revenue for the period. Non-compliance of this requirement was noted mainly in the insurance sector.

Dividends: IAS 1 requires disclosure either on the face of the income statement, or the statement of changes in equity or in the notes, the amount of dividends recognized as distributions to shareholders during the period and the related amount per share. Further

IAS 1 requires disclosures of the amounts of dividends that had been declared before the financial statements were authorized for issue but were not recognized as a distribution to shareholders during the period.

Domicile and country of incorporation: IAS 1 requires disclosure of the domicile, legal form of the enterprise and its country of incorporation.

IAS 2: Inventories

33. Inventories: IAS requires disclosures of the accounting policies that have been adopted including the cost formulas used in determining the cost of inventories. In addition, the carrying amount of the inventories carried at net realizable value should be disclosed.

IAS 7: Cash flow statements

34. Preparation of cash flow statements: IAS 7 requires preparation of a cash flow statement for the entity as a whole which shows how the company generates and uses cash and cash equivalents. It was observed that some companies presented cash flow information for only a section of the business rather than for the enterprise as a whole. For instance, an insurance company would present cash flows for only the general business and not the life business.

35. Acquisition of a subsidiary: IAS 7 requires that where a subsidiary was acquired during the period, the cash flow statement should clearly indicate the portion of the purchase price that was paid by means of cash and cash equivalents as well as the amount of cash and cash equivalents in the subsidiary that was acquired. It was observed that there were instances when an acquisition had occurred but this information was not disclosed.

IAS 12: Income taxes

36. Deferred tax on revaluation: IAS 12 requires recognition of a deferred tax liability for all taxable temporary differences. IAS 12 further notes that at times an asset is revalued and this revaluation does not affect the taxable profit for the current period. In such a case, the future recovery of the asset's carrying amount will result in a taxable flow of economic benefits to the entity and the amount deductible for tax purposes will differ from the amount of those economic benefits. The difference between the carrying amount of the revalued asset and its tax base is a temporary difference and therefore gives rise to a deferred tax liability that should be recognized. This in most cases was not being done.

IAS 14: Segment reporting

37. Segment Reporting: IAS 14 establishes the principles for reporting financial information by segment and should be applied by all those entities whose equity or debt securities are publicly traded. Those entities whose securities are not publicly traded but choose to disclose segmental information voluntarily in financial statements that comply with the IFRS, should comply fully with the requirements of IAS 14. Many companies, both listed and non-listed, which presented segmental information failed to comply fully with the requirements of IAS 14.

IAS 16: Property, plant and equipment

38. Revaluation of property, plant and equipment: IAS 16 requires that an increase in the asset's carrying amount resulting from revaluations should be credited directly to equity under the heading revaluation surplus. This was sometimes not being done and instead the revaluation surplus would be credited to reserves.

39. Disclosures: IAS 16 requires that where items of property, plant and equipment are stated at revalued amounts, the following information should be disclosed: the frequency of revaluations, restriction on distribution of revaluation surpluses and the carrying amount of the revalued class of property, plant and equipment had the assets been carried under the cost model. In most cases it was observed that this was not being done by companies. The disclosures were mainly regarding the effective date of revaluation as well the involvement of independent and professional valuers.

IAS 17: Leases

40. Operating leases: IAS 17 requires the following disclosures with respect to operating leases; the total of future minimum lease payments under non-cancellable operating leases for each of the following periods: not later than one year, later than one year and not later than five years, and later than five years. This was not being done.

IAS 19: Employment benefits

41. Retirement benefit obligations: IAS 19 sets out various disclosures that should be made with respect to defined benefit plans, which were not made by most companies.

IAS 24: Related party disclosures

42. Related party transactions: IAS 24 provides that if there have been transactions between related parties, then disclosures must be made on the nature of the related party relationships, the types and elements of transactions entered into so as to ensure better understanding of financial statements. In some cases, the disclosures that were made were not as complete and as comprehensive as they should be.

IAS 30: Disclosures in the financial statements of banks and similar financial institutions concentration of deposit liabilities

43. IAS 30 requires banks to disclose any significant concentrations of their assets, liabilities and off balance sheet items. Such disclosures should be made in terms of geographical areas, customer or industry groups or other concentrations of risk. In addition, the amount of significant net foreign currency exposures should also be disclosed. These disclosures are a useful indication of the potential risks inherent in the realization of the assets and the funds available to the bank. Many banks have not yet complied with this requirement.

44. Assets pledged as security: IAS 30 requires banks to disclose the aggregate amount of secured liabilities and the nature and carrying amount of the assets pledged as security. This is because at times banks are required to pledge assets as security to support certain deposits and other liabilities. The amounts involved are often substantial and may have a

significant impact on the assessment of the financial position of a bank. Many banks have not yet complied with this requirement.

IAS 33: Earnings per share

45. Measurement: IAS 33 requires computation of basic and diluted earnings per share by dividing the profit or adjusted profit attributable to ordinary shareholders as the numerator by the weighted average number of ordinary shares outstanding or as adjusted during the period as the denominator. The computed basic and diluted earnings per share should be presented on the face of the income statement for each class of ordinary shares that has a different right to share in the net profit for the period in accordance with IAS 33. The amounts used as numerators and a reconciliation of those amounts to the net profit or loss for the period as well as denominators should be disclosed in accordance with IAS 33.

IAS 32: Financial instruments: Disclosures and presentation and IAS 39: Financial instruments: recognition and measurement

46. Disclosures: IAS 32 requires various disclosures to be made so as to enhance understanding of the significance of financial instruments to an entity's financial position, performance and cash flows and assist in assessing the amounts, timing and certainty of future cash-flows associated with those instruments. As such companies should describe their financial risk management objectives and policies and provide information that will enable users assess the extent of market, credit, liquidity and cash flow interest rate risk related to financial instruments. This concept is further reiterated in IAS 39. Various disclosures as required by both IAS 32 and IAS 39 were not done. For instance it was observed that companies did not give information on how fair value was determined or the fair values of those financial assets and liabilities carried at amortized cost. Banks also did not disclose the interest income accrued on impaired loans and that has not yet been received in cash.

47. It was noted that most companies lacked clear policies on the recognition criteria, the classification for measurement purposes and the treatment of gains or losses on disposal of various financial instruments. Where there were policies these tended to be quite general and were therefore not useful in enhancing understating of the financial statements.

Accounting policies

48. IAS 1 requires disclosure of both the measurement basis used in preparing financial statements as well as all other significant accounting policies used by the company that would be relevant to an understanding of financial statements. In particular companies should disclose those policies that are selected from alternatives allowed in standards and interpretation. In addition those policies that have the most significant effect on the amounts recognized in the financial statements and any judgments used in applying such policies should be disclosed. As a general rule, disclosure of accounting policies used should be made where such disclosure would assist users in understanding how transactions, other events and conditions are reflected in the reported financial performance and financial position.

49. It was observed that there were areas where companies failed to disclose the accounting policies used even when the circumstances were such that disclosure was warranted. These areas included policies on consolidation principles; borrowings; components of cash and cash equivalents; leases; de-recognition of financial instruments and employee benefits where it was noted that most companies with defined benefit plans made no disclosures on the accounting policy for recognizing actuarial gains and losses.

Voluntary disclosures

50. Disclosures are usually of two types: mandatory and voluntary. Mandatory disclosures are those that are required by financial reporting standards. Voluntary disclosures are those that represent additional information over and above what is required by reporting standards. Such disclosures provide greater understanding of the financial position and liquidity of the enterprise.

51. During the 2005 FiRe Awards, recognition was given to those companies which had gone beyond the call of duty and made significant disclosures voluntarily. Some of the areas where voluntary disclosures were made included segment reporting by those companies that are not listed and for whom segmental reporting is therefore not mandatory. Other voluntary disclosures that were noted were with respect to property, plant and equipment where some companies disclosed the gross carrying amount of fully depreciated property, plant and equipment that is still in use as well as the carrying amount of temporarily idle property, plant and equipment. Some companies also made disclosures on those fully amortized intangible assets that were still in use. This was positive as it did enhance the value of the financial statements to users.

Reasons for the non-compliance with IFRS among Kenyan companies

52. One of the reasons of non-compliance includes the growing complexity of IFRS. IFRS have become increasingly more complex and subjective in recent years, requiring technical expertise to understand and implement. There have been frequent and rapid changes to various standards arising from improvements and convergence projects. The improvement project gave rise to simultaneous amendments to 13 standards while the Convergence project led to various changes to standards such as on presentation of financial statements; accounting policies; and changes in accounting estimates and errors.

53. The move towards the fair value model has also introduced complications. It is a subjective concept and is difficult to implement particularly in developing economies like Kenya. This has particularly been problematic for those in the financial services sector and as can be seen from the above table, the sector that seems to exhibit the highest levels of non-compliance is the banking sector. Fair value has been defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction. However, while the concept is easy to understand, determination of fair value has been very difficult and at times impossible.

54. In Kenya, fair valuation of financial instrument including bonds, derivatives has been very difficult due to lack of reliable market information. The Kenyan capital market is still in its infancy stage and cannot be relied on to determine fair value for the financial

instruments. Auditors in Kenya lack reliable accurate reference points for some instruments.

55. There are also cases where there are conflicts between the requirements of IFRS particularly with regard to fair valuations, and those of various regulations and legislation. In Kenya, there have been instances where the regulator has refused to accept fair valuations based on IAS. An example of this is the determination of provisioning using the methodology prescribed by the Central Bank for use by the banking sector and provisioning as per IFRS. The Central Bank of Kenya has issued a guideline CBK/guideline No. 10 on risk classification of assets and provisioning: Section 5 (d) on Minimum Provisioning allocations is very specific as to the minimum percentage amounts that Banks should use to compute provisions. As far as ICPAK can determine, these rates recommended by the Central Bank of Kenya seem arbitrary. ICPAK has recommended to the Central Bank that banks should be allowed to use IAS 39 to determine these provisions based on each bank's roll rates and recovery experiences for portfolio loans. In addition, for significant individual loans, impairment should be determined on a case-by-case basis using discounted cash flows from repayments and the security provided.

56. In general, there is need for further discussions on the use of fair values. Absence of accurate reliable data on discount rates volatility, industry or company data to support cash-flow trends, crop yields, loan yields, loan default rates and lack of markets or underdevelopment of the existing ones has made the situation worse. There is need to establish what items can be measured at fair values and which items cannot. Establishing of sector benchmarks will also help in determining of fair values for some items.

57. The issuance of IFRS 4 on Insurance Contracts further introduced complication in financial reporting for the sector. Previously the Insurance Sector prepared separate income statements for the long term and short-term businesses. This practice was now challenged resulting in opposition from many players in the industry. The need to provide comparative information especially for some items also posed difficulties for the preparers.

58. There were conflicts between the reporting requirements of IFRS 4 and those of the Insurance Act. For instance, the Act is explicit on the methods to be applied by the insurance companies when calculating claims reserves in respect of general insurance business. Thus, when computing the amounts of provisions for claims incurred but not reported (IBNR), the Insurance Act prescribes certain minimum percentages to be used depending on the levels of net written premiums. These percentages are to be used by all Insurance Companies. In contrast, the IFRS 4 requires that the percentages to be used should be determined from the respective Insurance Company's past experience which may indicate lower rates.

59. Other areas where there were conflicts with the Insurance Sector regulator in Kenya was with regard to the IFRS 4 approach in the determination of taxable profit for life business, especially due to the difficulties posed by unbundling of contracts between the (deposit) investment component and the insurance component. Reporting surpluses in the Profit and Loss Account that are not available for distribution to shareholders has been a major concern in the industry.

60. To tackle the challenges being faced in the insurance sector, ICPAK prepared specimen financial statements demonstrating the application of IFRS 4 to the sector. In preparing these statements, ICAK involved the various stakeholders including the Insurance regulator and the Association of Kenya insurers, an umbrella that represents the various insurance companies. Nevertheless, because there are various reports to be made to the insurance regulator which are prescribed in the Insurance Act, the regulator did indicate that while in general, insurance companies would be expected to produce IFRS compliant financial statements, they would at the same time prepare returns to the regulator in accordance with the Act and where there are differences between the returns and the financial statements, appropriate reconciliations would be prepared and reviewed by the auditors.

61. Having said this, it should be noted that the Insurance regulator does not have the resources and capacity to review the financial statements submitted by the various insurance companies and determine the level of compliance with IFRS.

62. The other area where there were difficulties in enforcing compliance is the application of the requirements of IAS 17 on leases. The requirement to separate land from buildings was difficult to implement, particularly where the cost of land and the buildings were not carried separately in the books of the entity. The determination of which cost to apportion to land and what portion to buildings, especially where these had been bought for a single consideration and were carried at cost, was difficult. The recommended method of apportioning costs between land and buildings would entail additional costs such as use of professional valuers.

63. IAS 17 on Leases was also challenged by the regulators and the preparers due to a number of issues. In some cases, companies which had classified leasehold land as long term were required to reclassify them as operating leases given the lease terms. In such circumstances, these companies were required to write back revaluation gains. In addition, now that the leases had been reclassified, the prepaid operating lease rentals would have to be amortized over the life of the lease whereas previously these leases were considered long term and not depreciated. The immediate impact of this was to reduce reported profits although this was minimal where the leases were for a period of say 999 years. The greater impact though was the implications on capital adequacy particularly for banks and insurance companies which had strict levels of capital adequacy that have been set by the various regulators. Indeed the impact on core capital for the banking institutions holding land on leases that were nearing termination was significant, since prior-period adjustments to reserves were for the entire cost of these leases. To reduce the impact some banking institutions had to dispose off non-core assets such as leasehold land and buildings particularly those that were being held as investments.

64. The treatment of unrealized reserves has also been of concern to regulators. For instance, IAS 40 on Investment Property does allow the gain or loss from the change in the fair value of investment property to be recognised in the profit and loss for the period in which it arises. This has prompted concerns by regulators that this may create a loophole through which companies may manipulate their performances. The insurance regulator was quick to issue a circular to all insurance companies which explained how the unrealized reserves should be treated. This circular indicated that only 50 per cent of

unrealized reserves could be distributed as dividends and the remainder was to be capitalized.

65. At the same time, there were concerns by preparers that reflecting unrealised gains through the profit and loss may lead to taxation by the tax authorities. This is an area that has yet to be resolved and ICPAK has engaged the tax authorities on the taxation of such unrealized gains with a view to eventually developing an appropriate guideline on the matter.

Status of implementation of auditing standards

66. In 2004, ICPAK embarked on a quality review programme, the intention being to review audit firms to determine compliance with auditing standards by audit firms. A pilot review of seven firms was carried out by a team from the Institute in 2004 and early 2005. Eighteen additional audit firms were reviewed in 2005.

67. The results of the pilot reviews were not encouraging. There were significant deficiencies in the application of auditing standards by the audit firms. In particular, it was found that there was no documentation of the audit process and the audit files maintained were incomplete. There was also non-compliance with IFRS, notably: IAS 1 on presentation of financial statements, IAS 12 on income taxes, IAS 17 on leases, IAS 16, on property plant and equipment, IAS 39 on recognition and measurement of financial instruments and IAS 40 on investment property. The reasons for non-compliance in these areas have been discussed earlier.

68. Other weaknesses noted included a general lack of evidence to demonstrate understanding and application of quality control and little documentation of quality control policies and procedures as well as little evidence of compliance with professional auditing standards especially: ISA 300, 315, 400, 610, 250, 520, 505, 400 and 260 encompassing the entire planning process, ISA 220 and particularly as regards the review of the firm's independence, ISA 530 on sampling, ISA 545 as regards fair value, ISA 570 as regards going concerns and ISA 560 regarding post-balance sheet events. It was also found that there was poor documentation of entire audit process more so in gathering and recording of procedures and the audit evidence sought, conclusions arrived at and the reporting results. Generally, there was poor documentation of the basis of overall audit opinion and a failure to issue the various standard letters used in audit including engagement letters, letters of representation, official clearance from outgoing auditor, comprehensive audit plan among others.

69. The feedback received from the firms reviewed was that there was need for comprehensive training for audit practitioners to appreciate and understand the auditing process. A decision was therefore taken to develop a training module to be rolled out for audit practitioners and this was done in 2005. The programme targeting audit partners/ owners of audit firms was highly subsidized by ICPAK. The Institute was charging each participant an equivalent of $150 for the three-day non-residential training. By the end of 2005, about 350 practitioners had undergone the training program and there was improvement in the results of the audit quality reviews.

70. Nonetheless, the practitioners requested the Institute to develop a similar program for their audit staff and also assist in producing audit manuals and even a sample audit file

that the firms could use in their audit work. ICPAK embarked on these projects and it is expected that the training will commence in the latter half of 2006 as will completion of the manuals and reference materials.

71. In 2006, ICPAK also rolled out the fully-fledged audit reviews with a target of 130 audit firms slated for review this year. While there have been slight improvements, it is envisaged that the results of the training will be evident in 2007 and subsequent years. Only then can we gauge the level of compliance with auditing standards.

IV. Lessons learned in the implementation process

72. The key to increase the compliance levels is to ensure that there are trained persons who understand the use of IFRS and ISA. This requires that the qualification process should emphasize proficiency in the use of the various standards. In Kenya, given that the body in charge of the qualification process is different from ICPAK, which is essentially the standard-setting body, there may be difficulties in ensuring the qualification process keeps up with the developments in the standards. Traditionally, it takes very long to change or review syllabuses to keep up with the changes that have been occurring in the standards over the past few years. The training of accountants is also two-fold; there are the academic programmes offered by universities and the professional programmes. In Kenya, there is no mechanism to coordinate the two different types of training and ensure that both keep up with changes in the accountancy profession. There is no linkage between the universities, KASNEB and ICPAK and this is an area that needs to be addressed. Having said this, it should also be noted that the number of qualified accountants is quite low in Kenya with only about 10 000 fully qualified accountants as at 31 December 2005.

73. In addition, a majority of preparers of financial statements do not have access to the standards and do not keep up to date with the standards and various developments. While ICPAK tries to provide the standards, the cost is prohibitive for most preparers and auditors. ICPAK requires its members to acquire a certain number of hours of learning per year. However, our statistics indicate that majority of our members do not adhere to these requirements. The reasons for non-adherence to the continuing professional education requirements are mainly to do with the cost of the various seminars and workshops organized by ICPAK. This is especially a problem for those whose employers do not meet the cost of the seminars and workshops. In addition, in prior years, ICPAK did not have the necessary mechanism to enforce learning requirements. There was no consequence to not meeting the minimum learning requirements. However with effect from 2006, the Institute's Council decided that one of the criteria to be used in evaluating a member's standing with the Institute would be attainment of the minimum learning requirements prescribed by the Council. Thus, any member who requests a letter of good standing from the Institute and who has not fulfilled the minimum learning hours for 2005, is required to make a written commitment on how the member will make up for the deficiency in 2006. The institute has also embarked on a campaign to foster a commitment to lifelong learning amongst its members. This campaign includes making presentations during various institute events and publishing articles in the ICPAK bi-monthly journal that emphasize the importance of developing a culture of life long learning.

74. ICPAK has also provided increased training and user support to ensure that its members fully understand the standards and can implement them without difficulty. However, ICPAK has faced challenges in accessing competent resource persons and at the same time ensure that the training sessions are affordable to all. In 2005, for example, ICPAK rolled out a series of training sessions on audit quality assurance. These were aimed at providing basic understanding of auditing techniques to practitioners and were highly subsidized by ICPAK.

75. ICPAK itself needs to increase the technical support offered to members and has therefore committed itself to building its technical capacity. However, this process is constrained by a lack of resources. ICPAK strives to develop various guides and sample financial statements to aid in the understanding of standards. However, this process is sometimes slow given the scarcity of resource persons who understand the issues adequately to ensure production of guides that are simple yet comprehensive. This is an area where standard-setters can harness their collective resources and share the guides among themselves – even perhaps at a regional level.

76. In Kenya, the vast majority of companies can be considered to be SMEs. They are largely owner managed or controlled with financial statements produced largely for use by banks and tax authorities. In most cases, they lack a well-developed finance function and do not employ qualified accountants due to lack of resources. Since they are managed by their owners, SMEs are not motivated to adhere to the reporting requirements of IFRS. Indeed the more complex the standards, the less likely that SMEs will understand and the higher the levels of non-compliance. The IASB's project on reporting for SMEs should be hastened. However, due consideration should be made of the fact that SMEs are defined differently in developed countries than they are in developing countries. Perhaps we need a very simplified set of standards for SMEs in developing countries.

77. To anticipate changes in standards, there is need for Institutes to have increased participation in standard setting. This may not be possible at the individual institute level but can be done through regional bodies such as the Eastern, Central and Southern Africa Federation of Accountants (ECSAFA) in the case of African countries. Increased participation would ensure that implementation challenges are anticipated prior to finalization of standards. In fact, regulators should be involved where the proposed standards will impact on the industries they regulate at all stages of the standard setting process. This will, however, not be easy given that regulators themselves are constrained and do not have personnel who have the expertise to understand and appreciate reporting standards.

V. Conclusion

78. A financial reporting system supported by high quality standards such as the IFRS and the ISAs is central to economic development. Increased levels of globalization are underscoring the important role of a common financial reporting framework supported by strong globally accepted financial reporting standards. However, the implementation of the standards will continue to be problematic. This can be attested by the fact that even after seven years since the adoption of IFRS and ISAs in Kenya, compliance levels remain quite low among companies in Kenya.

79. A multi-pronged approach is required to enhance adoption of international reporting and auditing standards. The focus should be on simplifying the standards themselves and creating a stable platform or period during which no new standards are issued until the existing ones have been well and thoroughly understood. The different reporting needs of various categories of companies, including those of SMEs must be recognized. These require a highly simplified set of standards to encourage compliance at these levels. For the developing economies, a majority of the population’s interactions with the economy occurs at the micro- and small-size firm level and if there can be an appreciation of the importance of good financial reporting at these levels, albeit based on simplified but nevertheless high quality standards, then the impact of sound financial reporting will no doubt cascade to the rest of the economy.

80. The education process needs to be addressed, as this equips preparers and auditors with the tools they need to understand and participate in the financial reporting process using IFRS and ISAs. In this case, the education process should comprise both the pre- and post-accountancy qualification phases. Accountants need to continuously review and enhance their skills set so as to remain relevant. In this regard, professional bodies must be strengthened so as to ensure that their members remain relevant and committed to the adoption and compliance with international reporting standards.

81. Ultimately, those pursuing the implementation of IFRS need to be relentless, however daunting the challenge may seem.