

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Kenya

ACCOUNTING AND AUDITING

Prepared by a staff team from the World Bank¹ on the basis of information provided by the Kenyan Authorities

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Executive Summary

This report provides an assessment of accounting and auditing practices in Kenya in relation to the requirements of the International Accounting Standards (IASs) issued by the International Accounting Standards Board (IASB), and the International Standards on Auditing (ISAs) issued by the International Federation of Accountants (IFAC). The standards assessment is conducted within the broader context of the institutional capacity needed to ensure compliance with the international standards and to improve the quality of financial reporting in the country. The strengths and weaknesses of the institutional framework are highlighted, and an action plan for institutional capacity building is presented.

Kenya has recently made progress in closing the gap between national accounting and auditing practices and international standards, notably by adopting the IASs and ISAs as national requirements. However, compliance with the requirements of IASs and ISAs is partial, due to enforcement mechanisms that continue to evolve and inadequate resources. In spite of these difficulties, institutional investors in Kenya perceive that the quality of financial reporting has significantly improved over the past 12 months.

Improvements are needed in the legal framework governing accounting and financial reporting, the professional education and training arrangements, the professional body, and the enforcement mechanism. Stakeholders in the country believe that successful completion of appropriate capacity-building initiatives, through implementation of an action plan, would help develop accounting and auditing practices and bring about improvements in compliance with the international standards within a period of three to five years.

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I. INTRODUCTION

1. An assessment of Kenya's observance of international accounting and auditing standards was undertaken under the auspices of the Bank-Fund joint initiative on the *Reports on the Observance of Standards and Codes (ROSC)*. This has helped to place the standards assessment in a broader capacity-building context, and identify the extent to which Kenya's institutional framework inadequate to ensure high-quality financial reporting by the corporate sector. This assessment report has been prepared by World Bank staff, on the basis of information compiled jointly by Bank staff and a team of local professionals from the Central Bank of Kenya, Capital Markets Authority, and Nairobi Stock Exchange, working under the leadership of the Institute of Certified Public Accountants of Kenya (ICPAK).

2. Kenya is a major economy in the east and central African region, and its success in improving economic performance is likely to have a significant demonstration effect on the region's economic development. Although the country has taken some measures to improve its economic governance, economic growth and various social indicators continue to decline. This is partly a reflection of how deeply entrenched many problems are, including in the area of financial accountability in both private and public sectors. Deep-seated skepticism on the part of private investors, specifically foreign private investors, about the possibility of successfully implementing reform initiatives has not yet been overcome, and private investment levels remain very low.

3. Weaknesses in corporate governance practices, lack of pressure from the users of financial statements for high-quality information, and the general absence of transparency in the corporate sector, pervade the corporate financial reporting regime in Kenya. The fact that a number of banks failed in the late 1990s, and the audited financial statements did not provide early warning signals about these failures, has raised concerns among the general public about the quality of accounting and auditing in the country. Against this backdrop, this review of accounting and auditing practices in Kenya is intended to provide inputs on appropriate measures to improve the financial reporting regime.

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

4. **The Accountants Act established a three-pronged structure for regulating the accounting profession.** On July 1, 1977, the Accountants Act, Chapter 531, Laws of Kenya, established three bodies: (i) Institute of Certified Public Accountants of Kenya (ICPAK); (ii) Registration of Accountants Board (RAB); and (iii) Kenya Accountants and Secretaries National Examinations Board (KASNEB). The KASNEB administers examinations for persons intending to qualify for registration as accountants and company secretaries; the bulk of its student membership comprises those pursuing accountancy either at the technician level or as full certified public accountants (CPAs). The RAB is empowered to register 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. Upon completion of examination requirements, when a person obtains CPA registration with the RAB, he/she is allowed to be a member of the ICPAK. Recommendations for review of the Accountants Act to address institutional weaknesses have already been presented to the Ministry of Finance, and a draft revised law has been forwarded to the Treasury.

5. The existing statutory framework poses challenges to efforts to strengthen the accounting profession. The arrangement for regulating the profession through three separate entities has given rise to coordination problems in mobilizing resources to improve the quality of professional education and training and to enforce rules, regulations, and standards. A Committee established by the Treasury has been entrusted with the responsibility to find ways to improve coordination among the three separate bodies involved in the process of examination, registration, and membership. The outcome of this process should help overcome constraints to effective decisions that impact the whole spectrum of accounting profession. The ICPAK and KASNEB are already addressing matters concerning the strengthening of the CPA qualification process. A market perception survey is in progress which will identify needs in addition to benchmarking the qualification to internationally accepted requirements.

6. The Companies Act requires all limited liability companies to prepare and present annual audited financial statements. The Kenyan Companies Act, which is substantially the same as the U.K. Companies Act of 1948, was not amended to reflect the requirements set by the Accountants Act. Consequently, there is lack of clarity concerning the statutory requirements on disclosures in the financial statements of limited liability companies.

B. The Profession

7. The Institute of Certified Public Accountants of Kenya (ICPAK) became a member of the International Federation of Accountants (IFAC) in the early 1980s. The institute is governed by a council of 11 members, of whom 10 are elected by ICPAK members and 1 is nominated by the Treasury. Although the Accountants Act authorizes the Minister for Finance to oversee the discharge of the Council's responsibilities, the Finance Ministry has never applied its power either to modify or to override the decisions of the Council.

8. There are about 3,000 qualified accountants in Kenya, of whom about 2,500 are registered as members of the ICPAK. The distribution of ICPAK membership in the economy is as follows: public practice 40%; commerce and industry 50%; and other including public sector and academia, 10%. A study carried out in the late 1980s estimated the national demand for qualified accountants at 3,800, with upper and lower bounds of 6,400 and 2,300 respectively. Although there are no current statistics on the demand for qualified accountants, the ICPAK believes that the number of qualified accountants needed for today's Kenyan economy ranges between 6,000 and 7,000. Many companies meet this large shortfall in supply by employing nonqualified persons in accounting positions.

9. About 20,000 qualified accounting technicians in the country are primarily involved in bookkeeping activities. The holders of this designation need to pass the Kenya Accounting Technicians Certificate Examination (KATC), and they are not entered as members of the ICPAK. Proposals currently being worked on may change the Accountants Act to allow ICPAK to broaden its membership to include and regulate accounting technicians and other emerging professional groups within a system based on tiers of membership.

10. The accounting profession is dominated by the four largest international accounting firms. These four firms are the auditors of all the publicly traded companies in Kenya; about 50 companies are listed on the Nairobi Stock Exchange. The partners of these firms—both local and expatriate—actively participate in various committees of the professional body. Of the two other major firms in the country, one is the associate of a Big 5 international accounting firm and the other is a Kenya-based regional accounting firm. There are more than 100 local firms with clientele concentrated mainly among the small and medium enterprises.

11. Except for local subsidiaries of multinational enterprises, the corporate sector in general does not have access to adequately trained accountants. The accountants for many corporate entities lack the skills to prepare financial statements in accordance with the mandatory accounting and reporting requirements. Consequently, compliance by preparers of financial statements with accounting and reporting requirements is limited. These limitations in the legal and regulatory environment provide little incentive for company directors to ensure that financial statements are prepared in accordance with established standards.

C. Professional Education and Training

12. The entry requirement for the CPA (Kenya) qualifying examination is the same as that of public universities in Kenya. However, representatives of the profession as well as academics believe that the entry requirement does not provide a sufficient foundation to acquire the knowledge, skills, and professional values needed to become a professional accountant. In view of this, the ICPAK has been trying to raise the required minimum level to bachelor's degree. The syllabus for the CPA examination was updated in 1991 to include an information technology (IT) module. While revisions have been made in recent years to the syllabus and the examination system for CPA qualification, representatives of professional firms and the corporate sector believe that further improvements are needed to enhance the relevance and quality of the qualification. As a part of the ongoing review of the CPA syllabus, ICPAK and the KASNEB are reviewing entry criteria, whether practical experience should be an integral part of the qualification process, and the need for direct vetting of the quality of training institutions by the profession, a process currently undertaken by the Ministry of Education.

13. The lack of adequate resources in a number of educational institutions constrains provision of high quality education and training in accounting. About 130 colleges offer nondegree programs with the curriculum based on the syllabus of the Kenyan CPA

examination. Students enroll in these programs to receive the training necessary for passing the CPA examination. Some colleges provide additional programs to prepare students to take the ACCA examination administered in Kenya by the Association of Chartered Certified Accountants of the United Kingdom. However, many of these colleges lack well-trained instructors and practical-oriented courses. Thus, students generally do not receive high-quality training in accounting and auditing and either fail the CPA examination, or start their professional career with a weak academic foundation.

14. Professional ethics for accountants is not taught in prequalification educational programs, as required by IFAC guidelines. This makes it more difficult for professional accountants to be aware of ethical dimensions or conflicts in their work, or informed about the views and expectations of their professional body and the public relating to the application of professional ethics. It can also contribute to perceptions in Kenya that professional accountants do not comply with the ICPAK's professional code of ethics.

15. The ICPAK requires its members to undertake Continuing Professional Education (CPE). Some changes are required in this area to meet IFAC guidelines. IFAC suggests that active accounting professionals should participate in structured learning activities for a minimum of 30 hours per year, or a minimum of 90 hours in every three-year period. The ICPAK requires CPE, although less than the IFAC standard: 20 hours in structured courses (10 hours must be in courses organized by the institute), and 10 hours in unstructured CPE courses per year. There is a need to operationalize effective norms for participation in structured and unstructured learning activities.

16. Professionals working in small accounting firms find it difficult to keep up to date with new developments in accounting and auditing. These practitioners state that, because of the downturn in the economy during the past several years, they are constantly struggling to earn enough to stay afloat, and they cannot afford to spend money and time on training programs. The small and medium-size practitioners in Kenya are also handicapped by their lack of access to appropriate literature on the application of established accounting and auditing standards.

17. The ICPAK secretariat encourages members to undertake CPE. However, due to the limited resources at its disposal, it has not yet developed a system to monitor effectively the extent to which members are complying with CPE requirements or to respond to instances of noncompliance.

D. Setting Accounting and Auditing Standards

18. The ICPAK promulgates accounting and auditing standards. In fulfillment of its mandate under the Accountants Act, "to promote standards of professional competence and practice amongst members of the Institute," the ICPAK has been involved in setting accounting and auditing standards for application in financial reporting by companies in Kenya since the early 1980s. In 1998, the Council of the ICPAK adopted international standards for financial reporting in Kenya, which thereby became Kenyan standards. All financial statements covering periods beginning January 1, 1999, must be prepared in accordance with International Accounting Standards (IASs), and financial statements

prepared for periods ending on and after December 31, 1999, must be audited in accordance with International Standards on Auditing (ISAs). ISAs are applicable for enterprises of all sizes and types, to the extent that they apply to the specific circumstances of the reporting entity. The country's tax authorities require enterprises to produce IAS-compliant income statements for determining accounting profit, which is adjusted to calculate taxable profit.

19. Although Kenyan law does not address accounting standards for listed companies and banks, regulators use their supervisory mechanisms to insist on observance of the IASs. The Banking Supervision Department of the Central Bank of Kenya, using its legal authority to require individual banks to disclose information in a particular manner, imposes IAS requirements. Until recently, although there was no legal requirement to follow IASs, listed companies were advised by the Capital Markets Authority (CMA) to prepare financial statements in compliance with IASs. The revised rules of the CMA, effective in June 2001, have made IASs mandatory for accounting and financial reporting by all listed companies. Moreover, the Nairobi Stock Exchange (NSE) is issuing a manual that requires listed companies to follow IASs.

E. Compliance with Accounting and Auditing Standards

20. Although adoption of IASs and ISAs was an important step in upgrading the financial reporting practices of Kenyan enterprises, there continue to be gaps in compliance with these standards. One problem is that the standards themselves need to be better disseminated: students, trainee accountants, practicing accountants, and auditors must have easy and affordable access to the latest versions. However, it is expensive for Kenyans to purchase annual volumes of these standards. In addition, many practitioners believe that the quality of accounting and auditing practice would improve significantly if ICPAK were to issue manuals on the appropriate application of the standards.

21. Although the ICPAK requires its members to apply the IASs, neither the Companies Act nor the Accountants Act imposes on Kenyan companies a legal obligation to comply with the accounting standards promulgated by the professional body. Therefore, Kenyan entrepreneurs tend not to devote resources to ensuring compliance with the established accounting and reporting requirements. This is an important gap in the legal and regulatory framework that needs to be addressed.

22. This review noted examples of failure by auditors to ensure compliance with IASs and ISAs. This may be due to an absence of demand for transparency and accountability, and capacity constraints among audit firms. The large professional firms with relatively better trained staff have heavy client lists, which may affect quality of service. Small and medium practices, on the other hand, struggle to win clients, and have difficulty in finding funds to invest either in upgrading the skills of existing partners and staff or in recruiting qualified professionals.

23. The Capital Markets Authority (CMA) does not have an effective mechanism for monitoring compliance with reporting standards in financial statements issued by the publicly traded companies or for punishing issuers for infractions. In some cases

where deficient financial reporting by listed companies was discovered and reported in the national press, the CMA did not take punitive action against the companies.

24. Recently, the Central Bank of Kenya (CBK) has begun to review and approve draft annual audited financial statements before issuance by the concerned bank. For this purpose, CBK officials meet with the representatives of a bank and the bank's auditor and discuss various accounting and disclosure items in the financial statements—this is in addition to other requirements on banking supervision. This process enables the CBK to provide inputs on disclosure issues based on IAS requirements before a set of financial statements is issued to the public. However, the efficacy of the review process depends very much on the adequacy of CBK representatives' knowledge about IAS requirements, and their ability to detect potential accounting manipulations concerning recognition and measurement issues. It is possible that noncompliance with some significant accounting requirements escape detection. Approval by CBK of financial statements at the pre-issuance stage limits its ability to take punitive actions if infractions are later discovered in the same set of financial statements.

25. The self-regulatory organizations do not monitor and enforce accounting and auditing standards. The Nairobi Stock Exchange (NSE) is satisfied if a listed company issues audited annual financial statements; it does not have any arrangement to improve the quality of financial reporting by the listed companies. ICPAK has not yet established a monitoring mechanism, making it difficult to identify and pursue violations of established rules and regulations. The ICPAK has designed a peer review program based on the approach followed in South Africa for monitoring quality assurance arrangements in audit firms. However, resource constraints have stalled the launching of the program.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

26. There are gaps between applicable accounting standards and actual accounting practices. While the adoption of the IASs has closed the gap between Kenyan and international accounting standards, the lack of implementation guidelines on the application of the standards and of a mechanism for providing interpretations means that different preparers and auditors of financial statements interpret and apply the IASs in different ways. Two recent reviews of the financial statements of Kenyan companies have identified a number of areas in which practice falls short of the standards. In the first review, the ICPAK's Professional Standards Committee examined about 40 sets of financial statements to select the best presented ones, as part of an ICPAK awards program. The second review, conducted for the preparation of this assessment, involved an examination of 31 sets of financial statements of major listed and unlisted companies using a checklist of disclosure requirements under applicable IASs. Both reviews used financial statements for the accounting year starting on or after January 1, 1999—the first year of mandatory IAS use in Kenya—and both obtained similar results. Details of the findings on disclosure items are presented below; the review did not cover compliance with “recognition and measurement” requirements, which is difficult to judge through a review of published financial statements, although a number of deficiencies were observed in these areas. The extent of the noncompliance identified suggests that noncompliance is likely in other areas as well.

“Basis of presentation” note. According to IAS-1, paragraph 11, financial statements should not be described as complying with the IASs unless they comply with all the requirements of each applicable standard and each applicable interpretation of the Standing Interpretations Committee. For many of the financial statements that did not comply fully with the IASs, the basis of presentation note attested that they had. In cases where the notes to financial statements pointed out departures from certain IASs, the disclosure requirements in support of such departures were not complied with.

Consolidated financial statements. Most companies did not adequately disclose the accounting policy on preparing consolidated financial statements. Except in a very few cases, the note on consolidation policy did not clearly state which subsidiaries were included or not included in the consolidated financial statements. Moreover, in a large number of cases, the consolidated financial statements did not contain a listing of significant subsidiaries including the name, country of incorporation or residence, proportion of ownership interest, and, if different, proportion of voting power held. In general, the companies did not provide accounting policy disclosure on the treatment of associates in the consolidated financial statements. Moreover, in almost all cases, the method used to account for subsidiaries in the parent’s separate financial statements was not described, as IAS requires.

Revenue recognition. Many companies did not disclose the accounting policy on revenue recognition, often providing instead the statement that “turnover represents the proceeds from the sale of goods to customers.” Some practitioners pointed out that many companies do not follow the generally accepted revenue recognition policy, and as a result there is a possibility of revenue misstatements in their financial statements.

Related-party disclosures. Inadequate disclosure of related-party relationships and transactions may facilitate the diversion of corporate resources for private benefit. The review noted poor related-party disclosures in the financial statements of most of the companies. Although balances due to and from related parties were generally shown, the disclosures were mostly inadequate because of widespread noncompliance with other IAS requirements on related-party disclosures.

Segment reporting. For the great majority of the listed companies, segment reporting in the financial statements was inadequate even though the notes to the financial statements indicated that the preparers (and the auditors) of the financial statements were aware of the IAS requirements. For example, the notes on significant accounting policies of a Kenya-based multinational enterprise stated that “International Accounting Standard number 14 on segment reporting is not applicable as the company has no distinguishable reportable segments” while the company has wholly-owned and majority-owned subsidiaries that suggest at least three geographical segments, and product lines that suggest at least two business segments.

Interest rate risk. IAS-32 paragraph 56 requires disclosure of maturity dates and (weighted average) effective interest rates of each type of financial asset (investments, advances, etc.) and financial liabilities (borrowings, etc.). Most of the companies did not

provide the required information on their exposure to interest rate risk. Generally, the disclosure on borrowings was confined to the amount due on bank loans and total interest expenses. The disclosure on interest income was also very limited.

Deferred taxes. Most companies that reported having complied with the requirement on computing deferred taxes did not disclose all information required by IAS-12 paragraph 81. A number of companies, in violation of the requirements of IAS-12 paragraph 20, did not compute deferred tax on revaluation surpluses arising from valuations of industrial buildings, property, plant, and equipment, claiming that these are “permanent differences that will not reverse.”

Post-employment benefits. A number of large companies complied with the IAS requirements on accounting and disclosure for a “defined contribution pension scheme”; however, noncompliance was evident in the statements of most of the companies that have a “defined benefit plan” for employees. For a few companies, the accounting policy section showed that “the pension accounting costs are assessed using the projected unit credit method”; however, only one provided an explanatory note in compliance with the IAS requirements.

Revaluing fixed assets. In many companies, the lack of a proper procedure for revaluing fixed assets distorted reported accounting numbers. Even during the years when the general market price of property, plant, and equipment experienced significant decreases, most of the financial statements showed revalued amounts that were significantly higher than the previously revalued amounts. Thus the provisions of IAS-16 concerning determination of fair value for revaluation purposes were not applied correctly. In addition, a number of companies that reported revaluing assets did not show clearly which classes of assets had been revalued, and many did not disclose one or more of the disclosure items required by IAS-16.

Impaired assets. A few of the large companies disclosed that the carrying amounts of property, plant, and equipment are reviewed at each balance sheet date to determine whether these exceed the recoverable amounts, in which case an impairment loss is recognized. However, this disclosure was not found in most of the financial statements reviewed. Discussions with a cross-section of professional accountants in the country revealed that companies generally do not properly follow the requirements on recognition and measurement of an impairment loss or the related disclosure provisions of IAS-36.

Assets pledged as security. The financial statements of most of the companies contained no disclosure on the existence and amounts of restrictions on title or on property, plant, and equipment pledged as security for liabilities (IAS-16 paragraph 61a). Since medium- and long-term borrowing from banks is a common source of business finance in Kenya, it seems reasonable to assume that many companies have pledged assets as security for liabilities, and they should be complying with the disclosure requirement.

Lessees’ disclosure. Lessee companies that disclosed the existence of a finance lease did not comply with some or all of the disclosure requirements of IAS-17 paragraph 23, and

those that disclosed the existence of an operating lease did not comply with some or all of the disclosure requirements under IAS-17 paragraph 27.

Financial risk management. IAS-32 paragraph 30 requires that enterprises describe their financial risk management objectives and policies. Some of the large banks provided detailed numerical data on liquidity risk, and in these cases the tendency was to try to comply with the Central Bank's disclosure requirement in form rather than in substance. In general, neither corporations nor banks complied fully with the disclosure requirements of IAS-32.

Investment in securities. IAS-39 requires that financial statements should classify investment securities in three groups: held for trading, held to maturity, and available for sale. Most companies did not comply with these provisions; they grouped investment securities together and included them in the asset section of the balance sheet at historical cost. In some cases, the quoted and unquoted investments were shown separately at historical cost either on the face of the balance sheet or in the notes to the financial statements, and the total market price of quoted securities was shown in parentheses in the notes.

Loan-loss provisioning. Inadequate loan-loss provisioning often distorted the reported profits of financially troubled banks, making it difficult to identify potential financial problems. There are fears that banks may be exposed to risk due to inadequate provisioning of non-performing loans. Most of the banks' financial statements did not disclose information on the aggregate amount included in the balance sheet for loans and advances on which interest was not being accrued, and the basis used to determine the carrying amount of such loans and advances, as required by IAS-30.

Concentrations of assets and liabilities. IAS-30 paragraph 40 requires that banks should disclose any significant concentrations of assets, liabilities, and off-balance sheet items—in terms of geographical areas, customer or industry groups, or other concentrations of risk—and the amounts of significant net foreign currency exposures. Few banks complied with these provisions.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

27. The adoption of the ISAs was an important step in upgrading Kenya's auditing practices, but the lack of guidance on their application has resulted in implementation problems. This review used a two-pronged approach in examining auditing practices in the country: first, interviews with representatives of audit firms, institutional investors, academic institutions, and regulators; and second, two days of facilitated discussions with 15 practicing auditors with long experience in auditing large and medium-size companies in the country. The review found that the degree of compliance with the ISAs varies. Although in general large firms have greater capability to provide quality auditing services, compliance is not universal even in those firms. Details of the findings of the review follow.

Professional ethics. A Code of Ethics for Professional Accountants, based on the code issued by IFAC, has been in force in Kenya for several years. However, there is no effective mechanism to ensure that the ethical standards provided in the Code are observed in practice. Some senior professionals and academics expressed concerns about deteriorating professional ethics in the delivery of auditing services. Most of the institutional investors interviewed highlighted the need for taking appropriate steps to improve auditors' integrity and independence.

Professional skepticism. ISA-200 requires that the auditor should plan and perform the audit with an attitude of professional skepticism, recognizing that a variety of circumstances may cause the financial statements to be materially misstated. Senior audit partners of firms of all sizes noted the difficulty in developing a culture of professional skepticism. Some observers are of the opinion that many auditors do not fully appreciate the need to verify the reliability of information provided by the enterprise's management.

Quality control. Inadequate quality control arrangements affect the quality of audit work. Except in the large firms, practitioners generally lack adequate resources to implement proper quality control, and even large firms with established quality control arrangements may not be in full compliance with the ISAs in this regard. Many audit firms fail to adhere to the standard on client acceptance and retention.

Risk assessment and internal controls. While some audit firms have established procedures for compliance with ISA-400 on risk assessments and internal control, the general business environment in the country restricts proper implementation of the standard. Most clients have weak internal control systems, and are unwilling to pay adequate fees for the application of rigorous and time-consuming audit procedures. Thus auditors are often unable to consider the assessed level of inherent and control risks in carrying out substantive procedures required to reduce audit risk to an acceptable level. In addition, many auditors lack adequate knowledge of information technology to assess the risks of highly computerized clients.

Audit evidence. ISA-500 and ISA-501 require the auditor to obtain sufficient appropriate audit evidence. For example, when inventory is material to the financial statements, the auditor is required to attend a physical inventory counting unless impracticable. Examples were noted of auditors accepting inventory figures provided by management even when it is possible to observe physical inventory counting. For initial engagements, auditors often do not carry out necessary procedures for obtaining audit evidence on the opening balances as required by ISA-510. Moreover, auditors often rely heavily on management representations regarding valuation of assets and liabilities, and segment information, not taking effective measures to seek corroborative evidence from sources inside or outside the audited entity, as required by ISA-580 on management representations.

Related parties. Under the prevailing business environment in the country, auditors often have difficulty fully complying with the requirements of ISA-550 on related parties and report resistance by enterprise management to the application of rigorous procedures for identifying related-party relationships and transactions. There are concerns about the

commitment of the business community to transparency in related-party transactions, resulting in auditors often being unable to obtain sufficient evidence to determine whether such transactions are treated appropriately in financial reports.

V. PERCEPTION ON THE QUALITY OF FINANCIAL REPORTING

28. Financial accounting practices are perceived to have improved significantly since ICPAK's decision to implement international standards in accounting and auditing.

Discussions with some institutional investors, regulators, company directors, and academics in Kenya reveal that the financial reporting regime has experienced significant changes over the past 12 months. Bank failures and reports about manipulation of asset valuation in the financial statements of some large enterprises in the late 1990s provide examples of the unsatisfactory quality of financial reporting. ICPAK's decision to introduce IASs and ISAs and the ensuing (largely voluntary) efforts have brought about improvements that represent a significant step forward. However, the investment community perceives that considerable further improvements are required.

VI. POLICY RECOMMENDATIONS

29. This section presents a brief outline of the actions needed to improve Kenya's accounting and auditing system. For preparing these policy recommendations, inputs were received from the representatives of ICPAK, KASNEB, Treasury, CMA, NSE, large and medium-sized accounting firms, and educational institutions. A detailed program of activities in each area would be developed by the team(s) responsible for implementation of an Action Plan to be developed by the country authorities on the basis of these policy recommendations. Successful implementation of the Action Plan will require commitment and resources on the part of government authorities, statutory agencies and institutions, institutions involved in preparing and certifying professional accountants, accounting professionals, corporate entities, and Kenya's international development partners.

29.1 Revise the Accountants Act, the Companies Act, and related regulations to achieve a legal and regulatory framework under which the preparers of financial statements (corporate entities), auditors, and regulators will be required to play appropriate roles in ensuring high-quality financial reporting. Take appropriate legal and institutional steps to differentiate between the financial reporting requirements for listed companies and financial institutions and those for small and medium enterprises (SMEs). Make IASs legally mandatory for large enterprises and financial institutions, and establish simplified reporting requirements for SMEs.

29.2 Strengthen the institutional framework of the profession by upgrading and rationalizing current arrangements under KASNEB (a parastatal responsible for organizing professional examinations), RAB (a body under the Ministry of Finance responsible for issuing CPA licenses), and ICPAK (the professional body of the CPAs).

- 29.3 Strengthen ICPAK to enable it to function as an effective and efficient self-regulatory professional body with particular emphasis on developing and disseminating appropriate implementation guidelines and practice manuals for proper application of IASs and ISAs; carrying out research and related activities; improving and enforcing the CPE requirements; monitoring compliance with IASs, ISAs, and the Code of Professional Ethics; implementing an effective peer review process and establishing quality control and quality assurance arrangements; and taking effective disciplinary actions where appropriate.
- 29.4 Review and upgrade the accounting curriculum to incorporate international standards and include practical-oriented teaching at undergraduate level in educational institutions. To increase teaching capacity, organize training of trainers programs for creating a critical mass of trainers with adequate knowledge on the practical application of international standards in accounting and auditing. Make arrangements to provide easy and affordable access to educational materials covering the international accounting and auditing standards.
- 29.5 Address CPA licensing issues. Raise the entry requirement and take other appropriate steps to ensure that CPA candidates acquire adequate academic knowledge before taking the licensure examinations. Improve the quality of the examination system, including question setting and paper grading. Increase the practical experience requirement for obtaining a CPA license to not less than three years, and establish a mechanism for monitoring the relevance and effectiveness of practical training.
- 29.6 Make necessary arrangements for delivering effective and high quality training programs to enable all practicing auditors to gain exposure to the practical aspects of implementing IASs and ISAs. Improve the delivery of the training programs for audit practitioners already on the ICPAK calendar.
- 29.7 Strengthen enforcement mechanisms. Organize programs to educate the corporate community, and practicing auditors and staff of relevant self-regulatory organizations and statutory regulatory agencies, about the obligations of the preparers of financial statements to comply with accounting and auditing standards. Take measures to improve the knowledge of supervisory and monitoring staff at the Capital Markets Authority and the Central Bank of Kenya on all aspects of accounting and disclosure requirements under IASs. Establish a strict monitoring regime in each of these organizations to identify possible noncompliance with accounting and reporting requirements, and to implement an effective system of penalties for noncompliant enterprises and auditing firms, where appropriate.