

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

ACCOUNTING AND AUDITING

April 20, 2010

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EXECUTIVE SUMMARY

Since the last ROSC Accounting and Auditing review in 2001, Kenya has made progress in strengthening its institutional framework for accounting, auditing, and corporate financial reporting. The major challenges are to further consolidate its achievements and continue to update and improve institutional arrangements in order to strengthen the corporate financial reporting regime and in turn improve the investment climate and business environment.

This ROSC provides an assessment of accounting and auditing practices in Kenya, positioned within the broader context of the country's institutional framework and capacity needed to ensure the quality of corporate financial reporting and auditing. Kenya's accounting and auditing standards were developed in line with international standards; however, without a strong monitoring and enforcement mechanism the country cannot ensure adequate compliance with applicable standards in line with international good practice. Building on past achievements, more effort should target strengthening the capacity of the regulators and ensuring compliance with applicable standards and codes. Despite the improvements in the corporate financial reporting over the years, compliance gaps are still evident. This is highly precarious for savings and credit cooperatives (SACCO) that constitute a significant portion of Kenya's financial sector.

In order to minimize compliance gaps in corporate financial reporting and auditing, it is necessary to augment required skills and competency of professional accountants and auditors, and effective and efficient regulation of the accounting profession. More important, corporate executive officers and financial officers need to do more to support transparency, accountability, and full compliance with the applicable financial reporting requirements. The ROSC, in view of looking at the systemic issues, outlines interrelated principle-based policy recommendations. Developed with the input of many stakeholders working toward Kenya's development, the recommendations provide a tool for country authorities in enhancing accounting and auditing practices in Kenya. The recommendations include further rationalizing statutory framework, explicitly providing legal backing for applicable accounting and auditing standards, and creating an independent regulatory structure for auditing and financial reporting practices of public interest entities, including SACCOs. Enhancing capacity of regulators, corporate accountants, auditors, and professional bodies should ensure adequate skills are in place to carry out responsibilities. Upgrading accountancy education and training should focus on practical application of international accounting and auditing standards, and improved communication skills and professional judgment. Attention should be given to review the current practice of conducting professional accountancy examination and integrate it as a core function of the professional accountancy body of Kenya. Continuing professional development should ensure regular upgrading of professional knowledge. These recommendations are expected to provide the framework for a country action plan and pave the way to achieving further improvements in Kenya's accounting, auditing, and corporate financial reporting practices.

PREFACE

There is a broad agreement among the international financial community that the observance of international standards and codes are pivotal in strengthening national and international financial architecture. The Reports on Observance of Standards and Codes, Accounting & Auditing Review (ROSC A&A) is one of 12 modules jointly developed by the World Bank and IMF soon after the Asian financial crisis in 1997. These modules were developed in order to assess a country's strengths and weaknesses of actual practices regarding the various components of financial architecture.¹

The ROSC A&A focuses on the institutional framework regulating the accounting and auditing practices, and the comparability of national accounting and auditing practices with international standards and best practice, using International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks. It evaluates the effectiveness of enforcement mechanisms for ensuring compliance with applicable standards and codes. The final draft report is submitted to the country authorities for comment, approval, and permission to publish. Once agreed, the report is published on the World Bank's website. An overview of the ROSC A&A Program, including rationale and detailed methodology are available at http://www.worldbank.org/ifa/rosc_aa.html.

As a follow-up of the 2001 Kenya ROSC A&A, this ROSC focuses on the systemic issues pertaining to overall institutional framework, underpinning the accounting and auditing practices in Kenya. Upon reviewing the actual accounting and auditing practices, the report presents policy recommendations for further improving corporate financial reporting regime in Kenya

This ROSC was carried out in Kenya from October 2009 to January 2010 through a participatory process involving in-country stakeholders from the Government, regulatory bodies, accounting and auditing firms, banks, insurance companies, state-owned enterprises, and academia. It was conducted by a World Bank team comprising Henry Amuguni (Financial Management Specialist and Task Team Leader); M. Zubaidur Rahman (Program Manager, OPCFM, and Study Adviser); Patrick Piker Umah Tete (Senior Financial Management Specialist and CLFM), Aleksander Kocevski (Junior Professional Associate AFTFM), Humayun Murshed (international consultant); and Evans Gikunju (local consultant).

¹ The 12 ROSC areas are data transparency, fiscal transparency, monetary and financial policy transparency, banking supervision, securities, insurance, payments systems, anti-money laundering, corporate governance, accounting, auditing, and insolvency and creditor rights.

ABBREVIATIONS AND ACRONYMS

A&A	Accounting and Auditing
CBK	Central Bank of Kenya
CPA	Certified public accountant
CMA	Capital Market Authority
CPD	Continuing professional development
GDP	Gross domestic product
IAASB	International Auditing and Assurance Standards Board
IAESB	International Accounting Education Standards Board
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
ICPAK	Institute of Certified Public Accountants of Kenya
IES	International Education Standard
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
IRA	Insurance Regulatory Authority
ISA	International Standard on Auditing
IPSAS	International Public Sector Accounting Standards
KASNEB	Kenya Accountants and Secretaries National Examinations Board
KENAO	Kenya National Audit Office
ROSC	Reports on the Observance of Standards and Codes
SACCO	Savings and credit cooperative
SME	Small and medium-size enterprise
SMP	Small and medium-size practices

I. BACKGROUND

1. This assessment of accounting and auditing practices in Kenya is part of a joint initiative of the World Bank and the IMF to prepare Reports on the Observance of Standards and Codes (ROSC). The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and involves a review of both mandatory requirements and actual practice. It uses International Financial Reporting Standards (IFRS)² and International Standards on Auditing (ISA)³ as benchmarks and draws on international experience and good practice in the field of accounting and audit regulation.

2. **There is a widespread recognition that global financial stability largely depends on robust national systems and requires enhanced measures at the country level.** In a world of integrated capital markets, financial crises in individual countries can dislodge international financial stability. This provides a basic “public goods” rationale for minimum standards that benefit both international and individual national systems. At the international level, standards enhance transparency. They identify weaknesses that may contribute to economic and financial vulnerability. They also foster market efficiency and discipline. At the national level, standards provide benchmarks for identifying systemic vulnerabilities and guide in designing an agenda for policy reform. To best serve these two objectives, the scope and application of such standards need to be assessed in the context of a country’s overall development strategy and tailored to individual country circumstances.

3. **The recent global financial crisis further confirms the immense need to follow international standards.** In an effort to deal with the global financial turmoil, the G-20 Summit, held April 2009 in London, emphasized the adoption of “international agreed high standards that a global financial system requires.” The Summit further pronounced that “regulators and supervisors must protect consumers and investors, support market discipline, avoid adverse impacts on other countries, reduce the scope of regulatory arbitrage, support competition and dynamism, and keep pace with innovation in the marketplace.” Furthermore, it encouraged actions by emerging and developing economies for strengthened transparency, accountability, and enhanced disclosures to reduce the risk of market failure. Monitoring liquidity positions and risk concentrations, especially in banks and financial institutions, calls for a strong accounting and auditing environment. If the preparers, auditors, and regulators ensure proper compliance with high-quality accounting and auditing standards, policymakers and market participants would be able to recognize reliable micro-level financial indicators that could, along with macroeconomic indicators, provide early warning signs. This ROSC is geared toward strengthening the monitoring and enforcement system in order to improve the accounting, auditing, and corporate reporting practices in Kenya, which will minimize the consequences arising from any untended financial vulnerabilities.

² IFRS are issued by the International Accounting Standards Board (IASB), an independent accounting standard-setter based in London, UK. The IASB announced that it would adopt all of the previously issued International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC). For simplicity’s sake, the term IFRS will mean both IFRS and IAS in this report.

³ ISA are issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

4. **The ROSC A&A adopts a participatory approach with a strong involvement of policymakers and other country stakeholders.** The stakeholders include regulators of corporate entities, banks and similar financial institutions; professional accountants and auditors; bankers and investment analysts; preparers of financial statements; and academics. The assessment uses a diagnostic tool, which captures a comprehensive review of institutional framework underpinning accounting and auditing practices in Kenya. The information gathered through this diagnostic tool is supplemented by the due diligence exercise in capturing primary experiences of stakeholders and other facts on corporate financial reporting practices in Kenya.

5. **The relatively stronger financial markets significantly generate development of Kenyan economy, but vulnerabilities remain.** Kenya's financial sector is the third largest in Sub-Saharan Africa. In recent time, the Kenyan economy has shown signs of strong growth. The country demonstrated a growth rate of 3.9 percent during the first quarter of 2009. There have been major legal, regulatory, and institutional developments in the financial sector. Despite the modernization of financial system infrastructure, there are still structural vulnerabilities arising primarily from poor lending practices. In recent years, access to finance has improved, but generally the savings and credit cooperative (SACCO) sector is poorly managed and several SACCOs are near insolvency.

6. **A major risk to stability is the loss of investors' confidence due to recent fraudulent practices in the brokerage industry.** Kenya's capital markets, the largest in East Africa, are dominated by equities and government bonds. As of August 2009, 55 companies were listed in the Nairobi Stock Exchange, and the market capitalization represented 37 percent of GDP. Market abuses, which led to collapse of three brokerage houses, included unauthorized trading of client securities, front running, and theft of client's cash and securities. Lack of sound governance and weaker enforcement action may have largely contributed to such abuse. While efforts are being taken by the Capital Market Authority (CMA) to improve investors' confidence, a stronger and more comprehensive approach of going forward will be crucial to improve governance and accountability and thereby shifting market perceptions in the longer term.

7. **One of Kenya's key development challenges is to attract more foreign direct investments in order to sustain economic growth.** In this regard, the Government emphasizes further private investment. In order for Kenya to continue to grow and further make the private sector vibrant, its financial system must be reasonably robust to earn investors' confidence. Among other necessary attributes in this respect, a mechanism that ensures a high-quality financial reporting system is critical.

8. **As Kenya moves toward further liberalization to enhance its business environment, improved financial transparency, and high quality accounting and auditing practices are necessary.** Kenya will benefit from further aligning its corporate sector practices with those of its main trading partners, and thereby enhancing the country's attractiveness in competing for foreign direct investment. In this context, this ROSC sets out policy recommendations in the final chapter to enhance the quality of corporate financial reporting and foster a financial reporting platform conducive to sustainable private and financial sector growth, and to increase access to global financial markets.

II. INSTITUTIONAL FRAMEWORK

9. Kenya has made significant strides in putting in place the institutional framework for improving corporate accounting, auditing, and financial reporting practices since the first time ROSC Accounting and Auditing review exercise conducted in 2001. The framework, salient features of which are discussed below, appears to be of higher quality than that of in 2001. However, there is room for improvement. Moreover, in order to face future challenges, updating of the institutional underpinnings of accounting and auditing, in line with international developments of good practices, would allow Kenya to emerge as a role model of accountancy reform and development both regionally and internationally.

A. Statutory Framework

10. **Since the 2001 ROSC A&A, efforts have been made to improve the regulatory framework underpinning corporate accounting and auditing practices.** In recent years, Kenya's legislative and regulatory regime, applicable to accounting and auditing of corporate entities, banks, and similar financial institutions, has changed significantly. In 2008, a new Accountants Act was promulgated. The Government is in the process of issuing a new Companies Act. Furthermore, many regulatory pronouncements were made with the objective of putting in place a sound institutional framework for regulating accounting, auditing, and corporate financial reporting.

11. **The Companies Act, based on the UK Companies Act of 1948, provides fundamental legal framework for accounting, auditing, and corporate reporting in Kenya.** Under the Companies Act, all limited liability companies are required to prepare and present legal entity financial statements. However, it does not provide any guidance or make reference as to which standard to be followed in preparing financial statements of the corporate entities. It defines the corporate reporting requirements and provides for the preparation of financial statements, their disclosure and publication, as well as audit and inspection.

12. **The requirements of Companies Act fall short of international good practice.** The Act requires the companies to prepare income statement and balance sheet and prescribes what should be included in these statements. The Act does not require the Kenyan companies to prepare the cash flow statement and statement of changes in equity. This is clearly in conflict with IFRS.

13. **The Company Act outlines management's obligation for the probity of legal entity financial statements.** Company management is responsible for ensuring timely preparation of annual financial statements reflecting true and fair view of the enterprise. Management is also responsible for submitting legal entity's audited financial statements for approval to the general shareholders' meeting within four months from the end of the financial year. The right of the shareholders to approve the legal entity financial statements is important as it allows the company owners to check on the performance of management and its stewardship of the entity's resources. Noncompliance with responsibilities for preparing financial statements and making them available to the shareholders may lead to sanctions, including a fine.

14. **Except SACCOs, the financial institutions and listed companies in Kenya are required to follow the IFRS and ISA.** The respective regulators of these entities require the preparation of financial statements in accordance with IFRS and their audit to be conducted as per ISA. The SACCOs constitute a critical part of Kenya's financial system. There are 3,200 SACCOs located throughout the country, with the majority located in Nairobi. However, the activities of this significant financial group as a whole, including accounting and auditing, are not subject to specific supervision. This reduces the regulator's ability to identify weaknesses and risks of instability within this group, tending to create serious financial vulnerabilities. Thus, there is an increasing threat to members' savings from the lack of appropriate oversight and regulation of this sector. As the asset base of the SACCO sector is growing, there is a greater likelihood that if one of the larger SACCOs collapses, it could cause a domino effect in the sector.

15. **With the exception of banks, insurance companies, and listed companies, there is no statutory requirement for corporate entities to make their financial statements publicly available.** The audited financial statements of the listed companies, banks, and similar financial institutions must be published in a printed annual report, and in designated newspapers by respective regulators. Noncompliance with this requirement could lead to sanctions. However, there is no requirement set by law in Kenya to require publication of financial statements by non-listed entities. Many very large entities may have significant public interest. Public availability of financial statements is essential for a healthy corporate sector, adding benefits in terms of transparency and credibility, market discipline, and making informed and rational investment decisions.

16. **The Capital Market Regulations 2002 requires listed companies to submit their interim financial statements to the CMA.** The regulations require the listed companies to prepare both interim (quarterly and half yearly) and annual financial statements and submit them to the CMA. The quarterly report must be submitted within one month after the end of the third month of the financial year, while the half-yearly report is to be submitted within two months after the end of the first-half of the financial year. The annual financial statements must be submitted within four months from the end of the financial year. It is mandatory that the annual financial statements be audited, while interim financial statements do not have such legal binding.

17. **The Accountants Act regulates the accountancy profession.** The Act defines the notions of audit and audit firm, specifies the requirements to become an auditor, outlines the rights and obligations of auditors, and establishes the Institute of Certified Public Accountants of Kenya (ICPAK). The fundamental objective of ICPAK is to act as a body for determining and maintaining adequate professional standards for its members. The major statutory functions of the ICPAK include designing and implementing policies regarding admission of membership, administering programs for members' professional development, ensuring adherence to professional ethics and standards, and taking disciplinary action against erring members.

18. **The Accountants Act established a separate body for the accountancy professional examination.** Kenya Accountants and Secretaries National Examinations Board (KASNEB) was established as a statutory body for administering 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 accountant (CPA). The Registration Committee, an independent arm of ICPAK, is empowered to register those who have attained the specified qualifications after passing the relevant examination administered by KASNEB.

19. **While formal power is vested on shareholders to designate external auditors, no legal pronouncement sets forth any termination procedure.** The general shareholders appoint the statutory auditor for a period of one financial year, renewable each year. However, the Central Bank of Kenya (CBK) requires the engagement partner of a listed company auditor to be changed at least once in every five years. In practice, the decision to terminate auditors is mostly exercised by the board of directors. The statutory regulators, including CMA and CBK, require notification together with justifications of any decision to terminate. Nevertheless, the role of regulators cannot be considered as substitute for proper governance mechanism that can ensure the independence of external auditors for the benefit of stakeholders. Indeed, the law should clearly outline the grounds for termination of statutory auditors for ensuring public interest and strengthening the case of auditors' independence to augment the credibility of corporate financial information.

20. **The Central Bank of Kenya and Capital Market Authority provide for establishment of oversight within the company to explicitly monitor the independent audit process on behalf of shareholders.** Good corporate governance practice requires that audit committees oversee the appointment of auditors and their discharge of professional responsibilities, including establishing adequate financial control within the entity. The statutory regulators, CBK and CMA, require corporate entities and banks to establish board of supervisors and audit committees in order to oversee whether the members of the board of directors and statutory auditors discharge their mandated responsibilities.

21. **The Central Bank of Kenya regulates the financial reporting of banks and similar financial institutions in Kenya.** The accounting and auditing requirements set by the CBK are additional to those stipulated by the Companies Act. It requires banking institutions to prepare their financial statements within four months after the financial year-end. It also prescribes disclosure requirements, primarily for prudential reporting, that each bank must follow. The CBK-approved auditors must audit banks' financial statements. Banks are obliged to submit monthly, quarterly, and audited annual financial statements to the CBK. The CBK has set up its own standard review procedures in order to determine whether the financial reporting of banks is adequate. The CBK carries out both on-site and off-site supervision; however, due to the capacity constraints, it cannot adequately ensure monitoring and compliance with the applicable standards and rules.

22. **The Insurance Regulatory Authority (IRA) regulates the corporate financial reporting of insurance companies.** The Insurance Act requires that the annual financial statements of insurance companies must be audited, and insurance companies are required to submit audited financial statements to the IRA together with other reports as prescribed monthly, quarterly, and annually for prudential purposes. In order to resolve the reporting differences arising from the variance between IFRS and IRA requirements, the insurance companies are required to reconcile the financial figures that need to be verified by the statutory auditors. The

IRA requires that the insurance companies' financial statements must be verified by external auditors with regard to material issues such as reinsurance activities, capital provisioning, liquidity, commissions, revenues, costs, profits, and profit distribution.

23. The stock exchange listing rules require all listed companies to present interim financial statements. The listing rules require all listed companies to publish unaudited quarterly financial results, according to a prescribed format. These quarterly financial statements do not require auditing, although the annual financial statements are to be audited by the statutory auditors.

24. Article 110 of the Kenyan Constitution empowers the Kenya National Audit Office (KENAO) to undertake audits of state-owned enterprises. The KENAO audit work primarily focuses on compliance with financial management rules set by the Government. Its audit of state-owned enterprises focuses on evaluation of fiscal plans implemented, reviews of income and expenses, and assurance of compliance with state's financial and economic guidelines. The KENAO has the authority to appoint statutory auditors to undertake the audit works on behalf of the Controller and Auditor General and, in such cases, the audit opinion is signed by the Controller and Auditor General.

B. The Profession

25. The accounting and audit profession is self-regulated by the Institute of Certified Public Accountants of Kenya. Among the major functions of ICPAK include the following:

- Promote standards of professional competence and practice amongst members
- Promote research and publications in the field of accountancy
- Promote international recognition of the ICPAK
- Advise the Minister of Finance for enhancing financial accountability in all sectors of the economy

Professional accountants and Government-nominated persons are represented on the governance structure of ICPAK. Nevertheless, the participation of independent and knowledgeable people from accounting, law, business and financial community, and academia in the ICPAK governance process should also be encouraged.

26. Many people who completed the final level of the CPA examination are not ICPAK members. As of November 2009, 18,000 people had passed the KASNEB-administered final-level CPA examination. Out of this total, 6,000 have become ICPAK members. The low number of KASNEB-qualified accountants obtaining ICPAK membership calls for actions to bridge the gap between KASNEB and ICPAK, considering the important role of the professional accountancy organization. The distribution of ICPAK membership in the economy is as follows: public practice, 20 percent; commerce and industry, 65 percent; and other, including public sector and academia, 10 percent. It is worth noting that the total number of ICPAK members includes members of foreign professional accountancy bodies. The member of a foreign professional accountancy body needs to register with the registration committee and maintain ICPAK membership in order to practice as an auditor in Kenya.

27. **The small and medium-sized practices (SMPs) face challenges in the audit market.** The members of international accounting firm networks dominate the audit market. There are 718 audit firms operating in Kenya, including the members of the large international accounting firm networks. The local members of international firm networks audit most of the publicly traded companies, banks, insurance, and other large corporate entities. More than 95 percent local firms are small in size, mainly with one partner, and they mostly concentrate on tax cases along with performing bookkeeping services and conducting audits for small companies.

28. **Certain factors appear to adversely affect auditors' accountability.** Kenya's relevant laws do not provide for sufficient penalties against negligent auditors. There is no statutory condition that requires practicing auditors to take professional liability insurance. This tends to limit auditor's accountability and in many cases has created an environment of unconcern toward risks of malpractice suits by auditors.

29. **There are cases when management gets some help from auditors for preparing financial statements.** Some stakeholders have cited instances when company management has either partly or fully relied on auditors for preparation of financial statements. This may be due to corporate management's misperception about the role of auditors. In order to be compliant with the independence rules, auditors should not audit the financial statements that they prepare.

30. **Although ICPAK has made progress with respect to the development of the accountancy profession Kenya, it needs to enhance its capacity to further support accountants and auditors in their activities.** The ICPAK needs to reinforce its technical capabilities and review its governance structure as its governance primarily rests on volunteer members. The ICPAK secretariat needs to be further strengthened in order to provide enhanced professional development services to its members. Specifically, ICPAK needs to focus more on professional capacity developments of the small and medium-size practices.

31. **More emphasis is needed on implementing the code of ethics for professional accountants.** The ICPAK has a code of professional conduct that is in line with the Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants (IESBA). The professional accountancy organization should further assist practitioners with the implementation of the ethical requirements and ensure that its members comply with the requirements of the code. Specifically, there is a need to develop and disseminate detailed and case-study based guidance on application of the code of ethics under Kenyan circumstances.

32. **Professionals working in small accountancy firms encounter difficulties in following recent developments in accounting and auditing.** These practitioners struggle to keep their client base. Many practitioners in small and medium firms in Kenya are also handicapped by their lack of access to current literature on applicable accounting and auditing standards. Such a situation diminishes the quality of auditing in the country.

33. **The ICPAK meets most of the IFAC Statements of Membership Obligations (SMO) but there is room for further improvement.** The ICPAK needs to continue making efforts to

strengthen its current arrangement of quality review for ensuring the compliance with International Standards on Quality Control (ISQC)-1 for the practicing members. With regard to SMO 2, *International Education Standards for Professional Accountants and Other IAESB Guidance*, the professional curriculum should also better focus on the practical application of accounting and auditing standards, as practical training is not a prerequisite of awarding CPA Certificate. Currently KASNEB and ICPAK are working towards addressing this issue, and have launched a pilot program on the practical experience framework which will entail CPA graduates without the required experience registering as Associate members of ICPAK until they acquire the experience upon which they will become full members. In addition, KASNEB in conjunction with ICPAK undertook a comprehensive review of the CPA syllabus with a view to ensuring compliance with the International Education Standards for Professional Accountants. The new syllabus was implemented with effect from July 2009. The ROSC team has observed that ICPAK is complying with other SMOs; however, further improving ICPAK capacity will create a better compliance environment.

C. Professional Education and Training

34. **Professional accounting and auditing education in Kenya requires further improvement to ensure that future auditors acquire adequate professional capabilities and competence.** The entry requirements to the program to become an ICPAK-licensed auditor generally comply with the requirements of International Education Standard (IES)⁴ issued by the International Accounting Education Standards Board (IAESB) under the auspices of IFAC. The ICPAK requires that candidates complete a degree in accountancy, economics, finance, or law from a recognized university. However, the ROSC team observed an uneven quality of university education in Kenya. The scope of the current ICPAK certification program can be further improved to provide future auditors with sufficient knowledge to undertake an audit.

35. **The ICPAK-required practical experience should be enhanced to incorporate IES 5, *Practical Experience Requirements*.** Candidates are required to have a minimum of three years' experience in their area of expertise, but there is no written guidance for employers, mentors, and trainees regarding the program of practical experience, clarifying their roles and responsibilities, nor a mechanism for approving employers as suitable for providing the appropriate experience for trainees.

36. **Accountancy education lacks sufficient exposure of practical application of standards.** In discussion with the ROSC team, many stakeholders expressed concern that new accountancy professionals lack exposure of the practical application of accounting standards, adequate level of communication skills, and aptitude in forming judgment in applying accounting policies for measurement and disclosure of financial information. The stakeholders believe that university graduates do not have adequate levels of practical knowledge and could be better prepared to deal with the challenges of discharging their professional responsibilities. In most cases, the employers have to spend substantial amount of time and resources to train newly hired accountants to begin their assigned jobs.

⁴ International Education Standard 1: *Entry Requirements to a Program of Professional Accounting Education*

37. The accounting and auditing curricula in Kenya would need to be further harmonized among universities and do not incorporate all international education standards. Kenyan universities have not established common minimum requirements for type and content of courses on accounting and auditing. The accounting curricula are mostly restricted to accounting technicalities and basic procedural aspects of auditing. Many Kenya universities, especially the public universities, which have the highest accounting students enrollment, are faced with financial and manpower capacity problems. Hence they may not be up to date with the demands of the accountancy profession. The curricula of most public and private universities require the under-graduates to undergo practical training or on-the-job internship before graduation. However, there are limited high quality internship vacancies available in both the public and private sectors. In addition, there is no government policy to facilitate internship for accounting and auditing students in the public sector. Furthermore, the universities lack necessary resources to monitor the skills acquired by the students who have an opportunity to take part in internship programs. Most accounting textbooks lack adequate focus on current international accounting and auditing practice, in particular the practical application of accounting and auditing standards. Some universities' curricula integrated IFRS and ISA through the launch of a CPA program. However, the capabilities of teaching practical implications of these standards would need to be enhanced. The members of international networks of accounting firms tend to recruit graduates from the 4 or 5 leading universities in Kenya whose reputations are good among authorities, the business community, and the public. These universities have developed accounting courses that give relatively adequate focus on financial reporting objectives, principles, and practices, with some international perspective, and do not limit themselves only to the teaching of bookkeeping. Nonetheless, since the small and medium accounting practices do not typically recruit from these leading universities, this is an impediment to their access to adequately skilled recruits and to their capacity to provide quality services to small and medium enterprises. Finally, the various universities visited by the ROSC team have little involvement with the international professional accounting organizations; for example, none of them subscribe to the updated IASB publications, and none have made attempts to implement IFAC recommendations regarding accounting and auditing education.

38. Within the structure of CPA examination in Kenya, there is no distinction between the accounting qualification and auditing qualification. The CPA examination should incorporate the requirements of IES 8, *Competence Requirements for Audit Professionals*. The IES 8 treats the auditor qualification as a follow-up to the qualification of a professional accountant and specifically states that audit professionals need an "advanced level" of knowledge in auditing financial statements. Its additional requirements on education and experience are not yet covered in Kenya. The KASNEB and ICPAK therefore need to look at the required upgrading to advance the curricula and examination process. In many developed economies, the auditors must pass an additional examination for obtaining the practice certificate.

39. Continuing professional development (CPD) for practicing accountants is mandatory, but there is a need for uniform guidance in organization and delivery. Practicing CPAs are required to participate in a CPD program for a total of 90 hours within 3 years. It is not mandatory for non-practicing CPAs to undertake continuing development. Also, the current CPD arrangement may need to be reviewed to ensure that CPD courses develop or maintain sufficient

knowledge and professional skills with regard to modern accounting and focus on practical implementation aspects of applicable accounting and auditing standards.

D. Setting Accounting and Auditing Standards

40. **The ICPAK prescribes IFRS, although there is no clear legal mandate with regard to application of these standards.** The ICPAK Council decided in 1998 upon wholesale adoption of IFRS, which thereby became Kenyan standards. Apart from legislative requirement of applying IFRS by the CMA, CBK, and other financial market regulators to their respective controlled entities, the Accountant Act, which established the ICPAK, does not specify which entities must comply with IFRS or standards prescribed by ICPAK. The IFRS 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 IFRS-compliant income statements for determining profit, which is adjusted to calculate taxable profit. The accounting standard-setting process for general purpose financial reporting in Kenya is one that is clearly defined and actively monitored by the ICPAK and involves all concerned parties.

41. **The ICPAK-issued implementation guidance on applicable standards needs to be more explanatory.** Despite the good practice, these guidance notes need to provide more detailed implementation guidance on IFRS and ISA that should inform and illustrate each standard's application with comprehensive examples and contextual situations for optimum understanding. Detailed implementation guidance reduces the knowledge gap among preparers and auditors of financial statements. Consequently, it raises a possibility of applying the standards consistently and minimizing the compliance gaps between IFRS and ISA requirements and actual practices.

42. **The financial sector regulators issue prudential regulations that have impact on preparation of general purpose financial statements.** In terms of practical application, the CBK and IRA issue prudential requirements that would sometimes prevail over IFRS if contradictions arise in preparation of financial statements. Accounting differences do arise between the banking and insurance sectors, such as in loan-loss provisioning of banks and calculation of technical reserves in the insurance sector. Such differences could lead to inconsistencies in application of accounting regulations across banks and insurance companies, limiting transparency and comparability. Furthermore, it remains unclear which accounting profit, based on either IFRS or prudential requirements will be the basis for tax calculation or profit distribution.

E. Ensuring Compliance with Accounting and Auditing Standards

43. **The current legal framework does not encourage a strong enforcement culture.** The outmoded Companies Act does not outline provisioning sufficient fine or imprisonment for noncompliance with applicable standards in Kenya. This situation is compounded by lack of an effective audit pillar to report noncompliance. The relevant laws do not define what type of control the authorities should exercise in cases of noncompliance with applicable standards. This has resulted in weaker monitoring and enforcement activities with regard to applicable standards. The consequence is that investors and bankers are deprived of a broad range of information that allows peer group financial analyses within a specific economic sector. This is seen by many

agents in the financial system as an impediment to their investing or lending activities and ultimately hampers enterprises' access.

44. **Regulators concentrate more on issuing than on enforcing accounting requirements.** The regulatory bodies in Kenya lack capacity to monitor compliance with accounting and financial reporting requirements and have not put in place an efficient and effective mechanism to monitor and enforce accounting and auditing requirements. The following points summarize the problems associated with the relevant regulatory bodies:

- *Office of the Registrar of Companies* suffers from lack of capacity to conduct effective review of financial statements and thus unable to identify real violations of the accounting and reporting requirements.
- *Financial sector regulators*, due to inadequate resource of technically qualified people (with the exception of CBK), primarily rely on auditor reports for ensuring compliance with the applicable standards by the insurance companies and pension funds instead of independently reviewing the financial statements. Such approach seriously restricts the effective enforcement actions.

45. **For non-listed entities, in both financial and non-financial sector, there is no system to effectively ensure that they adhere to applicable standards in their financial statements.** The absence of monitoring and enforcement of financial reporting requirements for the non-listed entities poses a significant threat in ensuring good governance and developing a sound financial architecture in Kenya. Many of the non-listed entities, including state-owned enterprises, and large privately-owned enterprises, have significant public interests. For instance, non-listed state-owned enterprises are not treated as a company, and thus there is no mandatory requirement for them to provide audited financial statements. Economic decisions regarding those entities might end up not being based on high-quality financial information. In the financial sector, it is unclear what sanctions could be imposed if non-listed financial institutions, such as SACCO, are found noncompliant with the applicable accounting and financial reporting requirements.

46. **Accounting and auditing is virtually unregulated in the SACCO sector.** Deposit-taking credit cooperatives, SACCOs are under the jurisdictions of the Ministry of Cooperation and Development. The Ministry does not supervise SACCOs on the basis of prudential criteria. There is no system in place to regulate their accounting and auditing practices. Such a situation has created a substantial threat toward the financial vulnerabilities, particularly when these institutions deal with a substantial number of rural depositors.

47. **There is a need for CBK to review general purpose financial statements of banks and other financial institutions in order to identify infractions with applicable accounting and financial reporting requirements.** The CBK enforcement actions are mostly limited to the specific problematic cases, either raised by the statutory auditors, or as a by-product of monitoring and enforcing prudential regulations. The CBK primarily relies on examination of prudential reports and their own investigations. Since the prudential norms set by the CBK generally address risk issues, both off-site and on-site supervisors give priority to checking the compliance with these requirements during their examinations.

48. **The ICPAK is responsible for conducting inspections of audit firms and individual auditors, however, the Quality Assurance review system would need to be further developed to meet international good practice.** The ICPAK has initiated a program of inspection of small and medium sized audit firms. Currently ICPAK has a team of five full time reviewers who undertake this inspection. For the larger audit firms, ICPAK has outsourced the inspection to an international organization that is required to transfer knowledge and build ICPAK's capacity to undertake such reviews in future. To date, 289 such reviews have been carried out including the larger 4 firms in the country. However, due to the inadequate resource of technically qualified people, it is difficult for ICPAK to sufficiently evaluate risk assessment procedures, human resources factors, monitoring of audit field work, or the processes relied upon in reaching final audit opinion. As such, there is room for improvement in ensuring that the quality control procedures meet the threshold of international good practice and SMO 1. Due to the absence of an independent audit oversight arrangement, the country does not yet have an effective audit regulatory framework, enforcement of rules and regulations by way of a strong monitoring, control and surveillance as well as quality control mechanisms.

49. **The CMA enforcement actions are constrained by insufficient resources to monitor listed companies' compliance with IFRS in a proactive and comprehensive manner.** The CMA does not presently have sufficient staff to enforce financial reporting requirements, including application of IFRS, of listed companies. It does not investigate the cases of denunciations or departure with IFRS or other financial reporting requirements. Also, it does not conduct inspection of audit firms to monitor compliance with accounting and auditing standards.

50. **The stock exchanges do not have any monitoring and enforcing mechanism with respect to accounting and auditing standards.** The Nairobi Stock Exchange is generally satisfied if a publicly traded company issues financial statements on a timely basis. They do not have any arrangement to monitor compliance with the financial reporting standards. Also, the Nairobi Stock Exchange suffers from capacity constraints in discharging their responsibilities as self-regulatory organizations of a capital market.

51. **Given Kenya's substantial numbers of public interest entities, including the growing financial sector, the statutory auditors should be fully transparent with financial information.** The statutory auditors of public interest entities should disclose description of ownership and legal structure of the audit firm, membership of a network of audit firms, description of the internal quality assurance system, information on fees earned for statutory audits, other assurance services, tax advisory services, and other non-audit services. Transparency reporting by audit firms would facilitate additional monitoring and supervision, and also augment public confidence in the statutory audit of public interest entities.⁵

52. **Given Kenya's economic size, there is a shortage of high-quality and credible expertise on the valuation of property, plant, and equipment.** This brings into question the

⁵ In general these entities should include listed companies, banks, insurance companies, investment funds, pension funds, and other large entities, including state-owned enterprises of certain size (which may be measured by the amount of revenue it generates or assets it owns, or by its number of employees).

reliability of valuations used on privatization, business combinations, and other non-cash transactions. Consequently, such a situation tends to significantly limit compliance with applicable standards in measurement and disclosure of financial information.

53. As is relatively common in many countries, tax rules tend to influence the preparation of general purpose financial statements. This practice often deters the fair presentation of financial information. In order to satisfy the requirements of taxation authorities with regard to the recognition of taxable revenues and deductible expenses, the preparers of general purpose financial statements often tend to deviate from applicable financial reporting standards, preferring to follow the taxation regulations. As a result, treatment of certain items in the general purpose financial statements may be different from that which should apply under IFRS. The ROSC team, through facilitated discussion with various stakeholders, observed that many preparers of financial statement manipulate accounting policies in revenue recognition and inventory valuation to reduce their tax liabilities.

III. ACCOUNTING STANDARDS AS DESIGNED AND PRACTICED

54. The IFRSs are the applicable financial reporting requirements in Kenya; however, companies and their accountants face some practical difficulties in implementing these standards. Discussions by the ROSC team with representatives of companies and auditors suggested some IFRS implementation problems. Most of these problems arise mainly from the reluctance of top management to comply with the full disclosure and transparency requirements of IFRS.

55. Evidence suggests the lack of adequate capacities to prepare IFRS-based financial statements. During its due diligence mission in discussions with company management, the ROSC team were told that some companies might not have adequate resources or ability to prepare IFRS-based financial statements. It is possible therefore that in these cases the auditors either prepared or provided substantial assistance with the preparation of such financial statements. This raises a significant independence issue that was subsequently confirmed on a few occasions as to whether the actual accounting policies followed by the companies comply with the “boilerplate” disclosures in IFRS-based financial statements.

56. Although the quality of audited banks’ financial statements is generally good, there may be differences between disclosed accounting policies and actual practices. Despite the fact that the quality of financial statements of Kenyan banks is relatively good compared to other corporate entities, differences exist between disclosed accounting policies and actual practices. For example, banks generally calculate impairment in the unsecured portion of loans and receivables on the basis of provisioning matrix approved by the CBK. This calls for a range of fixed provisioning rates for the number of days a loan has been classified as nonperforming. This methodology may not comply with IAS 39, *Financial Instruments: Recognition and Measurement*, which requires impairment or loan losses to be calculated as the difference between the asset’s carrying amount and the present value of the estimated future cash flows (excluding future credit losses that have not been incurred) and discounted at the financial asset’s original effective interest rate. The ROSC team is concerned that the disclosed accounting policy seems to be based on compliance with IAS 39 when the banks are in effect applying a different policy. Furthermore, some degree of noncompliance with IAS 32, *Financial Instruments:*

Disclosure and Presentation, and IAS 39 — requirements relating to the measurement and disclosure of financial assets — indicates the need for capacity building in this area. With regard to these issues, the ROSC team undertook a series of discussions with management, auditors, and regulators who acknowledged the need for targeted capacity building. Although after reviewing the financial statements of banks, the ROSC team in many cases could not identify any major noncompliance issues of material nature in appearance that could mislead the users of financial information, capacity building in this area is no less important for ensuring sustainability of a strong corporate financial regime.

57. The ROSC review of listed companies' financial statements shows high-level observance of standards, although the quality of those statements is still uneven. In most cases, the financial information provided by companies when preparing their financial statements was comprehensive and relevant, giving adequate coverage to some of the topics where IFRS compliance is the most challenging, including impairment of assets, segment information, financial instruments, and taxation. The ROSC review confirmed several departures from IFRS, and in some cases, one can raise serious doubts on the faithfulness of the income statement to the company's performance. Departures observed relate to the following issues:

- **Missing disclosures.** The main problem identified was the omission in notes to the financial statements of required disclosures including (a) accounting policies (IAS 1); (b) the description of the company's risk management and hedging policies (IAS 32); (c) the date of authorization for issue of the financial statements; (d) contingencies (IAS 37); and (e) earnings per share (IAS 33). The notes to the financial statements must be comprehensive and precise so that the users can gain a proper understanding of these statements and make informed decisions. Incomplete and substandard notes can also trigger investors' and lenders' suspicion, impeding them from relying on the financial statements.
- **Related party.** Many entities, including some financial institutions, omitted important disclosures such as the relationship and transactions, pricing policies, the volumes of related party transactions, and the corresponding amounts. Adequate disclosure of material related party relationships and transactions is essential to users' understanding of a company's financial position and results, and for minority investors' confidence that they will receive fair treatment. Inadequate disclosure in this regard leads to noncompliance with IAS 24, *Related Party Disclosures*.
- **Employee benefits.** Inadequate disclosure as to whether actuarial or any other forms of valuation had been used to quantify outstanding liabilities for post-employment benefits and thus not adhering to the requirements of IAS 19, *Employee Benefits*.
- **Inventory.** Some companies failed to follow all requirements related to measuring and disclosing inventories (IAS 2) at the lower of either cost or market value.
- **Contingent liabilities.** Some companies did not adequately disclose contingent liabilities, making their financial statements noncompliant with IAS 37, *Provisions, Contingent Liabilities, and Contingent Assets*.
- **Segment reporting.** Many companies did not provide detailed information on revenues, operating profit, total assets, and total liabilities of different segments. Also both

geographical segments and product segments were not disclosed. These suggest that companies' financial statements failed to comply with the requirements of IAS 14, *Segment Reporting*.

58. The reviewed financial statements of banks, insurance companies, and pension funds provided comprehensive information, although in some cases of lesser quality than required by IFRS. No cases of apparent material departure with the IFRS requirements arose from the ROSC review. Even though the financial statements reviewed had significant disclosures, they fall short of IFRS in a number of areas, especially with regard to financial instruments, the description of risk management policies, and related-party transactions. These differences reflect the fact that CBK accounting rules are prudential in nature and geared toward supervision, nor providing adequate information to shareholders, depositors, and third parties.

59. The overall presentation of state-owned enterprises' financial statements was good, although there are cases of inadequate disclosure. These include:

- Some IFRS-required disclosures were missing, including the components of cash and cash equivalents (IAS 7), employee benefits (IAS 19), details of foreign exchange gains and losses (IAS 21), interest rate for borrowing costs capitalized (IAS 23), management compensation (IAS 24), risk management policies (IAS 32), and relevant explanations on contingent liabilities (IAS 37).
- Except in one case, the financial statements did not indicate whether assets had been tested for impairment (IAS 36, *Impairment of Assets*) and if loss of value had been recognized.

60. The SACCOs' financial statements indicate widespread noncompliance. All reviewed SACCO financial statements were noncompliant with IFRS. Most SACCOs did not provide notes to their financial statements. Those that did provide notes did not disclose all accounting policies. Most of the financial statements did not include cash flow statement and statement of changes in equity. In real terms, SACCO financial statements are so poor that they cannot be even benchmarked in comparison with any IFRS.

61. In some cases, the financial statements of corporate entities are not readily available. The ROSC team found some difficulties in obtaining financial statements from companies for review purposes. The Registrar of Companies does not have an arrangement for public access of the financial statements of public companies. This problem indicates the relatively low importance attached to the use of financial information in the decision-making process. From the discussions held during the ROSC due diligence mission, it was inferred that many corporate entities view the preparation of financial statements as merely ritual and mainly necessary either for taxation purpose or apparent compliance with regulatory requirements.

IV. AUDITING STANDARDS AS DESIGNED AND PRACTICED

62. The ISAs are the applicable auditing standards in Kenya; however, in general, the level of compliance with applicable auditing standards varies greatly across audit firms. To assess actual auditing practices, the ROSC team interviewed practicing auditors and senior

leaders of the audit profession. Facilitated discussions were conducted with the partners representing large and medium-size audit firms. It appeared that auditors of firms associated with international accounting firm networks generally tend to follow auditing standards. Nevertheless, there were instances where some of these firms apparently could not ensure a proper quality audit. However, smaller audit firms encounter difficulties in bearing the cost of implementing auditing standards in an adequate fashion. In Kenya, as in all countries, application of IFRS requires auditors to make an assessment of risk and internal controls, leading to an audit strategy and plan that encompasses systems, transactions, and balance testing, which enable the auditor to gain adequate audit evidence for expressing opinion on the financial statements. The members of international network of accounting firms often have better trained staff and access to updated audit practice manuals. However, smaller audit firms struggle to keep up with latest standards and may have no or limited access to audit methodology, which has been designed to comply with applicable standards. In the absence of proper guidance, auditors generally find it difficult to deal with important concepts such as audit risks, audit planning, internal control, materiality, documentation, and going concern. The ROSC team observed through its review of audited financial statements that some cases of noncompliance with IFRS were not revealed in the corresponding auditors' reports. Various stakeholders suggested that improved audit supervision by the audit partners, would improve the application of auditing standards.

63. There is a need to improve implementation of auditor's independence rules. Many stakeholders expressed concerns about close relationship between some auditors and their clients. This may cause undue influence on auditors, resulting in noncompliance with appropriate audit procedures. It was observed that in some IFRS applications, auditors have the tendency of bringing material deficiencies to the attention of management through management letter rather than giving qualified audit opinion.

64. In many cases, actual practices diverge from ISA. The following are the few examples of auditing noncompliance in Kenya:

- Audit risk and audit materiality are not determined in accordance with the standard and not considered when conducting the audit.
- Documentation practices fail to provide audit evidence to support the audit opinion in most enterprises, apart from banks.
- Meaningful analytical procedures are difficult due to absence of industry information.
- Apart from the firms with international affiliations, most firms due to lack of capacity do not comply fully with ISA on quality control. Second partner peer reviews are generally not done.
- Auditors sometimes find it difficult to obtain audit evidence and so rely on management representations, particularly for related party transactions, segment information, and contingent liabilities.
- Professional clearance (communication with retiring auditor) is not always done, as most retiring auditors do not respond to such requests.
- Shortage of expertise in information technology (especially in medium-size and small firms) erodes audit quality.

- It is not always possible to obtain audit evidence that the opening balance does not contain material misstatements that affect the current period's financial statements.

65. Lack of understanding by directors and members of management about the purpose of audits sometimes makes it difficult for auditors to obtain appropriate audit evidence. Many auditors claimed that some directors and members of top management often fail to appreciate adequately the purpose and value of auditing. However, such a situation limits access to evidence to form professional judgments. Despite the arduous efforts by some auditors to carry out audits in accordance with international good practice, they view this task as a major constraint in discharging their professional responsibilities.

V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

66. Financial statement users interviewed during this ROSC acknowledge the progress made over the recent period but voiced some concerns regarding the quality of financial reporting. The adoption of IFRS is perceived as a very positive step toward facilitating investing, lending, and commercial activities. Nevertheless, some users indicated that the accuracy of financial statements presented by local companies was uneven, adjustments to the balance sheet or income statements were often needed to portray the company's financial position and/or profitability correctly. Issues of specific concern from interviewed stakeholders with respect to corporate financial reporting included (a) an undue influence of tax rules on the financial statements; (b) the uneven reliability of auditors; (c) the business community's lack of awareness on the importance of transparent and accurate financial reporting; (d) the fact that users in general have received little training to use IFRS-based financial statements.

67. The market perceives that the companies audited by the local member of international network of accounting firms have high-quality financial information. A high degree of reliance is placed on the financial statements that are audited by members of international accounting firm networks. Contrary to that position, some stakeholders thought in most cases that an audit does not add value but is only a requirement for the company to win a contract or to obtain a bank loan.

VI. POLICY RECOMMENDATIONS

68. The main purpose of this ROSC A&A assessment is to assist the Government of Kenya in strengthening the private sector's accounting and auditing practices and in enhancing financial transparency in the corporate sector. In turn, these activities are integral components of a broader effort to address certain strategic objectives, including (a) maintaining sustained levels of foreign direct investment, (b) enhancing the investment climate, (c) supporting the development of small and medium-size enterprises, (d) ensuring stability of the financial sector, and (e) furthering Kenya's economic integration internationally. The principle-based policy recommendations arising from the assessment of existing practices will be discussed during a workshop with the Government and in-country stakeholders. Following these discussions, a country action plan will identify specific activities to be undertaken for implementation of the ROSC recommendations, under the supervision of the Ministry of Finance.

69. Insofar as the recommendations would support some of the key development objectives set by the Government of Kenya, a wide range of country stakeholders would benefit from them. These stakeholders include the following:

- The financial community, especially pension funds, investment funds, and banks since increased accuracy and reliability of the financial information could enhance their ability to make informed investments and loans and could lead to broadening pension funds' investment potential.
- Small and medium-size enterprises and large non-registered enterprises, which could gain easier and cheaper access to capital. Making available more complete and accurate financial statements to investors and lenders will allow them to place greater reliance on those statements, which in turn will contribute to diminishing the perceived or real risk. Ultimately, the improved perception should lead to reducing investing and lending premium, reducing financing costs, and improving development prospects on small and medium-size enterprises.
- Employees of the private sector, who have an important stake in their company's success and are entitled to receive accurate information on which to judge the impacts and soundness of management decisions. Also, as future retirees, they would be the ultimate beneficiaries of improved private pension fund investments.
- The public sector would also benefit, since taxes on corporate profits are based on accounting records. Reinforcing accounting and auditing practices in the corporate sector would support the Government's efforts to limit tax evasion and increase its revenues.
- The accounting profession since increased visibility and public confidence arising from a selective certification process would elevate the image of the profession in the minds of the broader business community and its ability to attract high-quality graduates.

70. The ROSC A&A recommendations are interrelated and mutually supportive and require a holistic approach for implementation. Critical success factors for implementation include high-level government leadership, and capitalizing on previous achievements. The Government should form a multi-disciplinary steering committee to champion and coordinate the accounting and auditing reform. The members of the steering committee should advise policymakers on how to implement the country action plan for further improvement of the corporate financial reporting regime. The policy recommendations outlined in this report are based on the assumption that long-term country objectives include development of a sound corporate reporting infrastructure, leading to an environment for producing high-quality corporate financial statements. This requires continued reorganization and improvement of Kenya's legal framework and institutions; strong accounting and auditing profession and statutory regulators; improvement of an enforcement mechanism; and making necessary changes in the curricula for supporting high-quality professional training in accounting and auditing. Thus, the policy recommendations primarily focus on:

- Statutory framework,
- Institutional capacity-building measures,
- Establishment of the independent oversight body, and

- Professional education and training.

A. Statutory Framework

71. **Amend the Accountants Act.** For updating the statutory framework in line with international good practice, the following should be considered:

72.1 *Accounting Standards Committee and Auditing Standards Committee under ICPAK:* The Act should state explicitly those standards that are to be used for corporate accounting and auditing, and define a threshold for which entities would fall within the purview of this requirement. In this regard, the law should include provisions on formation and mandates of the Accounting Standards Committee and Auditing Standards Committee within the organizational framework of ICPAK. Legal backing for standard-setting will empower these committees to issue legally enforceable standards. Most importantly, the corporate directors, who are responsible for preparation and presentation of financial statements, will be under legal obligation to comply with the applicable accounting and financial reporting requirements. The law needs to put in place an arrangement under which the Accounting Standards Committee would work in collaboration with the financial sector regulators (e.g., Central Bank of Kenya, Insurance Regulatory Authority, and Capital Markets Authority) in order to ensure that the entities under the purview of these regulators are required to comply with the IASB-issued standards and interpretations. The law should also include provisions concerning determination of the thresholds for small and medium-size enterprises in the context of mandating the use of simplified financial reporting requirements.

72.2 *Strengthen the linkage between completion of the KASNEB-administered professional examination, and fulfillment of practical training requirements provided by ICPAK-authorized practical training providers, as the prerequisite for awarding ICPAK membership.* The law should provide a framework of integrating the activities of KASNEB and ICPAK with regard to the awarding of *ICPAK membership*. In order to ensure that all certified public accountants in the country are under the purview of professional accountancy body's regulatory framework, the CPA certificate holders should be required to maintain ICPAK membership in good standing. This will require substantive discussion among key stakeholders and restructuring the current arrangements between ICPAK and KASNEB.

72.3 *Establish an independent oversight body under the Ministry of Finance, with responsibility of carrying out audit quality assurance reviews of the auditors of public interest entities and providing policy directions for developing the accountancy profession with particular focus on enhancing competitiveness of the small and medium-sized practices in the country.*⁶ The law should provide the oversight body

⁶ The oversight body may be called the Kenya Public Accountants Oversight Board (KPAOB). Examples of similar oversight bodies are in South Africa, the Independent Regulatory Board for Auditors (IRBA); in the United Kingdom, the Financial Reporting Council (FRC); in the United States, Public Company Accounting Oversight Board (PCAOB); and in Australia, Financial Reporting Council (FRC). For more information about oversight bodies around the world, visit the website of International Forum of Independent Audit Regulators at www.ifiar.org.

with adequate authority to sanction appropriately against violations of applicable accounting and auditing standards and rules for ensuring effective monitoring and enforcement actions. The oversight body should work in collaboration with the financial sector regulators to ensure that auditors of entities under purview of these regulators provide high-quality professional services. The oversight body should also establish a cooperative relationship with regulators that will help to detect and deter noncompliance with certain key regulatory requirements. Because of the exposure to risks arising from weak governance and inadequate supervision, SACCOs require audit and related professional services as important measures for protecting public interest. From this perspective, the SACCOs' financial reporting and auditing should be subjected to strict supervision by the oversight body.

72.4 *Authorize the Council of ICPAK to establish various types of membership qualifications.* For example, the Council could decide to recognize full members as CPA (K); and other membership types might be recognized under other titles, including “trainee accountant” and “accounting technician”.

72.5 *Make professional indemnity insurance compulsory for all practicing auditors.*

72.6 *Require public interest entities' chief executive officers and chief financial officers to certify to the best of their knowledge and belief that the following have been done:*

- They have reviewed the financial statements for the year and (a) these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading; and (b) these statements together present a true and fair view of the company's affairs and are in compliance with the applicable accounting standards, applicable laws and regulations.
- There are no transactions entered into by the company during the year that are fraudulent or illegal.
- They accept responsibility for establishing and maintaining internal controls for financial reporting and have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting. They have disclosed to the auditors any deficiencies in the design or operation of such internal controls, of which they are aware, and make known the steps taken or proposed to rectify these deficiencies.

B. Institutional Capacity Building

73. Strengthen key institutions in the field of corporate accounting and reporting. The following should be considered with regard to this recommendation:

73.1 *The financial sector regulators (CBK, CMA, and IRA) should recruit adequate professionally qualified accountants and train existing staff to undertake the review of*

financial statements of their respective controlled entities. Each of these regulators should develop a core group that would receive adequate training to identify accounting infractions in the financial statements of the regulated entities.

73.2 The Central Bank of Kenya should align banking norms on loan-loss provisioning with applicable standards and Basel Committee's recommendations. In this regard, it should undertake a comprehensive study and cover the impact for banks in terms of (a) amount of provisions, (b) information system supporting the monitoring and accounting of loans, and (c) capacity-building efforts required for banks to be able to apply a methodology consistent with accounting standards and Basel Committee's principles.

73.3 The ICPAK should strengthen the secretariat and further improve its technical capabilities in order to scale-up provision of professional development services to the members of the profession. The ICPAK needs to reinforce its ongoing process for more rigorously supporting implementation of IFRS and ISA, and SME-focused IFRS. For purposes of ensuring ethical standard and independence of practicing auditors in line with international good practice, ICPAK should issue detailed guidance using local examples focusing on various issues covered by the Code of Ethics for Professional Accountants developed by the IESBA of IFAC.⁷ Guidance notes that cover actual cases should address issues covering threats to auditor's independence in a Kenyan-centered environment. In addition, ICPAK should reinforce the establishment of ongoing processes for the adoption and implementation of revised IFRS and ISAs.

74. The ICPAK should prepare and implement a strategy of enhancing capacity of small and medium-size practices to operate as strong professional services firms. Audit firms, in particular small and medium-size ones, should have access to updated audit practice manual, implementation guidance on IFRS and ISA, and help line on implementation of complicated IFRS issues, with the support of ICPAK. The internationally affiliated firms generally have access to these services through their networks. The local firms, specifically the small and medium-size practices face difficulties in this regard. The ICPAK should work in collaboration with the relevant staff of IFAC to develop and implement an action plan for capacity development of the small and medium-size practices. The ICPAK's technical assistance to the small and medium-size practices should not necessarily concentrate on enhancing their capabilities for providing audit and assurance services. Emphasis should also be given on building SMP capacity to provide a range of other value-added business advisory services to small and medium-sized enterprises. Many small and medium-size practices will be able to provide most if not all of the services listed below to small and medium-sized enterprises since they are part of the professional accountant's core skill set – or very close to it:

- Prepare financial reports tailored to their specific needs;

⁷ The IESBA Code, establishes ethical requirements for professional accountants and provides a conceptual framework for all professional accountants to ensure compliance with the five fundamental principles of professional ethics: integrity, objectivity, professional competence and due care, confidentiality, and professional behavior. Under the framework, all professional accountants are required to identify threats to these fundamental principles and, if there are threats, apply safeguards to ensure that the principles are not compromised.

- Interpret financial reports and suggest solutions to problems;
- Assist with strategic planning and its execution;
- Assist in the formulation of their business plans and financial forecasts;
- Help present a business for its sale;
- Help them control costs through cost accounting;
- Assist in identifying and managing risks;
- Advise on suitable business structures;
- Perform business or business unit valuations;
- Advise on relevant regulations – human resources, safety, and environmental;
- Advise family businesses on succession planning.

75. **Develop the accountancy profession to serve both private and public sectors of the economy.** The ICPAK should focus on this development. There is broad consensus among key international stakeholders that one professional accountancy body should cater to the needs of both public and private sectors of the economy. The benefits, common to many emerging and developing economies, include efficient utilization of scarce technical and human resources, and increased availability of skilled professionals for supporting transparency and accountability in both private and public sectors. However, both sectors require its unique skills and knowledge. Therefore, the policymakers will need to ensure that the ICPAK is resourced adequately to deliver satisfactory services that meet the requirements or unique skills for both sectors. In this regard, ICPAK should provide technical support to government in adoption of IPSAS for the central government accounting.

C. Establishment of the Independent Oversight Body

76. **Establish the independent oversight body in accordance with the provisions of the amended Accountants Act.** The oversight body would be expected to focus on the audit quality of the public interest entities. And, ICPAK would primarily concentrate on ensuring quality of the audit of non-public interest entities. The ICPAK should stay responsible for investigating and disciplining its other members, which include preparers of financial statements, for misconduct and breach of rules. The oversight body would also provide policy directions for developing the accountancy profession. In this regard, the oversight body could facilitate specific initiatives for capacity development of the small and medium-sized practices. An advisory committee should be formed to support activities of the oversight body. Such an advisory committee would ensure a cohesive cooperation among various stakeholders, including the financial sector regulators, ICPAK, the investor community, and academia. The activities of the oversight body would include the following:

- ***Registering statutory auditors of public interest entities.*** The practicing auditors who demonstrate adequate technical knowledge and professional competence would qualify

for registration with the audit review board. The board will set requirements for eligibility of audit firms to provide auditing services to the public interest entities.

- **Conducting audit quality assurance review.** The inspectors of the oversight body will conduct audit quality assurance reviews of the registered audit firms, ensuring each audit firm are reviewed at a reasonably regular interval. The oversight body should have experienced (full-time) inspectors with capabilities to conduct the review work. If needed, some part-time reviewers may be engaged to work as team members. In order to ensure the oversight body renders unbiased decisions with regard to audit quality assurance review and related activities, it should have transparent and clear procedures, a rapid and confidential investigation system, a risk-based approach reflective of available resources, and adequate authority to take effective enforcement actions. In addition, the scope of the quality assurance review system should focus on public interest entities and cover proper application of IFRS, ISAs, ISQC-1, professional ethics and CPD requirements.
- **Complaint handling.** Valid complaints against practicing auditors and audit firms, and any irregularities identified from the reviews of financial statements by any of the financial sector regulators (CBK, IRA, and CMA), should be investigated.
- **Enforcement actions.** The oversight body should have the powers to issue warnings, impose fines and penalties, and restrict particular auditors from carrying out statutory audit of public interest entities. In addition to resorting to the national legal system, the oversight body should be empowered to impose enhanced administrative sanctions against management of enterprises, auditors, and audit firms for their roles in violating accounting, auditing, and financial reporting requirements. The enhanced administrative sanctions would facilitate enforcement without depending fully on the lengthy legal process.
- **Public disclosure.** The enforcement actions taken by the oversight body against errant auditors, audit firms, and responsible corporate management should be made public in order to facilitate market discipline. This will increase confidence in audited financial information on the part of both domestic and international users of financial statements.
- **Specific focus on savings and credit cooperatives.** Due to weak regulatory framework of SACCOs, their audit and financial reporting should be used as an important measure for protecting public interest. From this perspective, the oversight body should put in place special arrangements for rigorously inspecting the auditors of SACCOs. These auditors' professional work would be relied upon for preventing fraud and corruption in these financial institutions.

D. Professional Education and Training

77. **Enhance academic and professional education and training.** The following recommendations should be considered:

- University-level accounting curricula should be reviewed to ensure a consistent approach is followed in Kenya's universities. Particular focus should be given to include the practical application of accounting and auditing standards and to improve communication skills and professional judgment. The study of IFRS would best prepare accountants (rather than bookkeepers) for careers in the corporate sector.
- The staff of the regulatory agencies should have adequate exposure to practical dimensions of accounting and auditing requirements as per international good practice. Furthermore, they should undertake industry-specific training to update their skills.
- Accountants in state-owned enterprises should be encouraged to enroll in retooling programs, and companies should also take a similar approach to support employee training and study toward professional accountancy qualification.
- The ICPAK should collaborate with higher educational institutions throughout the country to develop and implement guidance materials on delivery of high-quality training programs that cover practical implementation aspects of accounting and auditing standards and code of ethics for professional accountants. In this context, learning materials based on pronouncements of IASB and IAASB should be extensively used.
- The ICPAK should reinforce the importance of continuing professional development in order to ensure that members are fulfilling their requirement to upgrade professional knowledge. There is a clear need for improvement in the content, structure, and delivery of the CPD program. In this regard, ICPAK should take into consideration the abilities of practicing accountants and auditors to defray the cost of participating in ICPAK-delivered CPD programs.

E. Others

78. **Adoption of International Public Sector Accounting Standards for the public sector:** Arrangements need to be developed for adoption of all International Public Sector Accounting Standards (IPSAS) for central government accounting. Moreover, steps need to be made for adoption of IPSAS for local government authorities and donor financed projects, and IFRS for state owned enterprises.

79. **Government intervention is needed to increase availability of internship programs:** The government needs to formulate policies to facilitate internship for accounting and auditing students in both the public and private sectors.