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Influence of Creative Accounting Practices on the Financial Performance of Companies Listed In the Nairobi Securities Exchange in Kenya

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Abstract: **This study is an empirical investigation of creative accounting practices in the Kenya. Creative accounting is carried out with an objective of making the company appear to be financially stronger or weaker depending on the management's aspirations. There has been a corporate failure which has become a major issue with respect to firms worldwide which has been attributed to excessive practice of creative accounting. The general objective of the study was to evaluate the influence of creative accounting practices on the financial performance of public limited companies listed in the Nairobi securities exchange in Kenya. This study considered tax avoidance, accelerated depreciation, and income smoothing as part of the major creative accounting practices that influence financial performance of public limited firms listed in the Nairobi securities exchange in Kenya. The research used both descriptive and inferential statistics to examine the major practices of creative accounting that influence financial performance of public companies listed in the Nairobi securities exchange in Kenya. The target population of this study was top management of public limited companies that is the CEO, directors, top managers and accountants. A sample of 30 public companies was drawn using purposive sampling. Logistic linear regression technique was used to analyze the relationship between creative accounting practices and financial performance and the correlation between the variables and financial performance. Quantitative approach through the use of questionnaires was adopted to help in the collection of primary data for analysis purposes. The secondary data was collected from NSE handbook relevant text books, finance journals, financial statements and the website of public limited companies that were be sampled. Statistical Package for Social Sciences Software (SPSS) was used in carrying out the multiple regressions to establish the relationship between creative accounting practices and financial performance and the correlation between the variables and financial performance. Financial performance was measured using earning after tax. The study found a strong relationship exists between creative accounting practices and financial performance. The study revealed that R2 was 0.633 meaning only 63.3% of the factors affecting financial performance among firms listed at the Nairobi Securities Exchange in Kenya as represented by the model while 36.7% was caused by other factors outside the model. Thus the study reveals that creative accounting practices have a significant effect on the financial performance of a company and most companies used it abusively hence resulting in most collapses of many firms.**

Keywords: **creative accounting, financial performance, tax avoidance, income smoothing, accelerated depreciation.**

1. INTRODUCTION

There are many different definitions of creative accounting (and also earnings management and other terms related to account manipulation) in the literature. Amat and Gowthorpe (2004), who used earnings management and creative accounting synonymously, has considered creative accounting as involving a transformation of financial accounts using accounting choices, estimates and other practices allowed by accounting regulation. Sawabe (2005) has emphasized the

innovative aspects of creating accounting in manoeuvring accounting numbers and argued that innovation is an essential part of creative accounting practices involved in innovative accounting practices.

Simser (2008) elucidates that taxpayers are required to pay taxes based on accounting and legal advice provided which should be aligned to the firm's financial reports and the existing tax rules. Taxation is complex and exploring the tax system requires the guidance of skilled lawyers, accountants and other advisors. Tax evasion is unacceptable and/or illegal while tax avoidance is perfectly acceptable however there is no clear line between the two. This is the dilemma that is faced by the advisors. Tax evasion is perpetrated through acts such as presenting incorrect statement of accounts, making false entries or alterations, or false books or records, destruction of books or records, concealment of assets or covering up sources of income constitute tax evasion (Malkawi, and Haloush, 2008).

According to Ezeani, Ogbonna and Ezemoyih (2012), creative accounting brought to the multi-dimensional nature of the ongoing financial crises and its effect on financial reporting by way of increasing adoption of creative accounting. Creative accounting offers a formidable challenge of the accounting profession which when carried to extreme negativity has cast aspersion on the credibility of accounting principles and standards. In general, creative accounting lends itself as a deceitful and undesirable practice. The effect of the creative accounting raises the need for a close scrutiny of the potential abuse of accounting policy choice and manipulation of transactions.

A report of creative accounting scandal in African Petroleum PLC slated for privatization in 2001 showed that the financial statements of the company did not fairly present the company's financial position. A number of transactions, including substantial loans, were omitted from the financial statements. This fact was discovered when a due diligence audit was done in preparation for privatizing the company (Oyejide and Soyibo, 2001).

1.1 Creative accounting in Kenya:

According to Kamau, Mutiso and Ngui (2012) creative accounting is widely practiced among companies in Kenya. Their study established that the tax avoidance and evasion is a major motivation that drives practice of creative accounting. The findings of their research concur with the findings of other researches as indicated in the introduction section. Since tax is calculated on the basis of income, it is highly likely that the companies may understate their income so as to reduce the tax burden. These findings portrays a serious image for Kenya's professional accounting bodies, as they indicate that considerable potential value from the financial reporting process is being lost as a result of the creative accounting practice. These findings support the solutions provided by Amat and Gowthorpe (2010) especially on the issue of limiting judgment on choice of accounting methods to be applied.

1.2 Statement of the problem:

For many years, researchers have debated about creative accounting which is widely used to describe accepted accounting techniques which permit corporations to report financial results that may not accurately portray the substance of their business activities. According to Osisioma and Enahoro (2006), accounting processes and choice of policies resulting from many judgments at the same time are capable of manipulation, which have resulted in creative accounting. The differences which are observed in financial reporting are legitimately prepared from choice of varied accounting policies of the same organization for the same period, has brought about challenges of credibility to accounting.

Creative accounting activities that reduce transfers from stockholders to the government should generally enhance shareholder wealth. However, an emerging stream of literature, which examines tax avoidance in an agency framework, suggests that opportunistic managers employ the technologies of tax avoidance to advance managerial, rather than shareholder, interests (Desai and Dharmapala 2009)

Regulators of accounting profession in Kenya seem to be silent on the issue of creative accounting yet it is widely practiced among many companies in the country (Mbaire, 2012). Further users of accounting information seem not to have perceived this practice of creative accounting which has led to collapse of many major companies globally such as Enron and world com (Ayala and Giancarlo, 2006) and locally such as Nyaga stock brokers and Discount Securities (Bonyop, 2009). With increasing hard economic times, companies may be motivated to practice creative accounting for diverse reasons. Players in the accounting profession may not fully understand the operations of creative accounting because different companies practice creative accounting for different reasons. Carrying out research on the influence of creative accounting practices on financial performance of public limited companies in Kenya will help the players in accounting profession to empirically understand the implications of such practices on performance of firms in Kenya. It is upon this backdrop that the study intends to find out whether such practices as tax avoidance, accelerated depreciation,

and income smoothing as part of the major creative accounting practices have an influence on the financial performance of public limited firms in Kenya.

1.3 Objectives of the study:

1.3.1 General objective:

To evaluate the influence of creative accounting practices on financial performance of companies listed at the NSEin Kenya.

1.3.2 Specific objectives:

1. To establish the influence of tax avoidance on financial performance of companies listed at the NSE in Kenya
2. To examine the influence of accelerated depreciation on financial performance of companies listed at the NSE in Kenya
3. To examine the influence of income smoothing on financial performance of companies listed at the NSE in Kenya

1.4 Research Questions:

1. What is the influence of tax avoidance on financial performance of companies listed in Nairobi securities exchange in Kenya?
2. What is the influence of accelerated depreciation on the financial performance of companies listed in the Nairobi securities exchange in Kenya?
3. What is the influence of income smoothing on financial performance of companies listed in the Nairobi securities exchange in Kenya?

2. LITERATURE REVIEW

This chapter focused mainly on previous studies by various researchers in relation to creative accounting practices and financial performance. This chapter also covered the key theoretical consideration from previous studies to inform the general and specific objectives developed for this study that is the creative accounting practices and financial performance; reasons behind the manipulative behavior, strategies to avoid creating accounting that have been applied by public limited firms.

2.1Theoretical Framework:

Agency Theory:

The theoretical framework that this study is anchored at is the Agency Theory which means a conceptual relationship between the principal and the agent. Agency theory having its roots in economic theory was exposited by Alchian and Demsetz (1972) and further developed by Jensen and Meckling (1976). Here, the agent performs duty on behalf of another called his principal. A person who has given express or implied authority for another to as an agent on his or her behalf is called a principal while on the other hand, a person who is employed with or for the purpose of putting his employer (the principal) into legal relationship with the third parties is known as an agent.

The accountant as the agent of the principal (Stakeholders, Shareholders and Users of the Financial Information) is expected to discharge his work according to the specification of accounting principles, rules and regulations as to avoid misrepresentation of financial fraud or malfalsification of figures. The application of creative accounting by Osisioma and Enahoro (2006) and Amat, Blake and Dowds (1999) show that stakeholders, shareholders and other users of accounting information rely heavily on the yearly financial statements of a company as they can use this information to make as informed decision about investment. They rely on the opinion of the accountants who prepared the statements, as well as the auditors that verified it, to present a true and fair view of the company.

The agency theory shareholders expect the agents to act and make decisions to the best of the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interest of the principals (Padilla, 2000). Such a problem was first highlighted by Adam Smith in the 18th century and subsequently explored by Ross (1973) and the first detailed description of agency theory was presented by Jensen and Meckling (1976). Indeed, the notion of problems arising from the separation of ownership and control in agency theory has been confirmed by Davis, Schoorman and Donaldson (1997).

2.2 Empirical review of variables:

Tax avoidance:

Hanlon and Heitzman (2010, p. 137) have defined tax avoidance broadly as "the reduction of explicit taxes." This broad definition encompasses tax avoidance practices ranging from the benign to the abusive (Slemrod, 2004).

Researchers and the public alike have a keen interest in corporate tax avoidance, specifically; the amount of explicit taxes a company pays (Hanlon and Heitzman 2010). Corporate tax avoidance raises questions about companies paying "a fair share" of tax revenues, managers providing value to shareholders through tax savings, and, more generally, the various incentives and factors contributing to the cross-sectional variation in corporate taxes paid. In examining cross-sectional variation in tax avoidance, researchers commonly focus on variables such as size, return on assets, leverage, and foreign activities. Typically, these studies rely on book effective tax rates, cash effective tax rates, book-tax differences, and the residuals of a tax rate model as proxies for a client's level of tax avoidance (e.g., Dyreng et al. 2008; Frank et al. 2009; Wilson 2009; Chen et al. 2010; Dyreng et al. 2010; and McGuire et al. 2012)

According to Kamau, Mutiso and Ngui (2012), tax avoidance and evasion is a motivator of the practice of creative accounting for the purposes of evading and avoiding tax among companies in Kenya. Their study found out that creative accounting is widely practiced among companies in Kenya. The study established that the tax avoidance and evasion is a major motivation that drives practice of creative accounting. Since tax is calculated on the basis of income, it is highly likely that the companies may understate their income so as to reduce the tax burden.

Their findings portrays a serious image for Kenya's professional accounting bodies, as they indicate that considerable potential value from the financial reporting process is being lost as a result of the creative accounting practice.

Tax avoidance activities are traditionally regarded as tax saving devices that transfer resources from the government to shareholders, and thus should increase after-tax value of the firm (Desai and Dharmapala, 2009). An emerging literature in financial economics, however, emphasizes agency cost implications of tax avoidance and suggests that tax avoidance may not always increase the wealth of outside shareholders (Wang, 2010). In accordance with this alternative view, tax avoidance activity may contribute to managerial rent extraction, which ranges from theft of corporate earnings and earning manipulation to excessive executive compensation, in various forms. Tax avoidance may potentially reduce the after-tax value of the firm, since the combined costs of company, which include costs directly related to tax planning activities, additional compliance costs, and non-tax costs e.g. agency costs may surpass the tax benefits for shareholders (Wang, 2010).

Desai and Dharmapala (2009) have found that tax avoidance positively influences firm value, but the effect is sensitive to the quality of firm governance. The market views changes in book-tax differences as a sign of an overall tax avoidance focus for firms with a high quality of governance but as an isolated, single tax avoidance choice for firms with a low quality of governance.

While there is no conclusive evidence that some firms always favor tax avoidance over earnings management or vice versa, recent research treats tax avoidance or earnings management as a predominant managerial focus at different times where the firm's focus tends to drive economic outcomes (e.g. Blaylock, et al., 2012; Rego & Wilson, 2012).

Tax avoidance activities that reduce transfers from stockholders to the government should generally enhance shareholder wealth. However, an emerging stream of literature, which examines tax avoidance in an agency framework, suggests that opportunistic managers employ the technologies of tax avoidance to advance managerial, rather than shareholder, interests (Desai and Dharmapala 2009)

2.3 Timing of Genuine Transactions (TGT)/ Income smoothing:

Many empirical studies have found a negative relationship between earnings volatility and firm value (e.g. Lambert 1984; Minton and Schrand 1999; Rountree, Weston, and Allayannis 2008). Lambert (1984) shows that a risk-averse manager who cannot access the capital markets has the incentive to smooth reported income. Trueman and Titman (1988) show that in their economic model setting, even if managers are not risk-averse and the firm cannot borrow/lend from capital markets, income smoothing still increases the firm's market value.

A study conducted by Graham, Harvey, and Rajgopal (2005) indicates that most CFOs believe that earnings are the key metric considered by outsiders, and seventy-eight percent of the 400 executives in their sample would rather sacrifice the

long-term value to smooth reported earnings. When the manager of a firm has the option to choose the time when income is recognized, he or she may prefer the accounting measurement and reporting rules that are expected to result in more smoothed income streams. Recent empirical work by Rountree, Weston, and Allayannis (2008) suggests that earnings volatility decreases firm value.

A number of studies have examined the effect of income smoothing on cost of equity, earnings in formativeness, liquidity, and bond rating. For instance, Francis, LaFond, Olsson and Schipper (2004) examine the effect of income smoothing on the cost of equity. They find that income smoothing has a negative effect on the cost of equity, although the effect is weaker than for other attributes of earnings, such as accrual quality.

Prior research has documented that firms consistently engage in income smoothing activities (Beidleman, 1973; Ronen and Sadan, 1981; Healy, 1985; Hunt, Moyer, and Shevlin, 1995; Chaney, Jeter, and Lewis, 1996; DeFond and Park, 1997). For example, DeFond and Park (1997) find evidence that when a firm's current performance is poor relative to expected future performance, managers tend to smooth income by increasing accruals, i.e., "borrow" future earnings for use in the current period. They also find that when a firm's current performance is good relative to expected future performance, managers choose income decreasing accruals, i.e. "save" earnings for future period.

Income smoothing may conceal long-term changes in the profit trend. In countries with highly conservative accounting system, the income smoothing, effect can be particularly pronounced because of the high level of provisions that accumulate. Blake, Amat, Martinez and Gracia (1995), discuss a German example. Another bias that sometimes arises is called 'big bath' accounting where a company making a bad loss seeks to maximize the reported loss in that year so that future years will appear better.

Moreover company directors may keep an income-boosting accounting policy change in hand to distract attention from unwelcome news. According to Griffiths (1986) as cited by Amat et al (1999), creative accounting may help maintain or boost a company's share price by reducing the apparent levels of borrowing, thereby making the company less susceptible to risk, and by creating the appearance of a good profit trend. This helps the company to raise capital from new share issues, offer their own share in takeover bids, and resist takeover by other companies. However, where the directors engage in "insider dealing" in their company's shares, they can use creative accounting to delay the release of information, thereby enhancing their opportunity to benefit from inside knowledge.

Finally a number of notable studies (Grover, 1991a; Collingwood, 1991; Schroeder and Spiro, 1992; Sweeny 1994; Dahi, 1996; Fox 1997; Amat *et al*, 1999 and 2003; Gremlich, 2001; Leuz, Nanda and Wysocki, 2003; Henry, 2004; Desai and Dharmapala, 2006; Ningi, 2006; Chen, 2007) have investigated the reasons why entities seek to manipulate their accounts, and agree to the following: Income smoothing, borne out of the desire to report a steady trend of growth in profit, rather than to show volatile profits with a series of dramatic rise and falls. This is achieved by making unnecessarily high provisions for liabilities and against asset values in good years so that these provisions can be reduced, thereby improving reported profits, in bad years.

2.4 Accelerated depreciation method:

During World War II the United States increased normal depreciation or amortization allowances for approved defence facilities. And also in the post-war period many countries have liberalized their depreciation allowances with the objective of encouraging ordinary private investments (Goode, 1955). Goode (1955) defines accelerated depreciation as a method of deliberately speeding the rate at which the original cost of assets (less any salvage value) may be deducted from taxable income. More clear is the definition of accelerated depreciation by Dobrovolsky (1951): "The arrangement whereby the annual amount written off in the earlier years of the equipment's lifetime are greater than the amounts written off in the later years." This method leads to higher depreciation charges in the early years of an asset, and as a result lower profits. Because of this result, the accelerated depreciation method is often used as an instrument of tax policy (Barrit, 1959).

When comparing the examples of the straight-line and the accelerated depreciation method, you will see the depreciable amount is higher in the earlier years when using the accelerated depreciation method. This also leads to a lower book value. These higher costs in the beginning results in lower profits and thus lower taxes. The choice between one of these methods is an accounting choice which, like stated above, will have economic consequences. There is not much research done on the depreciation method choice. Dahliwal et al. (1982) argue that it is likely that one of the reasons why research on depreciation method choice has slowed is because of the perception that depreciation is an accounting issue where the

effects of the different methods are obvious and well understood. However, these effects are far from obvious. Prior research on the depreciation method choice has focused on the market-related consequences and contracting consequences of that choice (Jackson et al., 2009). Beaver and Dukes (1973) found no evidence that investors fixate on earnings prepared under different depreciation methods. And also Archibald (1972) and Kaplan and Roll (1972) found no stock price effect when firms are changing from accelerated depreciation to straight-line depreciation. Even though earnings are higher under the new method

3. RESEARCH METHODOLOGY

Research design guides the researcher in collecting, analyzing and interpreting data. It assists the researcher to determine the objectives of research, subjects of research, the sample size, the data to be collected, the procedures of collecting and recording that data, the procedures for analyzing that data and how the data was interpreted and presented (Nachmias, 1996). This research employed a survey research design along with descriptive and hypothesis testing designs. Survey design entails selecting a few respondents from a population with an aim of generalizing the results to the entire population while descriptive statistics describes a phenomena and hypothesis testing uses inferential statistics to evaluate a proposition. Purposive and random sampling methods were applied.

3.1 Data Analysis and Presentation:

The results of the study were presented in frequency tables, charts and graphs. The independent variables were tax avoidance, income smoothing and accelerated depreciation. The EAT represented financial performance as dependent variable. The primary data was collected, organized and coded for processing so as to generate tallies from every response per question. Likert's scale was used in a scale of 1 to 5 where 1 and 2 gave the average for positivity, 3 being the average for neutral or uncertain responses and lastly 4 and 5 gave for negativity. This made it possible for the researcher to meaningfully describe a distribution of scores and the diverse findings of the study. The data was analyzed using variance analysis so as to compare the year's financial performance. The data was presented using scale of frequencies and percentages in tables.

3.1.1 Model specification:

The Multiple Linear Regression model

$(\mathbf{Y = \beta_0 + \beta_1 TA + \beta_2 IS + \beta_3 AD + \varepsilon})$

$Y = \alpha + \beta_1 TA + \beta_2 AD + \beta_3 IS + \varepsilon$

Where:

Y= Earnings after TAX (EAT)

α = Alpha coefficient (the value of Y when all X values are zero)

TA= Tax avoidance

AD= Accelerated depreciation

IS = Income smoothing

ε = error term or stochastic error

4. RESULTS AND DISCUSSIONS OF THE STUDY

4.1 Descriptive Analysis:

Table 4.1.1 Descriptive Statistics for tax avoidance and financial performance

	N	Minimum	Maximum	Mean	Std. Deviation
TA1	50	1	5	2.20	1.108
TA2	50	1	5	2.00	1.193
TA3	50	1	5	4.34	1.345
TA4	50	1	5	2.24	1.268
TA5	50	1	5	2.22	1.228
TA6	50	1	5	2.01	1.297
Valid N (Listwise)	50				

Table 4.1.1, shows that TA1 (impact of tax incentives on firms profitability) shows that there is a positive effect (2.20 mean) of tax avoidance on financial performance. A mean of 2.00 by TA2 (tax avoidance is legal but managers take advantage of the practice to manipulate profits) shows that majority of the respondents agreed and that negatively impacts financial performance. TA3 (continuous tax avoidance leads to better management of organizations) showed that majority of the respondents disagreed with that assertion with a mean of 4.34 thus impacting financial performance negatively. TA4 (management practices tax avoidance not in the best interest of shareholders but themselves) with a mean of 2.24 tells that majority of the respondents agreed with that assertion hence resulting in poor performance. TA5 (most of the tax savings made from tax avoidance activities are misappropriated) has a mean of 2.22 which tells that majority of respondents agreed thus having a negative influence on financial performance. TA6 (detection of any attempt of underreporting incomes for the benefit of my shareholders) with a mean of 2.01 shows that majority of respondents agreed. This was attributed to poor remuneration and incentives.

Table 4.1.2 Descriptive Statistics for income smoothing and financial performance

	N	Minimum	Maximum	Mean	Std. Deviation
IS1	50	1	5	4.93	1.175
IS2	50	1	5	2.11	1.215
IS3	50	1	5	2.16	1.190
IS4	50	1	5	2.09	1.134
IS5	50	1	5	2.14	1.182
IS6	50	1	5	2.36	1.099
IS7	50	1	5	4.98	1.105
Valid N (Listwise)	50				

According to the findings in table 4.1.2, majority of respondents disagree that always organizations truly attain a steady growth in profits (IS1) represented with a mean of 4.93 thus a reflection of the same in financial performance could be misleading. Majority of respondents also agreed that the organization is able to sale off an asset and lease it back again to increase profits (IS2), this was represented by a mean of 2.11. Also the study found out that majority of respondents perceived that a risk averse manager who cannot access capital markets has the incentive of income smoothing to improve firm value (IS3) by agreeing as indicated by mean of 2.30. Also majority of respondents agreed that management always engage in delaying and pre-invoicing sales to attain their set targets as indicated by mean of 2.96. The study also sought to find out whether organizations transfer transactions from period to period to manage profitability of the firm (IS5) and majority of respondents agreed as indicated by mean of 2.14. The study also found out that majority of respondents agreed that management may classify some operating cash flows under investing or financing activities (IS6) as indicated by mean of 2.36. Finally the study sought to find out whether organizations recognize revenues while the sale transaction is still incomplete and majority of the respondents disagreed as indicated by mean of 4.98.

Table 4.1.3 Descriptive Statistics for accelerated depreciation and financial performance

	N	Minimum	Maximum	Mean	Std.Deviation
AD1	50	1	5	2.02	1.183
AD2	50	1	5	2.16	1.154
AD3	50	1	5	2.09	1.100
AD4	50	1	5	4.46	.982
AD5	50	1	5	2.28	.958
AD6	50	1	5	2.33	1.122
Valid N (Listwise)	50				

The study sought to find out whether forms do take advantage of accelerated depreciation to improve their financial performance (AD1) and majority of respondents agreed as indicated with mean of 2.02. The study also sought to know whether the criteria used to determine depreciation rate aims at creative accounting (AD2) and majority of respondents agreed as indicated with a mean of 2.16. On whether the company relies on or takes advantage of certain cost recovery provisions such as accelerated depreciation to creatively present the firm's financial performance (AD3), majority of the respondents agreed and this was indicated by a mean of 2.09. Majority of the respondents also disagreed that those recovery methods help organizations manage cash flows better (AD4) as supported by a mean of 4.46. The study also

found out that majority of the respondents agreed that there are areas in the rules governing depreciation that should be evaluated or modified in tax reform and that was indicated by a mean of 2.28. Finally the study sought to know the extent management of organizations practice overstatement of asset write-offs and majority of respondents agreed to that the practice was rampant as indicated by a mean of 2.33.

4.2 Multiple regression of financial performance for the period of study and evaluation of financial statements:

The researcher conducted a multiple regression analysis to test the relationship among the variables (independent) on financial performance of the firms listed at the Nairobi Securities Exchange in Kenya. Statistical Package for Social Sciences (SPSS) was applied in the regression analysis.

The coefficient of determination (R squared) explains the extent to which the changes in the dependent variable (financial performance) can be explained by the changes in the independent variables (tax avoidance, income smoothing and accelerated depreciation).

Table 4.2.1 Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.795[a]	.633	.583	0.80733

a.Predictors: (Constant), Accelerated Depreciation, Tax avoidance, Income smoothing

b. Dependent Variable: Financial performance (EAT)

The three independent variables that were studied, explain only 63.3% of the factors affecting financial performance among firms listed at the Nairobi Securities Exchange in Kenya as represented by the R^2. This therefore means that other factors not studied in this research contribute 36.7% influence on financial performance of firms listed at the Nairobi Securities Exchange. Therefore, further research should be conducted to investigate the other factors (36.7%) that affect financial performance of listed firms at the Nairobi Securities Exchange. Thus the study reveals that creative accounting practices are a key influence of financial performance.

Table 4.2.1 ANOVA[b]

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	24.713	3	8.238	12.639	.000[a]
Residual	14.339	22	.652		
Total	39.052	25			

a.Predictors: (Constant), Accelerated Depreciation, Tax Avoidance, Income Smoothing

b. Dependent Variable: financial performance (EAT)

The significance value is 0.000 which is less than 0.05 thus the model is statistically significance in predicting how tax avoidance, income smoothing and accelerated depreciation affect the financial performance of firms listed at the Nairobi Securities Exchange. The F critical at 5% level of significance was 1.32. Since F calculated is greater than the F critical (value =12.639), this shows that the overall model was significant.

Table 4.2.3 Coefficients[a]

Model	Unstandardized Coefficients		Standardized Coefficients		
	B	Std. Error	Beta	t	Sig.
1 (constant)	-5.606	2.098		-2.672	.014
Tax Avoidance	1.336	.459	.440	2.908	.008
Income smoothing	-.820	.330	-.381	-2.482	.021
Accelerated depreciation	1.759	.306	.854	5.747	.000

Dependent variable: Financial performance (EAT)

The researcher conducted a multiple regression analysis so as to explaining financial performance of firms listed at the NSE. And the three variables. As per the SPSS generated table 4.7.3, the equation ($Y = \beta_0 + \beta_1 TA + \beta_2 IS + \beta_3 AD + \varepsilon$) becomes:

Y=-5.606 +1.336 TA-.820 IS+1.759AD

Where Y is the dependent variable (financial performance), TA is the tax avoidance, IS is income smoothing and AD is accelerated depreciation. According to the regression equation established, taking all factors into account (tax avoidance, income smoothing and accelerated depreciation) constant at zero, financial performance will be -5.606. The data findings analyzed also showed that taking all other independent variables at zero, a unit increase in tax avoidance will lead to a 1.336 increase in financial performance; a unit increase in income smoothing will lead to a 0.820 decrease in financial performance, a unit increase in accelerated depreciation will lead to a 1.759 increase in financial performance. This infers that accelerated depreciation contribute more to financial performance of firms listed at the NSE in Kenya in Kenya followed by tax avoidance. At 5% level of significance and 95% level of confidence, tax avoidance had a 0.008 level of significance; income smoothing showed a 0.021 level of significant, accelerated depreciation showed a 0.000 level of significant hence the most significant factor is accelerated depreciation.

4.3 Discussion of the findings:

The aim of this study was to provide evidence of the influence of creative accounting on financial performance of firms listed at the Nairobi Securities Exchange in Kenya. The results of this study found out that creative accounting significantly influences financial performance among companies listed at the NSE.

These findings concur with the findings of other researchers e.g., according to Kamau, Mutiso and Ngui (2012), tax avoidance and evasion is a motivator of the practice of creative accounting for the purposes of evading and avoiding tax among companies in Kenya. Their study found out that creative accounting is widely practiced among companies in Kenya. The study established that the tax avoidance and evasion is a major motivation that drives practice of creative accounting. Examples of tax avoidance at the abusive extreme include attempts to shelter income from tax authorities via underreporting income, overstating deductions, non-filing, underpayment, and abusive tax shelters (Slemrod, 2004).

Tax avoidance activities are traditionally regarded as tax saving devices that transfer resources from the government to shareholders, and thus should increase after-tax value of the firm (Desai and Dharmapala, 2009). An emerging literature in financial economics, however, emphasizes agency cost implications of tax avoidance and suggests that tax avoidance may not always increase the wealth of outside shareholders (Wang, 2010). In accordance with this alternative view, tax avoidance activity may contribute to managerial rent extraction, which ranges from theft of corporate earnings and earning manipulation to excessive executive compensation, in various forms. Tax avoidance may potentially reduce the after-tax value of the firm, since the combined costs of company, which include costs directly related to tax planning activities, additional compliance costs, and non-tax costs e.g. agency costs may surpass the tax benefits for shareholders (Wang, 2010).

Tax avoidance activities that reduce transfers from stockholders to the government should generally enhance shareholder wealth. However, an emerging stream of literature, which examines tax avoidance in an agency framework, suggests that opportunistic managers employ the technologies of tax avoidance to advance managerial, rather than shareholder, interests (Desai and Dharmapala 2009)

Many empirical studies have found a negative relationship between earnings volatility and firm value (e.g. Lambert 1984; Minton and Schrand 1999; Rountree, Weston, and Allayannis 2008). Lambert (1984) shows that a risk-averse manager who cannot access the capital markets has the incentive to smooth reported income. Trueman and Titman (1988) show that in their economic model setting, even if managers are not risk-averse and the firm cannot borrow/lend from capital markets, income smoothing still increases the firm’s market value.

A study conducted by Graham, Harvey, and Rajgopal (2005) indicates that most CFOs believe that earnings are the key metric considered by outsiders, and seventy-eight percent of the 400 executives in their sample would rather sacrifice the long-term value to smooth reported earnings. When the manager of a firm has the option to choose the time when income is recognized, he or she may prefer the accounting measurement and reporting rules that are expected to result in more smoothed income streams. Recent empirical work by Rountree, Weston, and Allayannis (2008) suggests that earnings volatility decreases firm value.

Moreover company directors may keep an income-boosting accounting policy change in hand to distract attention from unwelcome news. According to Griffiths (1986) as cited by Amat et al (1999), creative accounting may help maintain or boost a company's share price by reducing the apparent levels of borrowing, thereby making the company less susceptible to risk, and by creating the appearance of a good profit trend. This helps the company to raise capital from new share issues, offer their own share in takeover bids, and resist takeover by other companies. However, where the directors engage in "insider dealing" in their company's shares, they can use creative accounting to delay the release of information, thereby enhancing their opportunity to benefit from inside knowledge.

5. SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

Summary:

The aim of this study was to provide evidence of the influence of creative accounting practices on financial performance of public limited companies in Kenya listed at the Nairobi Securities Exchange. This was to help the researcher assert that creative accounting practices (tax avoidance, income smoothing and accelerated depreciation) are part of the strong factors influencing financial performance among companies in Kenya listed at the Nairobi Securities Exchange. The summary elaborates on how specific objectives influenced financial performance and highlights areas of suggested recommendations.

The study revealed that majority of the employees had high levels of education and possessed the necessary qualification. This means that there is better decision making and efficient work force that can lead to achieving the firm's financial goals and objectives.

The study also revealed that tax avoidance has a major influence on financial performance of the firm. Under tax avoidance aspect, tax incentives has a significant influence on firm's profitability showing that tax avoidance impacts financial performance as represented by a mean of 2.20. The findings also established that tax avoidance is a legal practice but management took advantage of the practice to manipulate firms profits and this was indicated by a majority of respondents (mean of 2.00) attesting to that assertion. On the factor of tax avoidance still, majority of respondents believed that continuous practice of tax avoidance does not lead to better management of organizations. Also the findings established that most of the tax savings made from tax avoidance activities were misappropriated concurring with an emerging stream of literature, which examines tax avoidance in an agency framework that suggests that opportunistic managers employ the technologies of tax avoidance to advance managerial, rather than shareholder, interests (Desai and Dharmapala 2009).

The findings also established that income smoothing has a hand in influencing financial performance and its practice resulted in decrease in financial performance. Majority of respondents thought that always organizations do not achieve a steady growth in profits and this was indicated with a mean of 4.93. Also the findings established that organizations do transfer transactions from period to period to manage profitability and this was indicated by a mean of 2.14. Others measures looked at to check income smoothing were management engagement in delaying and pre-invoicing sales to attain their set targets, management classification of operating cash flows under investing or financing cash flows, sale off of an asset and leasing it back to increase profits and majority agreed to this assertions and they attributed this to tough economic times although this truly has a negative impression on financial performance but reveals a good impression to the investors since reporting of volatile growth in profits negatively affects firm value.

The research revealed that accelerated depreciation significantly influence financial performance of firms the respondents feel, firms do take advantage of accelerated depreciation to improve their financial performance as 12% of the respondents strongly agreed to that assertion, 40% of the respondents agreed, 14% or the respondents were neutral, 30% strongly disagreed while 4% of the respondents disagreed. The research also revealed that 60% correspondence agreed that the criteria used to determine depreciation rate aimed at creative accounting, 12% correspondence remained neutral to the statement while 28% correspondence disagreed with the assertion. The research further revealed that 48% of respondents agreed that companies relies on or takes advantage of certain cost recovery provisions such as accelerated depreciation to creatively present the firm's financial performance, 16% of the respondents were neutral while 36% of the respondents disagreed with the assertion. The high percentage in support of the assertion reflects what is happening currently in Kenya where firms are struggling with competition hence falling to creative accounting to rescue their financial performance and also mangers to appease their employers to ensure security of their tenure.

Also the research showed that 52% correspondence disagreed that the recovery methods in question 27 help organizations manage cash flows better. The study also revealed that 64% of the respondents agreed to the assertion that there were areas in the rules governing depreciation that should be evaluated or modified in tax reform. The research revealed that 56% of the respondents agreed that management of organizations practiced overstatement of asset write-offs showing a sign of manipulation.

Lastly the research revealed that the three independent variables that were studied, explain only 63.3% of the factors affecting financial performance among firms listed at the Nairobi Securities Exchange in Kenya as represented by the R^2. This therefore means that other factors outside the model contribute 36.7% influence on financial performance of firms listed at the Nairobi Securities Exchange. Thus the study reveals that creative accounting practices are important in the financial performance.

Conclusions:

Creative accounting offers a dreadful challenge of the accounting profession which when carried to the extreme negative has cast aspersion on the credibility of accounting principles and standards and also financial performance. In general, Creative Accounting lends itself as a deceitful and undesirable practice and it should not be practiced. Hence, the need for regulators and professional bodies to work towards the need for strengthening enforcement and monitoring mechanisms which would assist to enhance the quality of financial reporting as well as rebuild and sustain the warning confidence of financial investors.

Tax Avoidance:

The study concludes that tax avoidance pose both constructive and destructive influence on financial performance depending on the accounting choices, estimates and other practices allowed by accounting regulation but destructs firms performance when management takes advantage of these practices to misappropriate and manipulate profits and savings on tax avoidance hence resulting to major collapse of firms as seen in a number of firms collapsing and others struggling locally and internationally.

The study also concludes that with proper practice and advisory of tax avoidance and sound controls in place firms can use tax savings from the practice to improve financial performance as indicated in the findings that most of the savings are misappropriated.

Income Smoothing:

The study also concludes that most firms engage in smoothing of incomes rather than reporting volatile profits. The also concurs with conclusions made by other researchers who found a negative relationship between earnings volatility and firm value (e.g. Lambert 1984; Minton and Schrand 1999; Rountree, Weston, and Allayannis 2008). Lambert (1984) shows that a risk-averse manager who cannot access the capital markets has the incentive to smooth reported income. Prior research has documented that firms consistently engage in income smoothing activities (Beidleman, 1973; Ronen and Sadan, 1981; Healy, 1985; Hunt, Moyer, and Shevlin, 1995; Chaney, Jeter, and Lewis, 1996; DeFond and Park, 1997). For example, DeFond and Park (1997) find evidence that when a firm's current performance is poor relative to expected future performance, managers tend to smooth income by increasing accruals, i.e., "borrow" future earnings for use in the current period.

Accelerated Depreciation:

The study also concluded that accelerated depreciation significantly influences financial performance in that it most managers were noted to take advantage of it to creatively present firms financial status. The study also concludes that utilization of accelerated depreciation was aimed at overstatement of asset write offs which portrayed the impression of companies to be performing well financially which didn't reflect a true and fair view of the companies financial status.

Recommendations;

Based on the findings of this study, the researcher proposes the following recommendations:

Tax Avoidance:

The management should be more committed to displaying proper agency roles delegated to them by the shareholders so as to embrace sound custodians of the firm's assets and towards attainment of organizations financial success especially

when it comes to utilizing savings made from tax avoidance and practicing tax avoidance within the accounting regulations and also practicing tax avoidance in the best interest of the shareholders.

Income Smoothing:

There should also proper internal systems to curb the vice of income smoothing practice among the management of firms which transforms to poor financial performance or collapse of most companies Income smoothing should be hedged since the practice does not give a true reflection of firms financial performance.

Accelerated Depreciation:

The researcher also recommends management should use cost recovery methods such as accelerated depreciation effectively to manage firms better since the findings shows that mismanagement of cash flows has been the norm

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