

**ACCOUNTING DISCRETION, AUDIT QUALITY AND
EARNINGS PREDICTABILITY OF LISTED FIRMS IN
KENYA**

BEATRICE WANJIRU NDUNGU

**DOCTOR OF PHILOSOPHY IN
ACCOUNTING**

**JOMO KENYATTA UNIVERSITY
OF
AGRICULTURE AND TECHNOLOGY**

2026

**Accounting Discretion, Audit Quality and Earnings Predictability of
Listed Firms in Kenya**

Beatrice Wanjiru Ndungu

**A Thesis Submitted in Partial Fulfilment of the Requirements
for the Degree of Doctor of Philosophy in Accounting of the
Jomo Kenyatta University of Agriculture and Technology**

2026

DECLARATION

This thesis is my original work and has not been presented for a degree in any other University

Signature.....Date.....

Beatrice Wanjiru Ndungu

This thesis has been submitted for examination with our approval as the University Supervisors

Signature.....Date.....

Dr. Tobias Olweny, PhD

JKUAT, Kenya

Signature.....Date.....

Dr. Gordon Opuodho, PhD

JKUAT, Kenya

DEDICATION

I dedicate this thesis to my parents; Mr. John Ndungu and Mrs. Purity Ndungu, my brothers and all extended family members whose unwavering encouragement and support laid the foundation for the beginning and successful end of this journey. To my children Michelle and Amaya, for you both, I never gave up. May this achievement remind you that with commitment and perseverance anything is achievable.

ACKNOWLEDGEMENT

I wish to express my deepest appreciation to my supervisors for their invaluable guidance, constructive feedback, and unwavering support throughout the development of this thesis. Your insightful advice, rigorous intellectual engagement, and encouragement during numerous meetings, often under demanding timelines, were instrumental to the success of this work.

My sincere gratitude also goes to the panelists and former colleagues at Jomo Kenyatta University of Agriculture and Technology. Your mentorship, constructive critiques, and collaborative spirit have significantly contributed to shaping my scholarly journey.

I am equally indebted to the entire Mama Ngina University College fraternity for their steadfast support over the past three years. The enabling environment, resources, and facilitation you provided were vital to the completion of this research.

Finally, I extend heartfelt thanks to my family and friends and all others who have stood by me. Your patience, encouragement, and unwavering belief in my abilities have been a constant source of strength and motivation.

TABLE OF CONTENTS

DECLARATION.....	ii
DEDICATION.....	iii
ACKNOWLEDGEMENT.....	iv
TABLE OF CONTENTS.....	v
LIST OF TABLES	xiii
LIST OF FIGURES	xv
LIST OF APPENDICES	xvi
ACRONYMS AND ABBREVIATIONS.....	xvii
DEFINITION OF OPERATIONAL TERMS	xxi
ABSTRACT	xxiv
CHAPTER ONE	1
INTRODUCTION.....	1
1.1 Background of the Study.....	1
1.1.1 Earnings Predictability	2
1.1.2 Accounting Discretion	4
1.1.3 Nairobi Securities Exchange, Kenya.....	10
1.2 Statement of the Problem	13

1.3 Objectives of the Study	15
1.3.1 General Objective.....	15
1.3.2 Specific Objectives.....	15
1.4 Hypotheses of the Study	15
1.5 Significance of the Study	16
1.5.1 Significance to Investors	16
1.5.2 Significance to Regulatory Bodies.....	17
1.5.3 Significance to Research and Academia	17
1.6 Scope of the Study	18
1.7 Limitations of the Study.....	19
CHAPTER TWO	21
LITERATURE REVIEW.....	21
2.1 Introduction	21
2.2 Theoretical Review	21
2.2.1 Information Signaling Theory.....	21
2.2.2 Efficient Market Hypothesis	23
2.2.3 Efficient Contracting Theory	26
2.2.4 Agency Theory.....	28

2.3 Conceptual Framework	30
2.3.1 Earning Predictability	31
2.3.2 Cost Classification Shifting.....	34
2.3.3 Fair Value Accounting Estimates	36
2.3.4 Voluntary Disclosure Index	38
2.3.5 Accruals Earnings Management	41
2.3.6 Audit Quality.....	43
2.4 Empirical Literature	46
2.4.1 Cost Classification Shifting and Earnings Predictability	46
2.4.2 Fair Value Accounting Estimate and Earnings Predictability	53
2.4.3 Voluntary Disclosures and Earnings Predictability	59
2.4.4 Accruals Earnings Management and Earnings Predictability	64
2.5 Critique of Literature.....	70
2.6 Research Gaps	73
CHAPTER THREE	76
RESEARCH METHODOLOGY	76
3.1 Introduction	76
3.2 Research Philosophy	76

3.3 Research Design.....	78
3.4 Target Population.....	79
3.4.1 Census	80
3.5 Data and Data Collection Techniques.....	80
3.6 Data Processing and Analysis	82
3.7 Model Specification	84
3.7.1 General Panel Data Model	84
3.8 Diagnostic Model Tests	88
3.8.1 Normality Test	88
3.8.2 Panel Unit Root Test of Multicollinearity.....	88
3.8.3 Autocorrelation Test	89
3.8.4 Heteroscedasticity Test	89
3.9 Tests of Hypothesis.....	90
3.10 Variable Operationalization	90
CHAPTER FOUR.....	95
RESEARCH FINDINGS AND DISCUSSION.....	95
4.1 Introduction.....	95
4.2 Descriptive Statistics.....	95

4.2.1 Earnings Predictability	98
4.2.2 Cost Classification Shifting.....	99
4.2.3 Discretionary Accruals.....	101
4.2.4 Voluntary Disclosure Index	102
4.2.5 Fair Value Accounting Estimates	102
4.2.6 Audit Quality Index.....	103
4.3 Diagnostics Tests Results.....	103
4.3.1 Normality Test	104
4.3.2 Stationarity Test	105
4.3.4 Heteroscedasticity Test	106
4.3.5 Autocorrelation Test	107
4.3.6 Multicollinearity Test.....	109
4.4 Correlation Analysis.....	110
4.4.1 Hausman Test.....	119
4.5 Bivariate Regression Analysis	121
4.5.1 Influence of Cost classification on Earnings Predictability	121
4.5.2 Influence of Fair Value Accounting Estimates on Earnings Predictability ..	125
4.5.3 Influence of Voluntary Disclosures on Earnings Predictability.....	129

4.5.4 Influence of Accruals Earnings Management on Earnings Predictability	133
4.5.5 Relationship between Audit Quality and Earnings Predictability.....	137
4.6 Moderating effect of audit quality.....	140
4.6.1 Moderating Effect of Audit Quality on the Relationship between Cost Classification Shifting and Earnings Predictability of Listed Firms in Kenya	140
4.6.2 Moderating Effect of Audit Quality on the Relationship between Fair Value Accounting Estimates and Earnings Predictability of Listed Firms in Kenya	144
4.6.3 Moderating Effect of Audit Quality on the Relationship between Voluntary Disclosures and Earnings Predictability of Listed Firms in Kenya	148
4.6.4 Moderating Effect of Audit Quality on the Relationship between Accruals Earnings Management and Earnings Predictability of Listed Firms in Kenya	152
4.7 Overall Model Multivariate Panel Regression Analysis without Moderator.....	155
4.7.1 Hypothesis Test Results for the Independent Variables without Moderating Variable	158
4.8 Moderating Effect of Audit Quality on the Relationship between the Independent Variables and Earnings Predictability	160
4.8.1 Hypothesis Test Results for the Independent Variables with Moderating Variable	162
CHAPTER FIVE.....	165

SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS . 165

5.1 Introduction	165
5.2 Summary of Findings	165
5.2.1 To Determine the Effect of Cost Classification Shifting on Earnings Predictability of Listed Firms in Kenya	165
5.2.2 To Examine the Effect of Fair Value Accounting Estimates on Earnings Predictability of Listed Firms in Kenya	166
5.2.3 To Assess the Effect of Voluntary Disclosures on Earnings Predictability of Listed Firms in Kenya	166
5.2.4 To Determine the Effect of Accruals Earnings Management on Earnings Predictability of Listed Firms in Kenya	167
5.2.5 To Examine the Moderating Effect of Audit Quality on the Relationship between Accounting Discretion and Earnings Predictability.....	167
5.3 Conclusions	167
5.4 Recommendations	169
5.4.1 Policy Recommendations	169
5.4.2 Practice Recommendations	170
5.5 Contribution to Knowledge and Areas of Further Research	171
5.5.1 Contribution to Knowledge.....	171
5.5.2 Suggested Areas for Further Research	172

REFERENCES.....	174
------------------------	------------

APPENDICES	193
-------------------------	------------

LIST OF TABLES

Table 3.1: Data Measures and Sources	81
Table 4.1: Sectoral Statistics	96
Table 4.2: Overall Descriptive Statistics.....	97
Table 4.3: SGA Cost and Sales Descriptive Statistics	99
Table 4.4: Audit Report Lag	103
Table 4.5: Test of Normality	104
Table 4.6: Unit Root Test.....	105
Table 4.7: Breusch-Pagan / Cook-Weisberg test for heteroscedasticity	107
Table 4.8: Durbin-Watson Test.....	108
Table 4.9: Test for Multicollinearity	109
Table 4.10: Overall Correlation Analysis	111
Table 4.11: Presents the Results for the Hausman Specification Test	120
Table 4.12: Model Summary, ANOVA and Beta Coefficients for Cost Classification and Earnings Predictability	122
Table 4.13: Model Summary, ANOVA and Beta Coefficients for Fair Value Accounting Estimates on Earnings Predictability.....	126
Table 4.14: Model Summary, ANOVA and Beta Coefficients Voluntary Disclosures on Earnings Predictability	130

Table 4.15: Model Summary, ANOVA and Beta Coefficients Accruals Earnings Management on Earnings Predictability	134
Table 4.16: Model Summary, ANOVA and Beta coefficients Audit Quality on Earnings Predictability	137
Table 4.17: Moderated Model Summary, ANOVA and Beta Coefficients for Cost Classification and Earnings Predictability	140
Table 4.18: Moderated Model Summary, ANOVA and Beta Coefficients for Fair Value Accounting Estimates on Earnings Predictability	144
Table 4.19: Moderated Model Summary, ANOVA and Beta Coefficients for Voluntary Disclosures on Earnings Predictability	148
Table 4.20: Moderated Model Summary, ANOVA and Beta Coefficients for Accruals Earnings Management on Earnings Predictability	152
Table 4.21: Overall Regression Model Summary, ANOVA and Beta Coefficients.....	156
Table 4.22: Hypothesis Test without Moderating Variable	159
Table 4.23: Overall Moderated Regression Model Summary, ANOVA, Beta Coefficients	160
Table 4.24: Hypothesis Test with Moderating Variable	162

LIST OF FIGURES

Figure 1.1: Tradingeconomics.com/ NSE.....	12
Figure 4.1: PER Trend Descriptive Statistics	98
Figure 4.2: Discretionary Accruals Trend.....	101

LIST OF APPENDICES

Appendix I: Secondary Data Collection Sheet	193
Appendix II: Listed Firms at Nairobi Securities Exchange.....	195

ACRONYMS AND ABBREVIATIONS

ABC	Activity-Based Costing
ACVD	Accruals and Voluntary Disclosures
AEM	Accrual Earnings Management
AI	Artificial Intelligence
AMEX	American Stock Exchange
ANOVA	Analysis of Variance
AQI	Audit Quality Index
CAPM	Capital Asset Pricing Model
CEO	Chief Executive Officer
CFO	Chief Finance Officer
CG	Corporate Governance
CMA	Capital Markets Authority
COGS	Cost of Goods Sold
CSR	Corporate Social Responsibility
CVP	Cost–Volume–Profit Analysis
DA	Discretionary Accruals
DAC	Discretionary Accruals Component
DSE	Dar es Salaam Stock Exchange
DW	Durbin-Watson Test
EAC	East African Community

EBITDA	Earnings before Interest, Taxes, Depreciation, and Amortization
EMH	Efficient Market Hypothesis
EPS	Earnings per Share
ERP	Enterprise Resource Planning
ESG	Environmental, Social, and Governance
EXVD	Explanatory Voluntary Disclosures
EY	Ernst & Young
FV	Fair Value
FVA	Fair Value Accounting
FVAE	Fair Value Accounting Estimates
FVI	Fair Value Index
GAAP	Generally Accepted Accounting Principles
GRI	Global Reporting Initiative
H₀	Null Hypothesis
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICPAK	Institute of Certified Public Accountants of Kenya
IFRS	International Financial Reporting Standards
IFRS	International Financial Reporting Standards
II	Integrated Information
IIRC	International Integrated Reporting Council

IPO	Initial Public Offering
ISA	International Standards on Auditing
KAM	Key Audit Matters
NAS	Non-Audit Services
NDAC	Non-Discretionary Accruals
NI	Net Income
NSE	Nairobi Securities Exchange
NSE-20	Nairobi Securities Exchange 20 Share Index
NYSE	New York Stock Exchange
OLS	Ordinary Least Squares
PCAOB	Public Company Accounting Oversight Board
PER	Price Earnings Ratio
PPE	Property, Plant, and Equipment
PSASB	Public Sector Accounting Standards Board
P-value	Probability Value
R&D	Research and Development
R²	Coefficient of Determination
RBZ	Reserve Bank of Zimbabwe
RDAC	Related Discretionary Accrual Components
RDC	Ratio of Discretionary Accruals Components
ROA	Return on Assets
ROE	Return on Equity

SFAS	Statement of Financial Accounting Standards
SG	Sales Growth
SG&A	Selling, General, and Administrative expenses
SMEs	Small and Medium-sized Enterprises
SOI	Strategic Operating Information
TA	Total Accruals
USA	United States of America
USE	Uganda Securities Exchange
VDI	Voluntary Disclosure Index
VIF	Variance Inflation Factor

DEFINITION OF OPERATIONAL TERMS

Accounting Discretion the permitted latitude under accounting standards (such as IFRS or GAAP) that allows management to make judgments, estimates, or choices in how financial transactions are recognized, measured, and disclosed. This includes the selection among alternative accounting policies, estimation of accruals (both discretionary and non-discretionary), timing of recognition of revenues and expenses, and real business decisions that influence financial statement outcomes (Bowen, Rajgopal, & Venkatachalam, 2008).

Accruals Earnings Management A concept of earnings management that means to manipulate the earnings through the utilization of accounting principles provided by GAAP. It's an efficient earnings prediction technique that uses income smoothing and or discretionary accruals (Simamora, 2018).

Audit Quality the International Auditing and Assurance Standards Board (IAASB) defined audit quality as encompassing “the ability of the audit to enhance confidence in financial reporting through auditors’ competence, values, ethics, and independence, supported by strong audit processes and governance.” (IAASB, 2014).

Audit Quality Index This is a composite of indicators of qualitative measure that show insights about how a quality audit reports are achieved. It covers three concepts: audit professionals, audit process and audit results aiming to make an inherently unobservable construct measurable for regulators, investors, and academics. (*Public Companies Accounting Oversight Board*, 2015).

Cost Classification Shifting Shifting includes shifting expenses from operating expense to non-recurring expenses in order to increase core earnings. The intention to overstate core performance to achieve self-motivated reporting objectives. This is done with core expenses are less likely to persist thus influencing cost behavior estimation (Ha & Thomas, 2018).

Cost Stickiness a phenomenon in which costs increase more when sales increase than they decrease when sales decrease by an equivalent amount (Sun, Ho, Gu and Chen, 2019).

Discretionary Accruals the part of the total accruals that managers can manipulate based on their intentions; whether that's to meet targets, smooth earnings, or portray a healthier financial position within the constraint of accounting principles (Ghazali, Shafie and Sanusi, 2015).

Earnings Predictability the extent to which investors can predict future earnings and/or future cash flows of a firm based on current financial performance as indicated by financial reports (Nor & Ku, 2013).

Fair Value Accounting The accounting method which uses Fair Value measurements and captures the changes in value of assets and liabilities over time (Sapkauskiene & Orlovskij, 2017).

Fair Value Accounting Estimates management's approximations of the market-based value of assets or liabilities at the reporting date, determined using observable market data where available, or valuation techniques when market prices cannot be directly observed (IFRS 13; International Accounting Standards Board, 2021).

Voluntary Disclosures is the intentional release of financial and non-financial information by managers beyond what is mandatorily required by accounting standards or regulation, with the aim of reducing information asymmetry, building transparency, and influencing stakeholders' perceptions (Kılıç, Uyar, & Kuzey, 2019).

ABSTRACT

For earnings information to be considered relevant, it must demonstrate both predictive value and confirmatory value. Investors and other users of financial statements rely on the extent to which reported earnings can effectively forecast future firm performance. In Kenya, despite listed firms occasionally posting positive EPS, the NSE 20 Share Index has experienced sharp decline dropping from an all-time high of Ksh 6,161.46 billion in January 2007 with lowest numbers recorded between 2016 and 2020. We investigate whether discretionary accounting practices enhance or diminish the predictability of earnings for listed firms in Kenya. The research is anchored on the efficient contracting theory, information signaling theory, the efficient market hypothesis and agency theory, it conceptualizes on four key measures of accounting discretion: cost classification shifting, fair value accounting estimates, voluntary disclosures, and accruals earnings management. Empirical literature reviewed identifies audit quality as a moderating variable that mitigates the effects of accounting discretion. An unbalanced panel dataset comprising 650 firm-year observations was utilized, reflecting variations in data availability across the 13-year period between 2010 and 2022. The empirical analysis employed descriptive statistics, Pearson correlation, and multiple regression models, followed by moderated regression analysis to assess interaction effects. Descriptive statistics revealed notable heterogeneity across firms, with variables exhibiting both positive and negative skewness and kurtosis, indicating non-normal distributions and the presence of extreme values. This supported the use of robust estimation techniques. Pearson correlation results indicated that earnings predictability had a significant negative association with cost classification shifting and fair value accounting estimates, while being positively and significantly correlated with audit quality. Simple linear regression results showed that cost classification shifting significantly reduced earnings predictability, while fair value accounting estimates had the strongest negative impact. Accruals earnings management exhibited a positive effect on earnings predictability, whereas voluntary disclosures had no statistically significant effect. The overall multiple regression model, incorporating all four measures of accounting discretion, explained 49.0% of the variation in earnings predictability. Within this model, fair value accounting estimates and cost classification shifting retained their negative effects, while accruals earnings management maintained a positive influence. Voluntary disclosures remained statistically insignificant. Moderated regression analysis revealed that audit quality significantly enhanced the positive impact of accruals earnings management on earnings predictability and reduced the adverse effect of fair value accounting estimates. The moderated model explained 56.3% of the variance in earnings predictability, indicating strong explanatory power. The findings suggest that certain forms of accounting discretion, particularly fair value measurements and classification shifting, undermine earnings predictability, potentially due to their reliance on subjective estimates and opportunities for opportunistic financial reporting. In contrast, accrual-based discretion can enhance predictive accuracy, particularly when subject to high-quality external audit oversight. The study makes several contributions: empirically, it provides evidence from an African emerging market context, where financial reporting environments differ

significantly from developed economies; methodologically, it validates the use of unbalanced panel data in corporate finance research; and practically, it offers policy insights for regulators, investors, and corporate boards. Key recommendations include enhancing IFRS compliance, improving cost allocation transparency, mandating higher audit quality standards, and implementing targeted training for preparers of financial statements.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The two principal qualitative characteristics of accounting information are reliability and relevance. For earnings figures to be relevant, they must possess both predictive and confirmatory value. Users of accounting data depend on the efficiency with which earnings numbers can forecast future performance for firm valuation purposes (Dichev & Tang, 2009). According to Licerán-Gutiérrez and Cano-Rodríguez (2017), the quality of earnings reflects the extent to which reported figures provide decision-useful information from both economic and accounting perspectives. In this regard, earnings predictability, the ability of current earnings to forecast future earnings is considered a critical indicator of earnings quality (Salawu, 2019).

Investor analysis of firm value relies on the dependability of current accounting numbers and the ability to use them to make informed forecasts of future earnings. For instance, a basic investor might analyze trends and cross-sectional data on firms' financial performance to estimate potential returns on investment. From a regional perspective, the capital markets in Sub-Saharan Africa, including South Africa, Nigeria, and Kenya, have increasingly emphasized the role of high-quality financial reporting in attracting both domestic and foreign investment. Regional stock exchanges, guided by International Financial Reporting Standards (IFRS), seek to enhance transparency and comparability across firms. However, studies in emerging African markets reveal that accounting discretion, when unchecked by governance structures, can undermine earnings quality and diminish market confidence (Ntim, Soobaroyen & Broad, 2017).

In Kenya, the Nairobi Securities Exchange (NSE) serves as a vital platform for capital raising, yet it operates in a context where information asymmetry, inconsistent disclosure practices, and occasional earnings manipulation have been documented (Mwangi &

Njoroge, 2022). Regulatory bodies such as the Capital Markets Authority (CMA) have tightened reporting requirements, but the discretionary nature of certain accounting treatments remains a concern for market efficiency. For local investors, earnings predictability is not merely an academic measure but a practical necessity for investment decision-making in a market still characterized by relatively low liquidity and concentrated ownership structures.

1.1.1 Earnings Predictability

Earnings, often referred to as the “bottom line” of the income statement, represent a firm’s ability to generate and grow shareholders’ wealth as well as forecast its future performance (Simamora, 2018). Predictability is influenced by both economic and accounting factors (Ibrahim, Dogarawa and Bello, 2019). Economic factors incorporate market price mechanisms, whereas accounting factors are shaped by managerial accounting decisions. Fei (2015) observes that undetected accounting errors such as poor record-keeping, weak corporate governance, low audit quality, and breaches of professional ethics are magnified during economic crises.

Earnings per share (EPS) is among the most closely monitored indicators for investors (Jadhav, He, & Jenkins, 2015). However, fluctuations in earnings trends can hinder accurate forecasting and thereby affect expected returns (Silhan, 2014). To integrate market pricing into predictive models, Goh and Simanjuntak (2018) use the price–earnings ratio, calculated by dividing share price by EPS, as a measure of earnings variability.

Because earnings are critical to forecasting, management may sometimes use both legal and illegal techniques to meet earnings targets. Studies suggest that earnings predictability is shaped by factors such as earnings quality, earnings response coefficients, management forecasts, decision-making strategies, and firm-specific characteristics such as performance and size (Luttman & Silhan, 2011). Building on earlier work by Fairfield et al. (1996) and Kothari (2001), Banker and Chen (2006) note that decomposing earnings

into operating and non-operating components enhances time-series prediction models. This is because earnings variability depends not only on operational performance but also on the extent of managerial intervention in financial reporting, such as accrual management to smooth earnings.

From a risk assessment perspective, accountants often measure risk using earnings variability or financial leverage. If both market-based and accounting-based measures align, investors can reliably use accounting data to assess risk–return expectations (Jarvela, Kozyra and Potter, 2011). Accounting-based measures are more direct and require fewer assumptions than market-based ones. In Kenya, however, most studies on earnings predictability have relied on stock market trends, often focusing on securities price movements rather than integrating both market and accounting measures.

Earnings predictability is a recurring focus in financial research due to its implications for investment decision-making, valuation accuracy, and market stability. In emerging markets such as Kenya where financial systems are developing and regulatory enforcement varies predictability takes on heightened importance. Reliable earnings enable stakeholders to assess firm performance and future prospects with greater confidence. However, factors such as earnings manipulation, weak audit oversight, and inconsistent application of accounting standards can impair predictability. Consequently, identifying firm-specific and environmental factors that enhance or hinder earnings predictability remains a priority (Healy & Palepu, 2001).

Earnings quality plays a central role in this relationship. High-quality earnings stem from core operating activities, involve minimal managerial discretion, and closely reflect underlying cash flows. Dechow and Schrand (2004) argue that earnings closely correlated with future cash flows are more predictive of future performance. Conversely, aggressive revenue recognition, creative accounting, or excessive accrual use can distort performance signals and mislead stakeholders. In Kenya, the adoption of International Financial Reporting Standards (IFRS) is intended to enhance financial transparency, though challenges remain.

Audit quality is another determinant of earnings predictability. High-quality audits help curb managerial opportunism, reduce information asymmetry, and improve the credibility of earnings reports (Simunic & Stein, 2012). Engagements with reputable audit firms particularly the Big Four are more likely to ensure compliance with standards and detect misstatements. In Kenya, this is increasingly relevant given the Capital Markets Authority's (CMA) growing scrutiny of listed firms.

Voluntary disclosures also influence predictability by providing information beyond statutory requirements. Firms that provide detailed, consistent, and relevant voluntary disclosures can reduce information asymmetry and improve investor forecasts (Healy & Palepu, 2001). In Kenya, companies that adopt international best practices in disclosure especially in the banking and manufacturing sectors tend to exhibit more predictable earnings patterns.

Finally, regulatory frameworks and corporate governance structures are pivotal. Strong oversight discourages manipulation, while effective governance promotes transparency, accountability, and alignment between management and shareholders. In jurisdictions with weak enforcement including Kenya opportunities for manipulation are greater, potentially reducing predictability. Strengthening institutional capacity, such as enhancing the independence and effectiveness of the Institute of Certified Public Accountants of Kenya (ICPAK), could improve earnings quality and predictability in the long term.

1.1.2 Accounting Discretion

High-profile corporate scandals such as Enron and WorldCom illustrate that accounting discretion can be misused, allowing managers to exploit governance weaknesses and take advantage of flexibility within generally accepted accounting principles (GAAP) to increase personal wealth at the expense of shareholders (Bowen, Rajgopal, & Venkatachalam, 2008). The 2008 global financial crisis further intensified debates around the role of discretion in fair value accounting (Fiechter & Meyer, 2008).

International Financial Reporting Standards (IFRS) provide management with considerable latitude to exercise judgment in selecting accounting policies, measurement bases, and estimates when preparing financial statements (Bowen, Rajgopal & Venkatachalam, 2008). While such discretion can be used efficiently to communicate relevant information, it can also be applied opportunistically (Kazemian & Sanusi, 2015). Simamora (2018) argues that managerial actions may serve as either legitimate signals to the market or self-serving opportunistic behavior both of which increase information asymmetry between management and external stakeholders. Investor preferences and behavior can often be observed indirectly through indicators such as market capitalization.

García-Sánchez et al. (2019) classify accounting discretion into three determinants: the first being individual factors which entail the personal capacity and motivation of managers to make accounting choices, secondly, organizational factors which are the degree of flexibility permitted by the firm's internal structures and lastly environmental factors; the external conditions, such as regulatory frameworks, that permit variation in choices and changes.

Applied effectively, discretion can enhance the informativeness of financial reports (Choi & Nam, 2020). However, managerial private information is often constrained by earnings management practices, which may obscure transparency. One common approach is earnings smoothing, applied to reduce negative earnings surprises (McEwen et al., 2008). While literature frequently associates earnings management with reduced reporting quality, some studies suggest it can, under certain circumstances, enhance the informational value of earnings (Sankar & Subramanyam, 2001). Fei (2015) emphasizes that opportunistic reporting behavior is often driven by pressure to meet targets and expectations, leading to compromised recognition, measurement, presentation, and disclosure practices.

Classification shifting is one earnings management method where expenses are misclassified within the income statement without altering net income typically shifting operating expenses to non-recurring expense categories to inflate core earnings (McVay,

2006). This practice distorts the persistence of earnings components and may mislead investors about future performance. While Anderson and Lanen (2007) argue that classification shifting may reflect accounting conventions rather than intentional manipulation, Haw et al. (2011) caution that it undermines the credibility of financial statements. Weiss (2010) adds that understanding cost behavior, including sticky and anti-sticky costs, is critical to accurate earnings forecasts.

Classification shifting can be difficult for auditors to detect, as it does not affect bottom-line figures (Ha & Thomas, 2018). Persistent misclassification over multiple periods may create the illusion of sustainable performance, misleading investors. Anderson et al. (2003) link cost stickiness to managerial discretion in resource allocation decisions. Han et al. (2019) further note that such decisions are often influenced by expectations about future demand. Lu and Homburg (2013) identify managerial overconfidence as a driver of cost stickiness, with managers retaining selling, general, and administrative (SG&A) costs in anticipation of demand recovery. Similar overconfidence effects have been observed in capital expenditure decisions (Malmendier & Tate, 2005) and R&D spending (Hirshleifer et al., 2012).

From an African perspective, Ibrahim (2018) finds that Ethiopian management accountants carefully evaluate cost accounting techniques such as standard costing, activity-based costing, and cost–volume–profit analysis due to the non-constant nature of cost behavior. The study recommends that corporate governance reforms, including smaller board sizes, separation of chairperson and CEO roles, and greater institutional ownership, could mitigate opportunistic cost stickiness. Investors and analysts should therefore factor asymmetric cost behavior into earnings forecasts.

A second domain of discretion is fair value estimation. As per International Standard on Auditing (ISA) 540, accounting estimates represent approximations in the absence of precise measurement techniques. While fair value measurement has the potential to enhance relevance, it is also subject to measurement error and manipulation particularly

in Level 2 and Level 3 inputs under IFRS 13 (van Zijl & Hewlett, 2021; Šodan, 2019). Managers may exploit these estimation uncertainties to smooth earnings.

Ball (2006) cautions that IFRS 13's allowance for managerial discretion can introduce volatility and inconsistency into financial statements. While the IASB views discretion as a means of communicating private information, empirical studies also highlight its potential misuse for example, in goodwill impairments, stock option valuations, and timing of earnings recognition (Siekkinen, 2017). In developing economies, limited auditor expertise in fair value application further compounds these challenges (E-obodoekwe & Alio, 2018).

Voluntary disclosures represent another area of discretion, referring to the release of financial and non-financial information beyond mandatory requirements (Scaltrito, 2016). By providing integrated reports detailing strategy, risks, performance, and prospects, managers can reduce information asymmetry (García-Sánchez et al., 2019). Under agency theory, effective disclosures can protect investor interests and enhance governance outcomes.

Lastly, accruals defined as the difference between reported income and cash flows are inherently subject to managerial judgment and can be manipulated to influence earnings (Wysocki, 2005). Discretionary accruals are often used alongside real earnings management to achieve smoothing objectives (Capkun & Collins, 2018). Distinguishing between discretionary and innate accruals is critical for assessing whether earnings management is opportunistic or efficiency-driven (Simamora, 2018).

African evidence shows widespread creative accounting practices, particularly in the banking sector, to boost market value perceptions (Rabin, 2005; Akenbor & Ibanichuka, 2012). In Zimbabwe, the collapse of certain banks was linked to the maintenance of dual financial records—one overstating financial strength and another revealing the true position (Reserve Bank of Zimbabwe, 2006). Egyptian companies also display wide

latitude in voluntary disclosure practices, with analysts often seeking supplementary information directly from investor relations (Elfeky, 2017; Samaha & Dahawy, 2010).

The distinction between discretion and fraud lies in legality: discretion operates within the regulatory framework, while fraud involves breach of law or standards (Kamau et al., 2016). Audit quality plays a moderating role, Waweru and Ntui (2018) find that higher audit quality is associated with lower discretionary accruals. Locally, governance failures and management opportunism have been evident in high-profile Kenyan cases, including the collapse of Uchumi Supermarkets (2004), mismanagement at the National Bank of Kenya, and near-collapse events at Unga Group and CMC Motors (Iraya, Mwangi, & Muchoki, 2015).

A 2025 Kenya-focused study documents that cost classification shifting by moving recurrent operating expenses into non-recurring lines has become a non-trivial earnings management channel among NSE issuers, reducing transparency and complicating earnings predictability. The same analysis notes patterns consistent with cost stickiness, where SG&A costs are not reduced proportionately when sales fall, amplifying forecast error and diluting the signal in core earnings. While firm names are anonymized, the study's Kenya-specific sample and 2010s–2020s time frame make the evidence directly relevant to this research.

Recent empirical work on the NSE finds that discretionary accruals remain a material driver of predictability risk firms with higher discretionary accruals exhibit noisier next-period earnings, while higher audit quality appears to curb this tendency. A 2024 peer-reviewed article on NSE companies reports a negative association between audit quality and earnings manipulation, reinforcing the moderating role hypothesized in H_{05} . Complementary Kenya-specific evidence in 2025 further links elevated accrual use to weaker forecast-ability, strengthening the case for including audit quality as a governance lever in the model.

Regulatory monitoring has tightened: the Capital Markets Authority's Seventh Edition State of Corporate Governance Report (2024) shows continued improvement in issuers' governance scores and disclosure practices, signaling stronger board oversight and audit committee functioning. Although the report is not an "earnings manipulation" study per se, it documents system-level conditions board independence, disclosure quality, and internal control maturity that theory and prior evidence link to lower classification shifting and accrual opportunism. The CMA's public enforcement framework (updated materials in 2023) also underscores reporting integrity expectations that interact with firms' financial reporting choices.

On IFRS 13 fair value, Kenyan practice materials and illustrative financial statements used by preparers and auditors emphasize the fair value hierarchy (Levels 1–3) and the need for market-participant assumptions, especially for instruments valued with Level 3 inputs. While these sources are illustrative rather than case determinations of manipulation, they highlight judgement-heavy areas (discounted cash flows, valuation of thinly traded securities) that global regulators flag as susceptible to bias. In the Kenyan context, widespread reliance on these templates and guidance suggests where measurement discretion could affect persistence and predictability of earnings. Wambugu and Gichuhi (2023) investigate fair value accounting estimates in non-financial NSE-listed firms over 2012–2021. Their results show that Level 3 fair value inputs (IFRS 13) are negatively associated with predictability while Level 1 inputs have no significant effect highlighting how subjectivity in fair value measurement can impair forecasting.

Mwangi and Njoroge (2022) assess voluntary disclosure quality for NSE firms (2011–2020) using a disclosure index from annual reports, CSR reports, and forward-looking statements. They find a positive, significant relationship between voluntary disclosure scores and predictability reinforcing the importance of disclosure practices in reducing information asymmetry. Otieno and Kimani (2023) test whether audit quality moderates the link between accounting discretion and earnings predictability for NSE-listed firms (2011–2020). They find that Big Four-audited firms show a stronger positive relationship

between core earnings and next-period EPS indicating that high audit quality mitigates the adverse effects of discretion.

NSE's integrated reports (2022–2023) and the bourse's ESG Disclosure Guidance aim to standardize narrative reporting, risk factors, and performance discussion inputs analysts increasingly combine with accrual diagnostics to forecast future earnings. Improved, comparable disclosures reduce information asymmetry and can limit room for classification shifting “in the notes,” while still leaving judgement in areas like provisions and fair value estimates. The combination of fuller issuer transparency and visible audit sign-offs gives investors better cross-checks against accrual-based signals when modelling next-period earnings for Kenyan firms.

1.1.3 Nairobi Securities Exchange, Kenya

In the Kenyan context, the Nairobi Securities Exchange (NSE) serves as a key platform for capital formation, enabling firms to raise funds while providing investors with opportunities for portfolio diversification. Kenya adopted IFRS fully in 1999 and has since aligned its accounting standards with global practices through the Institute of Certified Public Accountants of Kenya (ICPAK) and oversight from the Capital Markets Authority (CMA). While this alignment was expected to improve financial reporting quality, studies (Gichaiya, 2015; Musau et al., 2021) indicate that challenges persist in ensuring uniform application of these standards across firms, particularly in valuation-sensitive areas like investment properties, biological assets, and complex financial instruments.

The Nairobi Securities Exchange (NSE) comprises companies classified into ten sectors: Agriculture, Automobile & Accessories, Finance, Commercial & Services, Construction & Allied, Energy & Petroleum, Insurance, Investment, Manufacturing & Allied, and Telecommunications & Technology. The listing process for companies on the NSE involves compliance with corporate governance guidelines set out in the Capital Markets Authority (CMA) Code of Governance, aimed at protecting investors from undue risk exposure (CMA, 2002). One such governance requirement is the establishment of an audit

committee as part of a firm's internal control structure to ensure the quality of financial reporting. Additionally, all publicly listed companies must undergo annual audits to enhance the reliability of financial statements for investment decision-making purposes.

The NSE Investors Handbook (2015–2018) provides key ratios and market indicators that can aid in earnings prediction. This includes: Firm-specific data such as board size, type of external audit firm, Financial metrics such as revenue, profits, assets, debt, and equity levels, Key ratios: such as current ratio, EPS, dividend yield and Market indicators: share price, outstanding shares, market capitalization

The NSE 20 Share Index (NSE-20) tracks the performance of the top 20 companies listed on the exchange, selected based on a 12-month weighted market performance incorporating market capitalization, trading volume, number of deals, and turnover. However, in practice, there is often a disconnect between share price performance, EPS, and market capitalization—indicating potential weaknesses in the quality of financial statements or in investor forecasting ability (NSE Handbook, 2018).

Historically, the NSE-20 reached an all-time high of Ksh 6,161.46 billion in January 2007, but significant declines have been observed, particularly between 2016 and 2020 (Trading Economics, 2020). Other market indicators have shown similar downward trends. For instance, equity turnover dropped from Ksh 16 billion in October 2019 to Ksh 10 billion in December 2020, while the volume of shares traded decreased from 450 million to 369 million over the same period.



Figure 1.1: Tradingeconomics.com/ NSE

Source: Tradingeconomics.com/ NSE

Each listed company's board of directors bears responsibility for preparing and presenting annual financial statements in accordance with IFRS and the Kenyan Companies Act, 2015. This includes: Designing, implementing, and maintaining internal controls, Selecting suitable and consistent accounting policies and Making reasonable accounting estimates and judgments

Furthermore, the post-2010 period in Kenya presents a unique context for studying this relationship. The era witnessed Significant regulatory reforms in the capital markets, Increased foreign investor participation in the NSE, greater corporate governance scrutiny following high-profile corporate failures (e.g., Mumias Sugar, Uchumi Supermarkets) and volatility in macroeconomic indicators such as interest rates and exchange rates, which interact with firm-level financial reporting practices.

Given this background, this study focuses on the period 2010–2022, covering a complete market cycle of expansion, contraction, and recovery phases. It investigates how the four identified dimensions of accounting discretion influence earnings predictability among

NSE-listed firms and whether the effect is moderated by audit quality, an important external assurance mechanism.

1.2 Statement of the Problem

In Kenya, earnings predictability poses a significant challenge for investors and the stability of the Nairobi Securities Exchange (NSE). For instance, despite firms posting positive EPS, the NSE 20 Share Index has experienced sharp declines, dropping from an all-time high of Ksh 6,161.46 billion in January 2007 to markedly lower levels between 2016 and 2020. Similarly, market activity indicators show weakening investor response: equity turnover declined from Ksh 16 billion in October 2019 to Ksh 10 billion in December 2020, while traded volumes fell from 450 million to 369 million shares over the same period (Trading Economics, 2020). These trends illustrate that earnings figures alone do not consistently translate into investor confidence or market performance. Such mismatches can be partly attributed to limitations in prediction models (Dichev & Tang, 2009) and to inefficiencies in how markets process available financial information, including accounting anomalies (Serrano-Cinca et al., 2019).

While (IFRS) and (GAAP) permit management some discretion in financial reporting, this discretion, though technically compliant can reduce the transparency and comparability of reported earnings (Bowel et al, 2008). Prior research documents that such discretion, when opportunistically applied, diminishes investor confidence, distorts the informativeness of earnings, and dampens market activity (Waweru and Ntui (2018). The core debate in the literature remains whether managerial discretion improves earnings informativeness through signalling, or reduces it through opportunistic manipulation. This tension has fueled a longstanding debate in the literature: on one hand, managerial discretion may enhance earnings informativeness by allowing managers to signal private information about a firm's future prospects; on the other hand, it can be exploited for earnings management, thereby obscuring the firm's true financial position and misleading investors.

Some studies show that discretionary practices such as accruals management and cost behaviour adjustments can convey private information about future profitability (Li et al., 2019; Tucker & Tan, 2012), while others suggest such practices are either insignificant or misleading to investors (Sankar & Subramanyam, 2001). Similarly, research on cost stickiness (Bradbury & Scott, 2018; Banker & Chen, 2006) and fair value measurements in developed markets has yielded inconsistent findings, with little exploration in emerging market settings. Prior research has mostly examined single dimensions of discretion such as discretionary accruals or voluntary disclosures, while neglecting other significant elements, such as cost classification shifting and fair value estimates, particularly among non-financial firms. Moreover, no comprehensive study has empirically tested the joint and moderating effects of these discretion measures, alongside audit quality, on earnings predictability in an African emerging market context.

Agency theory and corporate governance literature predict that managers may use discretion to serve personal or organizational incentives, potentially harming earnings quality (Gichaiya, 2015), while signaling theory suggests that discretion may help reduce information asymmetry by embedding forward-looking insights in reported numbers. Yet in Kenya's capital markets, where information environments are less efficient, it remains unclear whether accounting discretion supports or undermines earnings predictability.

This study addresses this gap by decomposing accounting discretion into four measurable drivers; cost classification shifting, fair value accounting estimates, voluntary disclosures, and accruals earnings management, and empirically testing their individual and combined influence on earnings predictability for NSE-listed firms from 2010 to 2022. By incorporating audit quality as a moderating variable, the study further examines whether robust assurance mechanisms can mitigate the potentially adverse effects of managerial discretion. The findings contribute original evidence that, in the NSE context, certain discretionary practices (particularly fair value estimates and classification shifting) significantly impair earnings predictability, while accrual-based discretion, when coupled with high audit quality, and enhances it.

1.3 Objectives of the Study

To meet the research gap outlined, the following are the general and specific objectives of the study

1.3.1 General Objective

The general objective of the study was to establish the influence of accounting discretion on earnings predictability of listed firms in Kenya.

1.3.2 Specific Objectives

The study was guided by the following specific objectives;

- i. To assess the influence of cost classification shifting on earnings predictability of listed firms in Kenya.
- ii. To determine the influence of fair value accounting estimates on earnings predictability of listed firms in Kenya.
- iii. To establish the influence of voluntary disclosures on earnings predictability of listed firms in Kenya.
- iv. To evaluate the influence of accruals earnings management on earnings predictability of listed firms in Kenya.
- v. To determine the moderating effect of audit quality on the relationship between accounting discretion and earnings predictability of listed firms in Kenya.

1.4 Hypotheses of the Study

The null hypotheses per objective were identified as below:

H₀₁: Cost classification shifting has no significant influence on earnings predictability of listed firms in Kenya.

H₀₂: Fair value accounting estimates have no significant influence on earnings predictability of listed firms in Kenya.

H03: Voluntary disclosures has no significant influence on earnings predictability of listed firms in Kenya.

H04: Accruals earnings management has no significant influence on earnings predictability of listed firms in Kenya.

H05: Audit quality has no significant moderating effect on the relationship between accounting discretion and earnings predictability of listed firms in Kenya.

These can be explained as the beta coefficient of the relationship between variables are not significantly different from zero.

1.5 Significance of the Study

The study is significant to the following stakeholders;

1.5.1 Significance to Investors

Poor-quality earnings can mislead stakeholders and lead to the misallocation of resources. Investors in NSE-listed firms, as well as other market participants, require reliable information to make rational investment decisions. This study will illuminate the extent to which accounting discretion affects earnings forecasts, enabling investors to determine the degree of reliance they can place on financial statements. Accurate earnings prediction can help identify profitable opportunities from firms with consistent, high-quality performance. Beyond the Kenyan context, the findings may guide institutional and cross-border investors in other regional capital markets, such as those in Uganda, Tanzania, and Rwanda, where similar IFRS-based frameworks are applied but enforcement levels vary. By understanding how discretion impacts predictability, regional investors can refine portfolio risk assessment tools and improve capital allocation decisions across multiple East African bourses.

1.5.2 Significance to Regulatory Bodies

Regulatory bodies such as the NSE, the Capital Markets Authority (CMA), and the Institute of Certified Public Accountants of Kenya (ICPAK) play a critical role in setting and enforcing governance and reporting standards. Insights into how audit quality moderates the relationship between discretion and predictability can inform policy-making, including the design of red-flag indicators to detect opportunistic reporting. Enhanced audit quality can improve market confidence, efficiency, and resilience. At the regional level, the study's results can serve as an evidence base for harmonizing reporting and governance codes under initiatives such as the East African Community's (EAC) capital markets integration agenda. Regulators in other emerging African markets could adopt similar audit oversight mechanisms and disclosure benchmarks, fostering greater investor protection and comparability of financial reports across jurisdictions.

1.5.3 Significance to Research and Academia

The study contributes to academic literature by addressing an underexplored area in Kenya: the multifaceted role of accounting discretion in earnings predictability. It connects IFRS-based discretion points with asymmetric cost behavior and other elements of earnings quality, enriching the measurement discourse in accounting and finance research. Regionally, this research offers a replicable methodological framework for scholars studying similar markets with shared economic and regulatory characteristics, such as the Dar es Salaam Stock Exchange (DSE) and the Uganda Securities Exchange (USE). Comparative studies could leverage the findings to explore whether policy interventions effective in Kenyan such as mandatory audit committee independence or enhanced fair value disclosure requirements yield similar improvements in earnings quality and predictability in other East African and Sub-Saharan capital markets.

1.6 Scope of the Study

This study focuses on the influence of accounting discretion on earnings predictability for companies listed on the Nairobi Securities Exchange (NSE) over the thirteen-year period from 2010 to 2022. The selection of this period is justified by three factors. Firstly, the timeframe captures significant changes in financial reporting and corporate governance in Kenya, including the mandatory adoption and updates of International Financial Reporting Standards (IFRS), the issuance of the Capital Markets Authority (CMA) Code of Corporate Governance (2015), and enhanced disclosure requirements for listed firms. Secondly, the period covers both expansionary and contractionary phases of the Kenyan economy, including the post-2008 recovery period, currency fluctuations, commodity price shifts, and the COVID-19 pandemic's impact on corporate earnings and disclosure practices. Studying such diverse conditions allows for a robust assessment of how accounting discretion interacts with market volatility in influencing earnings predictability. Thirdly, consistent audited financial statements and governance disclosures are accessible for this period, enabling reliable measurement of the study variables and cross-year comparability.

The study examines four independent variables representing distinct dimensions of accounting discretion: cost classification shifting, fair value accounting estimates, voluntary disclosure index, and accrual-based earnings management, as well as audit quality as a moderating variable, and earnings predictability as the dependent variable. These are guided by the theories of Efficient Contracting Theory, Information Signaling Theory, and the Efficient Market Hypothesis and Agency Theory, which collectively provide the lens for interpreting how discretion may either enhance or impair the usefulness of reported earnings.

The geographical scope is limited to the Kenyan capital market, but the insights are relevant to other emerging and frontier markets in the East African region that operate under similar IFRS-based frameworks and face comparable enforcement challenges. The findings may therefore have policy implications for regional capital markets integration.

and investor protection initiatives. By focusing on this defined scope, the study ensures both depth and relevance, offering actionable insights to investors, regulators, and scholars within Kenya and across comparable African capital markets.

1.7 Limitations of the Study

Like any empirical inquiry, this study was subject to several limitations that should be acknowledged when interpreting the findings. The study relied exclusively on secondary data extracted from the financial statements and disclosures of firms listed on the Nairobi Securities Exchange (NSE) between 2010 and 2022. While secondary data offers consistency and comparability, it is inherently constrained by the accuracy, completeness, and transparency of financial reports prepared by firms. Cases of missing disclosures, particularly with respect to fair value estimates, voluntary disclosures, and classification of expenses, led to the use of an unbalanced panel dataset, which may affect the robustness of certain estimations despite employing panel regression techniques to mitigate bias.

Operationalization of accounting discretion variables such as cost stickiness, discretionary accruals, and voluntary disclosure quality relies on established proxies (e.g., Modified Jones Model, disclosure indices). These proxies, while widely accepted in the literature, may not fully capture the full scope of managerial discretion in the Kenyan context. For example, voluntary disclosure scores may reflect disclosure quantity rather than quality, and discretionary accruals measures often face endogeneity concerns.

Although the findings provide valuable insights into the dynamics of earnings predictability in Kenya, caution should be exercised in generalizing the results to other regional or global capital markets. The NSE is relatively small, less liquid, and characterized by different institutional, regulatory, and governance frameworks compared to developed markets. As such, factors influencing accounting discretion and earnings predictability may differ in scope and intensity.

The study adopted a positivist paradigm and relied solely on quantitative, econometric approaches (including pooled OLS and panel regressions). This excludes qualitative perspectives such as interviews with managers, auditors, or regulators that could have enriched the interpretation of how and why discretion is exercised. Consequently, the study provides evidence of what relationships exist but not necessarily why managers engage in discretionary reporting practices.

The study period (2010–2022) spans significant regulatory and economic changes, including the adoption of IFRS 13 (Fair Value Measurement) in 2013, shifts in CMA and ICPAK oversight, and external shocks such as COVID-19. These changes may have introduced breaks in firm behavior that are difficult to isolate statistically. Although diagnostic tests (normality, multicollinearity, heteroskedasticity, autocorrelation) were conducted to ensure robustness, the study is still subject to model specification risks. Linear regression models may oversimplify complex interactions between variables. Furthermore, reliance on Pearson correlations and regression coefficients captures associations but does not fully establish causality.

No empirical study is entirely free from limitations. However, this study minimized their impact through a census design, a 13-year panel dataset, validated measurement models, comprehensive diagnostic testing, and the use of audited financial statements. These methodological safeguards enhanced the validity, reliability, and robustness of the findings, giving confidence that the conclusions are credible and useful for policy and practice.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter presents a theoretical review of literature to provide a strong conceptual foundation for the study variables. It also reviews relevant empirical studies to highlight existing knowledge gaps that this research seeks to address. In addition, the chapter outlines the conceptual framework, detailing the variables under investigation and their associated indicators.

2.2 Theoretical Review

The study was guided by the following theories.

2.2.1 Information Signaling Theory

Signaling theory was originally developed by Spence (1973) to explain information asymmetry in labor markets. Over time, its application has expanded to corporate voluntary disclosures. The theory suggests that managers of profitable firms are more inclined to voluntarily disclose information about the firm's future prospects because capital markets place a high value on such information. Conversely, non-profitable firms are less likely to disclose voluntarily, as doing so may incur additional costs without corresponding benefits.

According to Ross (1977), the presence of asymmetric information provides a rationale for corporations to use financial information as a means of sending signals to the market. Any information disclosed by managers to the market reduces asymmetry and is perceived as a positive signal. Ronen and Yaari (2008) classified earnings management into two categories: value-enhancing earnings management and opportunistic earnings management. Value-enhancing earnings management allows managers to signal value-

relevant information to shareholders without excessive disclosure detail. For example, Banker and Chen (2006) find that cost variability prediction models produce forecast errors that have greater relative information content than alternative models based on financial statement data, particularly in explaining abnormal stock returns.

The theory further suggests that managers may take discretionary actions to manipulate earnings in order to communicate favorable or unfavorable information about the company's future to the capital markets. Earnings management in this context reflects changes in reported earnings that may not be aligned with actual cash flows (Sun et al., 2010). This manipulation can influence business valuation and investor expectations, sometimes signaling anticipated improvement in earnings and cash flows.

Healy and Palepu (1993) argue that managers concerned with the effectiveness of their financial reports may expand voluntary disclosures to better convey value-relevant information. When accounting standards restrict managerial discretion, managers may increase voluntary disclosure outside financial statements to maintain their ability to signal effectively. Bowen et al. (2008) found a positive association between accounting discretion, attributable to governance quality, and subsequent firm performance suggesting that some earnings management benefits shareholders by signaling future performance. However, other studies portray accounting discretion as an opportunistic tool for influencing investor decisions. Fei (2015) identifies opportunism through manipulation of cash flows and abnormal capital expenditures, while Šodan (2019) links opportunism to the use of fair value adjustments.

Information signaling theory also explains the role of disclosures in shaping market reactions. Investors rely heavily on disclosed financial information to assess firm performance, risk, and future profitability. Voluntary disclosure of positive forecasts is often perceived as evidence of strong governance and sound financial management (Verrecchia, 2001). Conversely, lack of disclosure or inconsistent patterns may raise concerns about opportunism, increasing perceived risk and lowering valuations (Hassanein & Hussainey, 2015).

Regulatory frameworks such as IFRS and GAAP aim to enhance transparency and reduce asymmetry (Barth et al., 2008). Nonetheless, compliance varies, and managers may selectively disclose favorable information while withholding negative details (Leuz et al., 2003). This selective disclosure reflects the strategic use of signaling.

Firms with higher voluntary disclosure tend to attract more institutional investors, who rely on timely and accurate disclosures for investment decisions. Frequent and detailed disclosure enhances perceptions of reliability and transparency (García-Meca & Martínez-Ferrero, 2018).

Beyond financial reporting, signaling theory also extends to corporate governance and executive compensation. Firms with strong governance and transparent reporting signal a commitment to shareholder value, leading to higher valuations and reduced cost of capital (Bushman et al., 2004). In contrast, limited disclosure may prompt greater regulatory scrutiny, higher capital constraints, and reputational damage.

In summary, signaling theory provides a framework for understanding how managers use financial disclosures to influence market perceptions. While voluntary disclosures can promote transparency and reduce asymmetry, they can also be exploited opportunistically. Therefore, stakeholders must critically assess reported information to distinguish genuine value signals from managerial manipulation.

Nyang'oro (2021), studying NSE financial sector firms, found that voluntary disclosures sometimes correlated with higher earnings manipulation, implying they were used opportunistically to mislead, not inform, investors. This implies that the credibility of a signal depends heavily on enforcement and audit verification, without which, signals may have adverse selection effects rather than reducing information asymmetry.

2.2.2 Efficient Market Hypothesis

The Efficient Market Hypothesis (EMH), proposed by Fama and French (1969), describes a market that responds rapidly to new information. In 1991, Fama expanded on this idea,

noting that markets not only react quickly but also process information rationally and systematically, with share prices reflecting underlying market fundamentals. The EMH is based on three key assumptions the one, all market participants have simultaneous access to relevant information; two, information is quickly and fully incorporated into stock prices; and three that investors value securities rationally in frictionless markets.

There are three recognized forms of market efficiency In weak form efficiency , the current stock prices reflect all past publicly available information, including historical prices, returns, trading volumes, and market-generated data. In semi-strong form efficiency, current prices incorporate both historical price data and all publicly available corporate information. In strong form efficiency, security prices reflect all information, both public and private.

Grossman and Stiglitz (1980) challenge the EMH by arguing that information acquisition involves costs, creating an incentive for investors to spend resources to obtain it. This implies that prices may not fully reflect all available information, and the expected return must exceed the cost of acquiring it. This observation provides practical insights for investors relying on accounting data to improve earnings forecasts.

A firm's reported earnings variability is influenced by operational performance volatility and the degree of managerial intervention in financial reporting (Ghosh & Olsen, 2009). Low variability in earnings can result from stable operations, effective earnings smoothing, or a combination of both. Empirical evidence is mixed: Dichev and Tang (2009) find that analysts do not fully incorporate earnings variability into their forecasts, while Tan and Sidhu (2012) show that investors factor in these variances when making predictions, particularly for firms with high-quality earnings.

Despite its theoretical appeal, EMH faces criticism due to observed anomalies in financial markets. Behavioral finance research shows that investors are not always rational, with biases influencing decision-making. Market phenomena such as overreaction,

underreaction, and momentum investing indicate that markets sometimes fail to adjust instantaneously or accurately to new information (Shiller, 2003).

Other anomalies, such as the January effect (higher average returns in January) and the value effect (undervalued stocks outperforming overvalued ones), suggest that inefficiencies persist (Jegadeesh & Titman, 1993). These anomalies indicate opportunities for investors to earn abnormal returns, contradicting the idea that prices always fully reflect all available information.

Corporate earnings announcements and financial disclosures also play a critical role in market efficiency. Research shows that investor reactions to earnings surprises vary depending on firm characteristics and prevailing market sentiment (Bernard & Thomas, 1989). Firms with transparent reporting and strong governance tend to see faster, more accurate price adjustments, while weak governance may delay or distort market responses.

The rise of algorithmic and high-frequency trading has further influenced market efficiency. These systems can process vast datasets in milliseconds, enabling rapid price adjustments. However, they also introduce risks, such as flash crashes, where automated strategies cause sudden, extreme price swings (Kirilenko et al., 2017). Such events challenge the assumption that markets operate smoothly at all times. Munyua & Githui (2020) found significant short-term market overreaction to earnings announcements on the NSE, leading to temporary mispricing, inconsistent with semi-strong EMH. This implies that in thinly traded or emerging markets, low liquidity, slow dissemination of information, and investor biases often prevent prices from adjusting instantly and accurately.

In conclusion, while the EMH remains a foundational framework for understanding market behavior, real-world conditions reveal its limitations. Market imperfections, investor psychology, and structural changes can cause deviations from perfect efficiency. As markets evolve, a more nuanced approach, combining EMH principles with behavioral and institutional insights, is necessary to fully explain market dynamics.

2.2.3 Efficient Contracting Theory

The efficient contracting theory, originally developed as contract theory by Kenneth Arrow (1960), has been applied to explain institutional structures such as loan agreements, compensation arrangements, and accounting choices. It is also referred to as the contracting cost theory. The theory evolved into the Jensen and Meckling (1976) agency theory. It posits that since the accounting system is part of efficient contracts technology, accounting controls and systems can be employed to reduce conflicts between organizational parties and enhance firm value.

Bowen et al. (2008) indicate that, under the efficient contracting view, there should be no observable cross-sectional associations between corporate governance and accounting discretion. However, under lax governance, the observed relationships suggest that management can exploit governance weaknesses, thereby encouraging opportunistic behavior. This theory operates on the accounting assumptions of reliability and conservatism, which aim to protect users from managerial opportunism.

The theory interprets the association between accounting discretion and poor governance quality as evidence that weak governance structures enable opportunistic behavior. Emanuel et al. (2003) argue that while an ex-post perspective may interpret discretion as opportunistic, the ex-ante perspective views accounting systems as designed to ensure resource efficiency, hence, the figures reported are part of efficient contracting technology. However, no single theory fully reconciles these perspectives to justify managerial discretion in accounting method choice. Empirical literature increasingly recognizes that accounting choices may reflect both efficiency and opportunism, with some opportunism present even within efficient contracting frameworks.

Strong corporate governance structures should ensure the quality of financial reports (Nor & Ku, 2013). However, recent corporate failures despite the presence of seemingly effective boards reduce investor reliance on such governance measures. Studies show that auditors can limit management discretion and opportunistic behavior due to their superior

knowledge. Khaneja (2017) notes that auditors, as corporate governance actors, possess the expertise to critically evaluate financial statements prepared by management. Nevertheless, internal auditors may lack full independence, sometimes failing to meet their obligations to shareholders, thereby underscoring the need for external audit roles.

A key limitation of the theory is that both accounting discretion and corporate governance are often estimated rather than directly observed, creating measurement challenges. Moreover, discretion is not inherently negative, as highlighted by the information signaling theory. The efficient contracting perspective also underscores the role of accounting policies in aligning managerial actions with shareholder interests. Well-structured policies can ensure reported financial information reflects the firm's economic reality (Dechow & Skinner, 2000). However, without strong governance, managers may exploit discretion to manipulate earnings, undermining reliability (Healy & Wahlen, 1999).

External auditors play a vital role in mitigating these risks by independently verifying financial statements. High-quality audits act as external monitoring mechanisms to ensure fair and accurate reporting (Francis, 2011). The effectiveness of audits, however, depends on independence, quality, and regulatory oversight. Weak enforcement or conflicts of interest can significantly reduce auditors' ability to curb opportunistic practices (DeFond & Zhang, 2014).

The theory also interacts with market discipline: when discretion is used efficiently, it enhances report informativeness and reduces information asymmetry between managers and investors (Ball & Shivakumar, 2008). Conversely, opportunistic discretion can lead to manipulation, volatility, and reduced investor confidence, stressing the importance of regulatory frameworks that safeguard transparency (Bushman & Smith, 2001).

Despite its relevance, the theory does not fully account for external market pressures, regulatory interventions, or behavioral factors affecting managerial decisions (Watts & Zimmerman, 1986). Managerial behavior can also be influenced by psychological biases

and strategic motives beyond efficiency (Holthausen, 2009). Therefore, efficient contracting theory should be complemented with other perspectives, such as agency theory and information signaling theory, to achieve a holistic understanding of accounting discretion.

Contrary to the central argument by the efficient contracting theory, Aduda, Magutu & Wabwire (2015) found that in NSE-listed firms, even with well-structured governance codes, earnings manipulation persisted, indicating that governance mechanisms alone may not realign managerial incentives as the theory predicts. Implying that the assumption that accounting systems inherently evolve to maximise firm value may not hold in environments with weak enforcement, high political connections, or limited investor activism.

2.2.4 Agency Theory

Agency theory addresses the fundamental conflict of interest between managers (agents) and shareholders (principals). According to Jensen and Meckling (1976), agency relationships are characterized by the possibility that managers may prioritize personal gain over maximizing shareholder wealth. Information asymmetry enables managers to manipulate earnings to meet short-term targets, potentially misrepresenting the firm's true financial performance. To mitigate these risks, external auditors are engaged as a form of agency cost to reduce information asymmetry and enhance the credibility of financial statements. This study examines the extent to which audit quality can improve the reliability of financial reporting and curb opportunistic earnings management.

The International Standard on Auditing 200 (ISA 200) outlines the core principles of audit quality. It requires audits to provide reasonable assurance that material misstatements whether caused by error or fraud are detected. ISA 200 also mandates that auditors maintain professional skepticism and exercise due professional care throughout the engagement (IAASB, 2020). This includes vigilance for creative accounting practices such as income smoothing, premature revenue recognition, and aggressive cost

capitalization. Consequently, the effectiveness of external auditors in detecting misstatements is a critical factor in strengthening corporate governance and protecting shareholder interests.

Empirical evidence highlights mixed results regarding audit quality's ability to curb earnings manipulation. A global survey by Ernst & Young (2013), involving 100 Kenyan firms, revealed that 53% of managers admitted to over-reporting performance, raising questions about the capacity of local audit firms and regulators to detect creative accounting effectively. Audit quality depends on factors such as auditor independence, industry expertise, and firm size. The "Big Four" firms; PwC, Deloitte, EY, and KPMG, are often perceived to deliver higher audit quality due to greater resources and reputational risk concerns (Francis & Wang, 2008). Nonetheless, high-profile failures such as Enron and WorldCom demonstrate that large firms are not immune to lapses.

The appointment of external auditors addresses the classical agency problem by providing independent assurance that management-prepared financial statements comply with accounting standards (Habib & Bhuiyan, 2011). However, audit quality is difficult to measure directly and is typically proxied by indicators such as audit firm size, auditor tenure, audit fees, and discretionary accrual levels (DeAngelo, 1981). Some studies suggest that longer auditor tenure enhances reporting quality due to accumulated client knowledge, while others caution that extended relationships may erode independence (Carey & Simnett, 2006).

Regulatory oversight is another critical dimension of agency theory in practice. In Kenya, bodies such as the Institute of Certified Public Accountants of Kenya (ICPAK) and the Public Sector Accounting Standards Board (PSASB) are tasked with enforcing compliance with auditing standards. However, enforcement has been criticized as reactive rather than proactive. Financial scandals involving Imperial Bank and Chase Bank Kenya reveal weaknesses in audit oversight, underscoring the need for stricter regulatory measures (Kamau et al., 2018). Enhancing auditor independence, imposing tougher

penalties for audit failures, and improving financial disclosure transparency could help resolve agency conflicts and bolster investor confidence in capital markets.

Agency theory posits that independent audits reduce information asymmetry, but Francis & Yu (2009) found no significant difference in earnings quality between Big Four and non-Big Four auditors in some markets. Wambugu & Mungai (2018) showed that some NSE-listed firms with reputable auditors still engaged in aggressive earnings management, suggesting that auditor reputation alone does not guarantee high audit quality. This shows that factors such as auditor tenure, client dependence, and regulatory capture can undermine the monitoring role assumed by agency theory.

2.3 Conceptual Framework

A conceptual framework provides a concise description of the phenomenon under study, supported by a graphic or visual illustration of the major variables and their interrelationships. According to Mugenda (2008), a conceptual framework systematically organizes descriptive categories into a broad structure of propositions, statements that explain the relationships between two or more empirical properties (variables), which can subsequently be tested and either accepted or rejected.

In this study, the conceptual framework depicts the independent, dependent, and moderating variables, as well as the expected direction of their relationships. It serves as both a theoretical guide and an analytical tool for examining the hypothesized associations discussed in the preceding theoretical review.

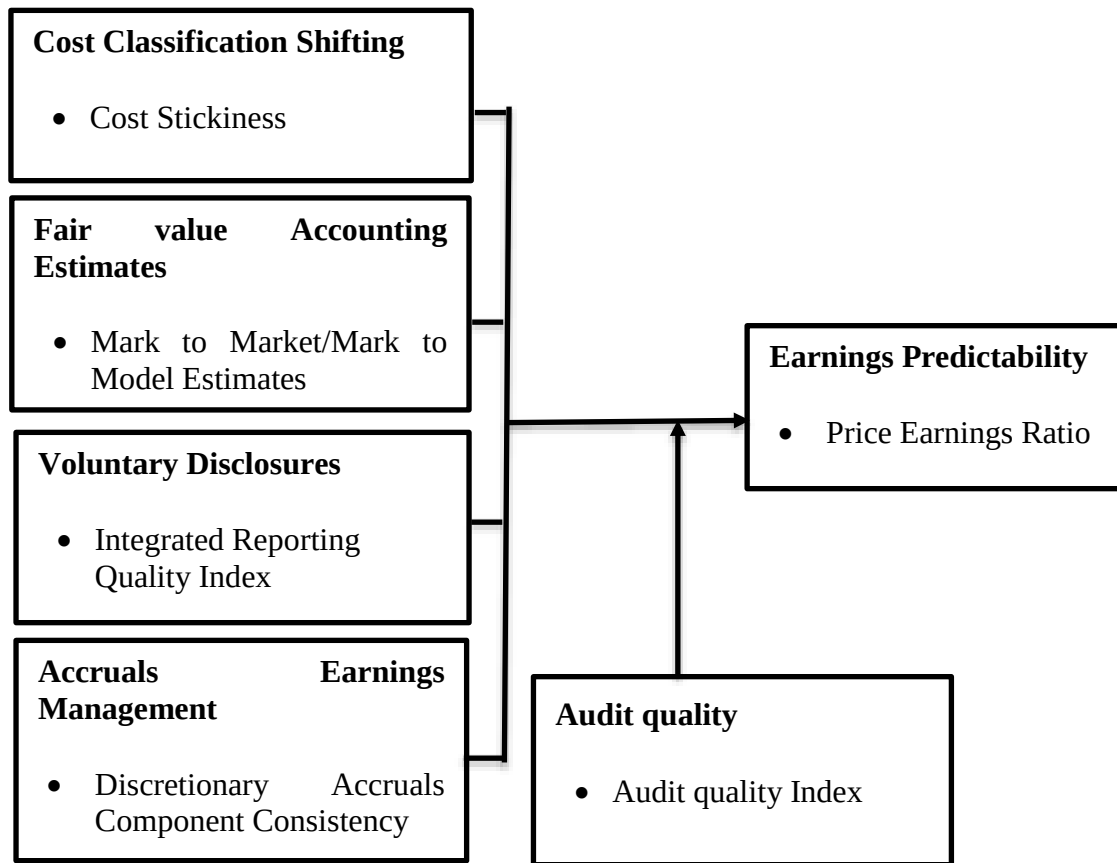


Figure 2.1: Conceptual Framework

2.3.1 Earning Predictability

Earnings predictability refers to the extent to which a firm's future earnings can be forecast based on its historical performance. It can be measured using the standard deviation of earnings data across different periods whether daily, weekly, monthly, quarterly, or annually. Silhan (2014), for example, measured earnings before extraordinary items scaled to total assets, operationalized as the standard deviation of return on assets. Jadhav et al. (2015) emphasized that earnings per share (EPS) is one of the most critical performance metrics for investors, while Goh and Simanjuntak (2018) assessed earnings predictability using the price–earnings ratio, calculated as the share price divided by EPS.

A less volatile EPS trend is considered more reliable for predicting future performance than a highly volatile trend (Donelson & Resutek, 2015).

Earnings predictability is vital for investors, analysts, and other stakeholders, as it offers insights into a firm's likely financial performance. High earnings predictability indicates consistency and reliability in reported earnings, allowing stakeholders to anticipate future trends and make informed decisions. Conversely, volatile earnings increase uncertainty, diminish investor confidence, and may negatively affect stock valuation (Dechow et al., 2010).

One common measure of earnings predictability is earnings persistence the degree to which current earnings explain future earnings. Firms with high earnings persistence are deemed more predictable because present earnings serve as a strong indicator of future performance (Richardson et al., 2005). Stability in revenue streams, cost structures, and accounting policies contributes to predictability, while aggressive earnings management typically undermines it (Guay et al., 2016).

Cash flow predictability is another important dimension. Research shows that firms with a strong correlation between reported earnings and actual cash flows tend to have more predictable earnings (Penman & Yehuda, 2019). Since cash flows are less prone to manipulation than accrual-based earnings, they serve as a more dependable indicator of financial health. Excessive accrual-based earnings management distorts reported earnings, reduces predictability, and risks misleading investors (Francis et al., 2004).

Audit quality significantly influences earnings predictability. High-quality audits increase the likelihood that reported earnings reflect the firm's true financial position, thus reducing manipulation risks (Francis & Wang, 2008). Firms audited by reputable, independent, and experienced auditors are more likely to comply with accounting standards, minimising discrepancies between expected and actual earnings. This aligns with broader goals of transparency and market confidence.

Industry-specific factors also shape earnings predictability. Sectors with stable demand patterns, such as utilities or consumer staples, typically exhibit more predictable earnings due to consistent revenues and lower exposure to economic cycles. In contrast, industries like technology or construction may face pronounced demand fluctuations, pricing instability, and regulatory uncertainties, leading to less reliable forecasts (Lev & Thiagarajan, 1993). Sectoral dynamics, therefore, must be considered when comparing firms across industries.

Corporate governance frameworks further affect predictability. Strong governance marked by independent boards, effective audit committees, and transparent reporting tends to limit managerial opportunism and support earnings reliability (Bushman & Smith, 2001). In Kenya, regulatory bodies such as the Capital Markets Authority are increasingly emphasizing compliance with governance codes to improve accountability and predictability in corporate disclosures.

Macroeconomic conditions also impact earnings predictability. Economic stability facilitates accurate forecasting, while downturns, inflationary pressures, and exchange rate volatility increase earnings uncertainty. For instance, firms dependent on imports or exposed to foreign currency risk may face unpredictability due to fluctuating exchange rates. This is especially relevant in emerging economies like Kenya, where macroeconomic volatility can have a pronounced effect on earnings reliability.

Technological integration in financial reporting systems has emerged as another key factor. Firms using advanced Enterprise Resource Planning (ERP) systems, real-time data analytics, and robust internal controls can produce more accurate and timely financial information. These systems reduce human error, improve data traceability, and enhance compliance, thereby fostering earnings consistency (Hunton et al., 2004).

Finally, behavioural factors, including investor sentiment, indirectly influence earnings predictability. Even when earnings are objectively predictable, market reactions may deviate due to biases, short-term overreactions, or herd behaviour. Such behavioural

dynamics can distort the link between reported earnings and stock valuations. Therefore, effective investor communication is essential to align market perceptions with financial reality and ensure that predictable earnings translate into accurate market valuations (Barberis et al., 1998).

The determinants of earnings predictability discussed above align closely with the theoretical perspectives underpinning this study. Efficient contracting theory suggests that strong governance and audit quality enhance earnings predictability by aligning managerial decisions with shareholder interests. Information signaling theory supports the idea that transparent and consistent earnings patterns serve as credible signals to the market, reducing information asymmetry. Efficient market hypothesis (EMH) underscores that predictable earnings facilitate the incorporation of relevant information into share prices, enabling more efficient capital allocation. Finally, Agency Theory emphasizes the role of monitoring mechanisms, such as high-quality external audits and independent boards, in mitigating opportunistic earnings management that undermines predictability. By integrating these theoretical perspectives, the study positions earnings predictability not merely as an outcome of firm-level practices, but as a construct shaped by broader governance, market, and behavioral dynamics.

2.3.2 Cost Classification Shifting

Cost classification shifting is a form of earnings management where managers reallocate expenses from operating categories e.g., Selling, General, and Administrative to non-operating or non-recurring items to inflate core earnings (McVay, 2006). This practice allows firms to present an improved operational performance without directly altering reported revenues or accruals. Scholars have developed various empirical methods to detect and measure cost classification shifting:

McVay (2006) pioneered the detection model by examining the unexpected core earnings component. Core earnings are regressed on sales changes and other control variables to identify abnormally high non-recurring expenses that coincide with unusually high core

earnings. The residuals from this model indicate potential cost shifting. Athanasakou et al. (2011) used a modified version of McVay's model, adding industry and firm-specific controls to improve detection accuracy, particularly in multi-segment firms.

Fan et al. (2021) measured shifting by analyzing the ratio of special items (non-recurring charges) to total expenses and testing whether these special items increased disproportionately when core earnings were higher than predicted by fundamentals. Baik et al. (2020) employed an analyst forecast error approach, reasoning that cost classification shifting increases the likelihood of positive earnings surprises. They measure the absolute difference between actual and forecasted earnings and examine whether misclassification variables predict the deviation.

Donelson et al. (2019) used abnormal changes in specific expense categories (e.g., SG&A, COGS) relative to sales changes as a red flag for classification shifting, especially when accompanied by increases in reported special items.

Misclassification can distort performance ratios such as operating profit margin, EBITDA, and ROA (Gupta et al., 2022). Since analysts and investors often rely on these metrics to assess operational efficiency, cost shifting can mislead investment decisions and impair earnings predictability. Detection is challenging due to the legitimate discretion firms have in expense categorization. Stronger governance (Donelson et al., 2019), enhanced audit scrutiny, and industry-specific expense benchmarking can reduce opportunities for shifting. Forensic accounting techniques, such as time-series anomaly detection and machine learning classification models, are increasingly being applied to flag unusual expense patterns that might indicate classification shifting.

The long-term consequences for firms caught engaging in this practice are severe. Beyond reputational damage, companies may face regulatory penalties, litigation, and loss of investor trust (Enomoto et al., 2015). As capital markets increasingly demand transparency, the tolerance for manipulative classification practices is diminishing, and stakeholders are more likely to penalise such behaviour once identified.

From an Efficient Contracting Theory perspective, cost classification shifting undermines contractual efficiency by concealing true operational performance, potentially leading to misaligned performance-based incentives. Information Signaling Theory suggests that misclassified expenses send misleading positive signals to markets, distorting investors' perceptions of a firm's operational health. Under the Efficient Market Hypothesis, the practice compromises semi-strong market efficiency by reducing the reliability of publicly available information, thereby impairing accurate asset pricing. Finally, from an Agency Theory viewpoint, cost classification shifting exemplifies managerial opportunism, agents exploiting informational advantages at the expense of principals' best interests.

2.3.3 Fair Value Accounting Estimates

Fair Value Accounting (FVA) refers to the measurement of assets and liabilities at their market-based value rather than historical cost, as per IFRS 13. Fair value measurements are categorised into three levels: Level 1 that shows quoted prices in active markets for identical assets/liabilities, Level 2 showing observable inputs other than quoted prices (e.g., interest rates, yield curves). And Level 3 that shows unobservable inputs requiring significant managerial judgment.

While FVA is designed to enhance relevance and timeliness of financial information, Level 3 estimates present significant scope for managerial discretion and earnings management (Song et al., 2010).

Researchers have operationalized fair value accounting discretion and quality using various proxies; Song et al. (2010) measured reliability by examining the market pricing of Level 1, 2, and 3 assets disclosed under SFAS 157 (now IFRS 13 equivalent). They found Level 3 estimates have lower market pricing coefficients, indicating lower perceived reliability. Kolev (2009) used the difference between reported fair value and historical cost to assess the incremental value relevance of fair value measurements. Goh et al. (2015) applied a residual model where fair value gains/losses were regressed on observable market indicators, with large residuals suggesting discretionary estimation.

Badia et al. (2017) constructed a “discretion score” by examining the sensitivity of Level 3 estimates to managerial incentives such as earnings targets or debt covenant thresholds. Enomoto et al. (2015) studied firms with frequent upward property revaluations, measuring the timing and magnitude of revaluations relative to earnings pressures, thus identifying opportunistic use of FVA. Penman (2007) proposed using the volatility of recurring fair value gains/losses as an indirect measure of estimation reliability, with unusually high volatility being a red flag.

Fair value gains and losses, particularly from Level 3 inputs, can increase earnings volatility, making future earnings harder to forecast (Laux & Leuz, 2009). Ratios such as ROE and book value per share may be temporarily inflated by upward revaluations, while sudden downward adjustments can trigger covenant breaches or investor sell-offs.

Studies such as Goncharov et al. (2014) show that independent audit committees, external valuation experts, and robust disclosure practices improve the reliability of fair value estimates. Mandatory disclosure of valuation techniques and assumptions, as required under IFRS 13, also enhances transparency, though selective disclosure remains an issue (Leuz et al., 2003).

Advanced data analytics including Benford’s Law applications, industry benchmarking, and machine learning models are being used to detect anomalies in fair value adjustments that may indicate opportunistic reporting (Krauss et al., 2017). Governance mechanisms play a critical role in constraining opportunistic fair value adjustments. Independent audit committees, robust internal control systems, and the use of external valuation specialists can reduce management discretion and improve the reliability of reported fair values (Goncharov et al., 2014). In addition, mandatory disclosure requirements under IFRS 13, particularly the three-level hierarchy of inputs, provide users with greater insight into the reliability of reported fair values, thereby enhancing market discipline.

However, reputational and regulatory risks remain significant. Firms that are found to have deliberately misstated fair values may face legal action, restatements, and loss of

investor trust. These consequences are particularly damaging in capital markets such as Kenya's, where investor confidence is sensitive to perceived weaknesses in financial reporting. The Capital Markets Authority (CMA) has in recent years increased its scrutiny of listed firms' fair value disclosures, especially for property revaluations and financial instrument valuations in the banking and insurance sectors.

From an Efficient Contracting Theory perspective, fair value accounting should, in principle, enhance resource allocation efficiency by reflecting current economic conditions. However, when managerial discretion is exploited, it undermines contractual efficiency and distorts decision-making. Information Signaling Theory suggests that fair value adjustments, particularly upward revaluations, can serve as market signals about future profitability, but opportunistic use sends misleading signals to investors. Under the Efficient Market Hypothesis, FVA should improve semi-strong market efficiency by providing timely market-based information; yet, opportunistic estimates reduce informational reliability, impairing price accuracy. Finally, from an Agency Theory viewpoint, the subjectivity inherent in Level 3 fair value inputs offers managers an avenue for self-serving behavior at the expense of shareholders, reinforcing the need for strong monitoring and governance mechanisms.

2.3.4 Voluntary Disclosure Index

Voluntary disclosure refers to the provision of information beyond statutory requirements, aimed at enhancing transparency and reducing information asymmetry between a firm and its stakeholders. The Voluntary Disclosure Index (VDI) serves as a quantitative tool to measure the breadth and depth of such disclosures. Botosan (1997) pioneered the VDI concept, developing a framework that scored annual reports based on the presence of five categories of information: Background information (e.g., company history, mission, market position) Historical results (multi-year financial trends) Key non-financial statistics (e.g., market share, employee metrics) Forecasted information (earnings, sales, or capital expenditure projections) Management discussion and analysis (narratives on operational strategies, risks, and opportunities).

Over time, scholars have expanded and refined VDI measurement: Botosan (1997) developed an unweighted disclosure index, assigning 1 point for each disclosure item present in an annual report, with equal importance to all items. Botosan and Plumlee (2002) applied the index in capital markets research, linking higher VDI scores to lower cost of equity capital. Consoni and Colauto (2016) proposed a broader set of categories: market view, corporate strategy, economic and financial performance, and operational aspects. This framework is particularly relevant in emerging markets, where forward-looking strategic disclosures are less common.

Hussainey and Wang (2010) used narrative content analysis to identify forward-looking statements in annual reports and corporate announcements, measuring both quantity and tone. Karajeh (2019) weighted disclosure items based on stakeholder importance, giving higher scores to disclosures on risk management, governance, and sustainability. Consoni et al. (2017) introduced a strategic disclosure index to investigate whether high-disclosure firms engaged in earnings management. Some researchers adopt binary scoring systems (1 = disclosed, 0 = not disclosed), while others use weighted scoring to capture the perceived value of different disclosures. Others still incorporate content richness metrics, assessing not only whether an item is disclosed but also the depth and quality of discussion.

The relationship between voluntary disclosure and earnings quality is complex. Consoni et al. (2017) suggest that some firms strategically increase voluntary disclosures to deflect attention from aggressive earnings management practices, a phenomenon aligned with the distraction hypothesis. Conversely, Karajeh (2019) found that high-quality voluntary disclosures correlate with higher earnings persistence and predictability, acting as a governance mechanism to deter opportunistic behavior.

The extent of voluntary disclosure is influenced by various factors such as Corporate governance where firms with independent boards, active audit committees, and dispersed ownership structures tend to have higher VDI scores (Hussainey & Wang, 2010). Regulatory environment by nature of the strength of the capital market where stronger

capital market regulations encourage voluntary disclosure as a competitive signaling tool and vice versa. Industry characteristics such as Capital-intensive and highly regulated industries (e.g., banking, telecommunications) exhibit higher levels of voluntary disclosure to maintain investor trust. Firm size and performance also tends to affect voluntary disclosures; Larger, more profitable firms tend to disclose more information voluntarily to attract and retain investors.

On capital markets such as the NSE in Kenya, Higher VDI scores are associated with Lower cost of capital due to reduced perceived investment risk (Botosan & Plumlee, 2002). Improved investor decision-making through enhanced earnings forecasts and Reduced stock price volatility due to better alignment of market expectations with firm performance. However, voluntary disclosure can also be selectively biased toward favorable information, potentially misleading stakeholders if not subject to independent assurance.

The rise of integrated reporting, ESG (Environmental, Social, Governance) disclosures, and digital investor communication channels has transformed the VDI landscape. For example: International Integrated Reporting Council (IIRC) frameworks encourage integrated disclosure of financial and non-financial performance. The Global Reporting Initiative (GRI) guidelines promote ESG-related disclosures, increasingly incorporated into VDI scoring. Digital and AI-based analytics now allow real-time tracking of corporate disclosures across multiple platforms (annual reports, investor presentations, and social media).

Theoretically, according to Efficient Contracting Theory, Higher voluntary disclosure levels can enhance contractual efficiency by providing stakeholders with decision-useful information. Based on Information Signaling Theory, voluntary disclosures can act as positive market signals, especially in contexts where management seeks to convey superior performance or strategy.

The Efficient Market Hypothesis (EMH) suggests that high VDI scores improve semi-strong form efficiency by ensuring market prices reflect a broader information set while the Agency Theory argues that Voluntary disclosures, especially when monitored by strong governance mechanisms, can reduce agency conflicts by limiting information asymmetry between managers and shareholders.

2.3.5 Accruals Earnings Management

Accruals Earnings Management (AEM) refers to the manipulation of reported earnings through adjustments to accruals—accounting entries that do not directly involve cash flows but are based on estimates and managerial judgment. It is one of the most examined forms of earnings management due to its subtle nature and the difficulty of detection. AEM exploits the subjectivity inherent in accrual accounting, such as in estimating depreciation, amortization, provisions for doubtful debts, and timing of revenue recognition.

Scholars have developed various models to measure discretionary accruals, which serve as proxies for AEM: Ratio of Discretionary Accruals Components (RDAC), proposed by Ibrahim (2009), RDAC measures the consistency of signs and magnitudes across accrual components to distinguish between deliberate managerial manipulation and normal estimation error. This approach is particularly useful for identifying accrual-based manipulations embedded in firms with artificially inflated accruals. RDAC is typically applied in panel data analysis, using absolute and aggregate discretionary accrual values to assess consistency.

The Modified Jones Model was developed by Dechow et al. (1995) and widely used in studies such as Sánchez-Ballesta & García-Meca (2007), Nuryaman (2013), and Waweru & Ntui (2018), this model adjusts the traditional Jones model to control for changes in revenues and property, plant, and equipment (PPE). By isolating non-discretionary accruals from total accruals, the model estimates discretionary accruals as the residual component.

Performance-Matched Modified Jones Model as used by Kothari et al. (2005) enhanced the Modified Jones Model by including Return on Assets (ROA) as a performance-matching variable, reducing bias when comparing firms with different profitability levels. Earnings Persistence Tests as used by Francis et al. (2005) and Dechow & Dichev (2002) used the persistence of earnings over time as an indirect measure of accrual quality. Lower persistence indicates higher discretionary accruals and lower earnings quality.

Empirical studies reveal that managerial incentives play a central role in AEM. Nuryaman (2013) found that highly leveraged firms tend to record higher discretionary accruals to present a stronger financial position to creditors. Waweru and Ntui (2018) reported that declining profitability motivates managers to use AEM for income smoothing to maintain investor confidence. Other motivations include meeting analyst forecasts, influencing stock prices, or securing performance-based compensation.

The adoption of International Financial Reporting Standards (IFRS) aimed to enhance transparency in financial reporting by standardizing accrual recognition principles. However, Chen et al. (2010) observed that even under IFRS, managerial discretion in applying accounting estimates provides opportunities for AEM. This suggests that strong enforcement mechanisms and enhanced audit scrutiny remain necessary.

Corporate governance mechanisms significantly influence the prevalence of AEM. Larcker et al. (2007) demonstrated that board independence, audit committee expertise, and institutional ownership reduce the incidence of discretionary accruals. Conversely, Donelson et al. (2019) noted that weak governance allows greater latitude for earnings manipulation.

Zang (2012) highlighted that macroeconomic conditions affect AEM strategies. During economic downturns, managers are more likely to inflate earnings using accruals to cushion revenue declines, while in economic booms, income smoothing via AEM may be less prevalent.

Although AEM is not always illegal, it undermines financial statement reliability and can mislead stakeholders. Nelson et al. (2002) found that auditors often face challenges in detecting accrual manipulation embedded within complex estimates, emphasizing the need for auditor expertise and independence. High discretionary accruals have been linked to earnings restatements, reputational damage, and regulatory penalties (Hennes et al., 2008).

Recent research suggests integrating advanced analytics, such as machine learning and anomaly detection models, into audit procedures to identify unusual accrual patterns (Chen et al., 2018). Combining accrual-based measures with other earnings quality metrics, such as cash flow persistence and voluntary disclosure indices, can yield a more holistic assessment of reporting integrity.

Theoretically, Agency Theory argues that AEM arises from conflicts of interest between managers (agents) and shareholders (principals), where managers may manipulate earnings for personal benefit. The Efficient Market Hypothesis (EMH) reveals that Persistent accrual manipulation can impair market efficiency by distorting the information content of earnings. The Efficient Contracting Theory debates that contractual arrangements that rely on accounting numbers (e.g., debt covenants) can be affected by accrual manipulation, altering contract outcomes. While according to the Information Signaling Theory, Some managers may justify AEM as a way to signal future growth potential, although such signaling risks credibility loss if manipulation is later detected.

2.3.6 Audit Quality

Audit quality refers to the degree to which an audit is conducted in accordance with professional auditing standards, ensuring that the financial statements are free from material misstatements and faithfully represent a firm's financial position. External auditors play a pivotal role as independent assurance providers, safeguarding the interests of stakeholders by enhancing the credibility, transparency, and reliability of financial reporting.

Scholars have operationalized audit quality using several proxies, each capturing different dimensions of the construct: The most widely used proxy for audit quality in empirical research is the size and reputation of the audit firm. Large international firms (the Big Four—Deloitte, PwC, EY, and KPMG) are perceived to deliver higher-quality audits due to their larger resource base, technical expertise, and stricter quality control systems. Nuryaman (2013) employed this proxy to demonstrate that Big Four audits are associated with reduced earnings management and improved market confidence, as their independence and monitoring capabilities discourage opportunistic managerial behavior.

Audit quality has also been measured by the type of opinion expressed in the auditor's report—unqualified (clean), qualified, adverse, or disclaimer of opinion. Walker and Hay (2013) observed that firms with qualified or adverse opinions were more likely to have underlying financial reporting issues, making audit opinion a relevant indicator of audit rigor and independence.

Audit report lag defined as the time elapsed between fiscal year-end and the audit report date, audit report lag serves as an indirect measure of audit effort and thoroughness. Nuryaman (2013) noted that while a longer audit lag may reflect more comprehensive verification, excessively long delays can signal operational inefficiencies or disputes between auditors and management. In empirical studies, audit lag is often measured in days and included as a continuous variable.

Key Audit Matters (KAMs) – ISA 701 is another measurable, since its introduction in 2016, ISA 701 requires auditors to disclose significant matters encountered during the audit, such as areas of high estimation uncertainty or management judgment. The number and nature of KAMs disclosed have been used as a qualitative proxy for audit quality, as more substantive KAM reporting indicates deeper auditor engagement and transparency (Pinto & Morais, 2019).

DeAngelo (1981) conceptualized audit quality as a joint function of auditor competence and independence. Independence is commonly proxied by audit tenure (number of

consecutive years an auditor has served a client) and provision of non-audit services (NAS) fees. Carey and Simnett (2006) found that excessively long auditor tenure may impair independence through familiarity threats, whereas very short tenure can limit understanding of client-specific risks.

Choi et al. (2010) suggested that audit fees, especially abnormal fees (significantly above or below expected levels based on client size and complexity), can proxy for audit quality. Abnormally low fees may signal reduced audit effort, while abnormally high fees could indicate economic dependence on the client, threatening independence.

Klein (2002) demonstrated that strong, independent, and active audit committees enhance audit quality by reinforcing oversight and supporting auditor independence. Audit committee characteristics (independence, expertise, and meeting frequency) are often included as moderating variables in audit quality studies.

Emerging research considers the use of advanced audit analytics, artificial intelligence, and continuous auditing systems as modern indicators of audit quality. For instance, firms employing data analytics to test 100% of transactions rather than samples are perceived to deliver higher assurance levels (Brown-Liburd et al., 2015).

Audit quality often features as a moderating variable in the relationship between earnings management and market-based outcomes. Nuryaman (2013) found that high audit quality weakens the negative association between earnings management and stock returns by improving investor trust in reported figures. Similarly, Francis & Wang (2008) showed that audit quality mitigates the effect of weak investor protection on earnings quality.

Theoretical linkages by agency theory show that high-quality audits serve as monitoring mechanisms to align managerial actions with shareholder interests. The signaling theory shows that the appointment of reputable auditors or disclosure of extensive KAMs signals financial reporting credibility to the market. The stakeholder theory opines that audit

quality protects the interests of multiple stakeholders by ensuring fair and transparent reporting.

High audit quality enhances investor confidence, reduces information asymmetry, and supports efficient capital allocation. However, measuring audit quality remains complex due to its multidimensional nature. Regulators and standard setters continue to promote stronger audit oversight e.g., audit partner rotation, mandatory KAM disclosures in order to enhance audit effectiveness, particularly in emerging markets like Kenya, where enforcement may be inconsistent.

2.4 Empirical Literature

2.4.1 Cost Classification Shifting and Earnings Predictability

Existing studies provide evidence that when the activity level decreases, costs decrease less than when the activity level increases by the same amount, that is, the cost is sticky (Anderson et al., 2003; Banker et al., 2013; Weiss, 2010; He et al., 2020). Cost stickiness is proved to be common in different countries and different cost categories (Anderson et al., 2003; Banker et al., 2013). The existence of cost stickiness not only affects operational efficiency and operational risk (Anderson et al., 2003; Yao, 2018), but also have a significant impact on analysts' forecasting behaviour (Weiss, 2010) At present, the view that cost stickiness affects the accuracy of analysts' earnings forecasts has been widely recognized by the academic community, and many literature have discussed this issue (Banker and Chen, 2006; Weiss, 2010)

Weiss (2010) investigated the effect of asymmetric cost behavior on analysts' earnings forecasts, focusing on the accuracy of consensus forecasts for industrial firms in the United States over the period 1986–2005. Using data on COGS and SG&A cost components, the study found that firms with stickier cost behavior exhibited less accurate analysts' earnings forecasts compared to those with more flexible cost structures. The findings also revealed that cost stickiness influenced analysts' coverage priorities and that

investors incorporated sticky cost behavior into their valuation assessments. This seminal U.S.-based study provides a foundational link between management accounting topics on cost behavior and financial accounting issues such as forecast accuracy, analyst coverage, and market reactions to earnings surprises.

Other asymmetric cost behaviour studies relate it with influence in managerial expectations and their deliberate resource adjustment choices. Chen (2015) examined the influence of managerial expectations on cost stickiness, focusing on how managers' tone in the Management Discussion and Analysis (MD&A) sections of annual reports reflects projections of current and future demand. Using 45,048 firm-year observations of non-financial firms in the United States (excluding financial and public utility firms due to their industry-specific disclosure requirements) over the period [insert exact years if known], the study measured managerial expectations through textual analysis of MD&A tone and cost stickiness as the log change in SG&A expenses from one year to the next. Findings revealed a positive and significant association between favorable managerial tone and the degree of cost stickiness, with the relationship being contingent on the availability of slack resources and adjustment costs. This U.S.-based study highlights how managerial disclosure language serves as a predictor of cost behavior, linking qualitative reporting practices to quantitative financial outcomes.

Ibrahim (2018) studied the impact of corporate governance mechanisms on the extent of asymmetric cost behaviour for 80 non-financial firms companies listed on the Egyptian Stock Exchange during 2008-2013. They exclude financial firms due to the stringent regulatory provisions. Corporate governance aspects are extracted from board information provided on the front pages of the financial reports including board names, positions, and executive and ownership structures. Applying the Anderson *et al.* (2003) model the changes in cost of goods sold is regressed against changes in revenues to determine the costs' response to sales changes. The regression results of estimating the basic model provide evidence on asymmetric cost behaviour from the emerging economies. The results confirm assertions of resource adjustments influenced by management's decisions such as discounts on COGS. Further results indicate that smaller boards and chairman/CEO

separation could mitigate cost stickiness while the ratio of non- executives on boards found to increase cost stickiness.

This study by Hevas *et al.* (2020) investigates the relationship of asymmetric cost behaviour with earnings quality for European listed firms. It uses a sample that consists of 11,416 firm-year observations of European listed firms over the period 2005-2019 to explore the relationship of asymmetric cost behaviour with (i) the managerial incentives to meet earnings targets, (ii) conditional conservatism, (iii) the level of operating accruals, and, (iv) earnings' smoothing. Empirical evidence indicates that the presence of managerial incentives to meet earnings targets decreases the intensity of SG&A cost stickiness. It also shows that asymmetric timeliness estimates in the conditional conservatism estimation models have an upward bias unless these models do not control for asymmetric cost behaviour. Finally, it seems that the presence of asymmetric cost phenomenon affects earnings smoothing because the level of earnings smoothing decreases as the level of cost stickiness increases and earnings smoothing is more sensitive to sale decreases than to sale increases.

A study by Hwang, Lee, and Nam (2023) explored the relationship between classification shifting and stock price crash risk, focusing on the hoarding of bad news through this practice. Previous research has shown that investors give more weight to core earnings and that stock price crashes may be triggered by delayed bad news releases. Extending these findings, the authors hypothesized that stock price crash risk would be positively associated with the reversal of core earnings by managers engaging in classification shifting. Their results confirmed this positive relationship, demonstrating that classification shifting was linked to future stock price crash risk, even when the bottom-line net income remained unchanged. This relationship persisted after accounting for endogeneity and other influencing factors. The authors also noted that the effect was more pronounced among opportunistic shifters, offering valuable insights into the market's reaction to manipulated earnings. This study contributes to understanding stock price crash risks and the market's negative reaction to changes in core earnings driven by classification shifting. The gap in this research, in light of the current study's objective,

lies in its focus on stock price crash risk, whereas the present study seeks to understand how voluntary disclosures impact earnings predictability in Kenya's listed firms.

Anagnostopoulou, Gounopoulos, Malikov, and Pham (2021) investigated how earnings management through classification shifting impacts the survival of newly listed firms using a dataset of 1969 non-financial US firms during 1990–2018,. They argued that income-decreasing expenses shifted from core earnings to special items could signal poor future operating performance by masking the actual repeatable profitability of a firm. Their findings revealed that classification shifting negatively affected IPO success and long-term survival. The study also identified economic mechanisms driving this negative relationship, with stronger corporate governance mitigating the effect. For IPO firms operating in favorable business contexts, weaker-than-reported sustainable performance did not translate into lower firm survivability due to external factors aiding firm operations. These findings challenge the notion that classification shifting is merely a “soft” form of earnings management, without long-term consequences. While their study offers important insights, the gap for the present study lies in its focus on IPO survival, whereas the current research aims to examine the impact of voluntary disclosures on earnings predictability among listed firms in Kenya.

Adıgüzel (2017) examined the use of classification shifting by managers to classify operating expenses as non-operating, focusing on income-decreasing discretionary accrual firms. Data are obtained for the years 1994-2014 from the Bloomberg Database. The study found no evidence of shifting between operating and non-operating expenses. However, the author discovered that when income-decreasing accrual management was not employed, managers still engaged in shifting operating expenses to non-operating categories. This suggests that income-decreasing accrual management influences both operating and non-operating expenses, making it difficult to accurately measure classification shifting without considering accrual management. The author's findings highlight the importance of accounting for discretionary accrual management in the measurement of classification shifting. This paper contributes to the literature by questioning the validity of previous studies that neglected the role of accruals in their

models. Given the current study's objective to explore the influence of voluntary disclosures on earnings predictability, the gap in this study lies in its focus on accrual management in the context of classification shifting, whereas the present research aims to investigate the effects of voluntary disclosures on earnings predictability in listed firms in Kenya.

Almaleeh (2019) conducted a systematic review of the motivations behind managers' engagement in classification shifting, revealing that firms often resort to this practice to inflate core earnings. a comprehensive database analysis was performed using five major databases that include accounting-related journals were identified: EBSCO academic search complete database, Emerald e-journals premier collection, ELSEVIER databases, JSTOR digital library of academic journals, and ProQuest dissertations and theses. The study identified several reasons for classification shifting, including its lower cost compared to other earnings management techniques, the firm's financial distress, and the desire to meet or exceed earnings benchmarks. The author also highlighted that firms in weak corporate governance environments were more likely to engage in classification shifting, as this practice is difficult for external monitors to detect. This paper offers valuable insights into the motivations behind classification shifting and its implications for financial reporting. The study also emphasizes the importance of ownership structure and the role of corporate governance in mitigating such practices. The gap in this research, considering the current study's objective, is that it focuses on motivations for classification shifting, while the current study aims to understand how voluntary disclosures influence earnings predictability in Kenya's listed firms.

Špacírová et al. (2020) conducted a scoping review of costing methodologies in healthcare, covering studies published between 2005 and 2018 across online databases in 41 documents from 26 European countries. Their review identified significant discrepancies in the terminology and methods used in economic evaluations, especially in healthcare organizations that may lack sophisticated accounting systems. The study revealed that top-down micro-costing was the most common analysis method, followed by top-down gross-costing and bottom-up micro-costing. The authors suggested that

inconsistencies in costing methods could affect the outcomes of economic evaluations in healthcare. They proposed a general framework for classifying costing methods to standardize evaluations in healthcare. While the study provides insights into costing methodologies, it does not directly relate to classification shifting or earnings predictability, presenting a gap in understanding how voluntary disclosures might affect earnings predictability in Kenya's listed firms.

Abdalla and Clubb (2023) provided an improved classification shifting model that addresses potential biases in prior studies that used accruals as controls. They collected annual accounting data from Compustat for the period 1989 to 2017. Their research revealed that including accruals in classification shifting models could lead to biased results, and they proposed a new model that controls for these biases. Their study found strong evidence of classification shifting, rejecting the hypothesis that accruals cause bias. The authors also found that shifted core expenses exhibited forecasting properties, making the improved model more reliable. Furthermore, their results indicated that there was rationality in relation to shifted core expenses, though partial irrationality might exist for adjusted special items. This paper offers significant advancements in the methodology for measuring classification shifting, contributing to the literature by refining the tools used to analyze such practices. However, the gap in this study lies in its focus on the methodological improvements for detecting classification shifting.

Fan, Barua, Cready, and Thomas (2009) investigated the joint use of non-GAAP disclosures and classification shifting to highlight core performance. Using results from McVay (2006) they found that managers often employed both strategies simultaneously, particularly in firms under heightened external monitoring by institutional investors and financial analysts. Their findings revealed that such firms exhibited more persistent earnings, thereby enabling analysts to form more accurate expectations. Importantly, the study suggested that these practices were not purely opportunistic but could serve as an informative signal of underlying performance. This perspective challenges the traditional view that discretionary reporting practices always reduce transparency. However, the study leaves a gap by focusing primarily on U.S. firms and external monitoring pressures,

while the current research extends the inquiry to Kenyan listed firms, examining how such practices influence earnings predictability in an emerging market context.

Ha and Thomas (2020) explored the relationship between classification shifting and earnings predictability, investigating whether managers use this practice to aid investors in forecasting future performance. Using a dataset of financial and stock returns data from Compustat and CRSP. Accruals are computed as the difference between net income and operating cash flows the study found that, in certain contexts, classification shifting may actually enhance earnings predictability rather than undermine it. This challenges the dominant view of classification shifting as purely opportunistic, suggesting instead that it can serve an informative role by signaling underlying performance to investors. Their findings contribute to the literature by emphasizing the potential positive consequences of classification shifting, while also highlighting the need for further research into contextual factors that determine whether the practice is informative or misleading. However, the gap for the present study lies in its focus on investors' interpretive outcomes, whereas the current research investigates how accounting discretion—of which classification shifting is one element—affects earnings predictability in the Kenyan capital market context.

Ha (2021) investigated the joint use of non-GAAP disclosures and classification shifting as a dual reporting strategy to emphasize core performance. Based on an empirical sample of U.S. publicly listed firms drawn from Compustat data the study found that managers systematically deploy both practices together, especially under conditions of high external monitoring by institutional investors and financial analysts These firms demonstrated more persistent earnings, aided analysts in forming less dispersed and more accurate forecasts, and exhibited a higher earnings response coefficient around earnings announcement. The authors concluded that combining these strategies may serve as an informative signal of firm performance, rather than purely opportunistic manipulation. This study advances the classification shifting literature by illustrating how managerial discretion can enhance earnings predictability in certain contexts, notably through the interplay of disclosure types. However, its scope is limited to national markets with robust external monitoring, making its findings less generalizable to emerging capital markets.

2.4.2 Fair Value Accounting Estimate and Earnings Predictability

Šodan (2019) empirically tested the impact of fair value hierarchy inputs particularly Level 2 and Level 3 “mark-to-model” inputs on earnings volatility among 1,220 U.S. banks over the period 2011–2016. The focus on banks was appropriate because they typically hold a higher proportion of financial instruments and unrealized fair value gains or losses than non-financial firms, making them more exposed to valuation subjectivity. Earnings volatility was operationalized as the standard deviation of net income scaled by total assets, a common measure of stability in accounting earnings. The study’s findings revealed that a higher share of Level 2 and Level 3 inputs increased earnings volatility, while a greater reliance on Level 1 “mark-to-market” inputs reduced volatility. This result is attributed to the higher subjectivity and potential measurement errors associated with Level 2 and Level 3 inputs, which are often based on management judgment or unobservable market data. Conversely, Level 1 inputs, derived from active market prices, were shown to enhance the reliability of reported earnings. This research provides important insights into the trade-off between relevance and reliability in fair value accounting, supporting concerns that mark-to-model measurements may undermine earnings predictability by introducing estimation noise. However, the findings are based on U.S. financial institutions, which operate in highly regulated markets with sophisticated investors and auditors. For emerging markets like Kenya, where capital market depth and regulatory enforcement are comparatively weaker, the volatility implications of fair value accounting may be even more pronounced

Siekkinen (2017) investigated the influence of board characteristics on value relevance of fair value estimates for financial firms as guided by IFRS 13 from 29 European countries in the post-IFRS 13 implementation period. It sought to seek if the board had a significant monitoring effect on the role of managers in disclosing level 1-3 of fair value hierarchical elements. Board characteristics elements such as board independence, gender diversity, board size, activity and risk. Findings show that all the three fair value levels are of importance to decision makers. While level 3 estimates lack verifiability, the disclosures made on them increase the reliability of the estimates provided. According to this study,

investors assume that the need to make additional disclosures makes investors more conscious of the information and managers therefore have less possibilities to misuse the measurement discretion. Overall findings show that investors place more reliance on fair value estimates for firms with larger, more diverse and independent boards. However, the findings are drawn from the European financial sector, where corporate governance frameworks and investor protections are relatively advanced. For developing markets such as Kenya, where board structures may be less robust and investor monitoring less effective, the extent to which board characteristics influence the credibility of fair value estimates remains underexplored.

Fiecher and Meyer (2010) examined the reliability of reported fair values in the banking sector, focusing on whether financial institutions overstated asset values to influence perceived performance and risk. The study analyzed a sample of 329 U.S. banks, covering financial reporting data from the early 2000s up to the pre-crisis period, and situated within the United States banking industry. The scope of data collection included reported fair values, the use of Level 2 and Level 3 inputs, loan portfolio sizes, and regulatory capital requirements. Their findings revealed that some banks, particularly those with smaller loan portfolios and lower regulatory capital obligations, tended to overstate reported fair values in order to appear less risky and more profitable. The results raised concerns about the reliability of mark-to-model estimates and emphasized the importance of reliability as a key criterion in the International Accounting Standards Board (IASB) framework when selecting between accounting alternatives. This study provides empirical evidence that subjective fair value inputs may distort earnings quality and reduce the credibility of financial reports.

Song et al. (2010) analyzed the value relevance of fair value disclosures across the three levels of the fair value hierarchy using a statistical correlation model. The study examined 431 U.S.-listed banks over the first three quarters of 2008, during the global financial crisis. The scope of data collection included fair value inputs categorized under Level 1 (mark-to-market), Level 2, and Level 3 (mark-to-model) disclosures. The findings showed that Levels 1 and 2 fair value estimates were more relevant to investors than Level 3

estimates, which were still relevant but discounted due to their subjectivity and susceptibility to measurement error. The results suggested that investors placed less reliance on mark-to-model estimates, likely due to information asymmetry and moral hazard concerns. However, the study further revealed that the relevance of Level 3 estimates increased in firms with stronger corporate governance structures, underscoring the moderating role of governance in enhancing the credibility of less verifiable fair value disclosures.

Tutino and Pompili (2017) examined how the hierarchy of fair value inputs (Levels 1, 2, and 3) shapes investors' perceptions of reported values. The study focused on European listed firms using a sample of 506 insurance companies in two main areas –in the US and in Europe - all listed between 2008 and 2013. Their analysis showed that a lower degree of input observability, such as reliance on Level 3 estimates (mark-to-model), is associated with reduced reliability of reported fair values, largely due to investor concerns about management discretion, estimation errors, and the potential for manipulation. The results indicated that the Fair Value Input (FVI) index demonstrated a positive relationship with predictability, volatility, and value relevance, although the coefficient for persistence was not statistically significant, suggesting no stable long-term effect. Importantly, the study found that while Level 3 fair values were still value-relevant, their explanatory power decreased significantly compared to Level 1 and Level 2 estimates. Overall, the evidence confirmed a negative relationship between reliance on fair value accounting (FVA) and earnings quality, especially in terms of predictability and volatility. However, the authors concluded that there were no strong or consistent differences among the three input hierarchies, which implies that investor skepticism toward Level 3 disclosures could be partly mitigated by the broader reliability of IFRS-mandated disclosure frameworks.

Dee et al. (2024) examined whether regulatory oversight improves perceptions of fair value (FV) reporting quality, focusing specifically on Public Company Accounting Oversight Board (PCAOB) inspection reports in the United States. The study used a market-based measure of financial reporting quality as its scope of data analysis. Findings revealed a positive association between the intensity of FV-deficient inspection reports

and the perceived reporting quality of Level 2 FV investment assets, but not Level 3 assets. Notably, this effect was stronger when audit office expertise in FV was high, suggesting that technical competence enhances the usefulness of oversight. The scope of audit quality in this study is only limited to the audit office. The results indicate that PCAOB inspections improve disclosures by making FV footnotes more readable and reducing the amount of cautionary language, especially as Level 2 holdings increase. This contributes to the literature on fair value accounting by demonstrating that regulatory oversight and audit expertise jointly shape investor perceptions of FV-based reporting quality.

García Osma et al. (2022) investigated whether changes in accounting estimates reflect new information or are strategically motivated by managers. Drawing from a sample of US publicly listed firms and covers the period of 2003–2017, the study categorized material estimate changes and examined their association with subsequent financial restatements. It differentiated between income-increasing and income-decreasing estimate adjustments, uncovering that the underlying motivations and determinants vary by type, some firms appear to employ estimate changes opportunistically when other channels under GAAP are restrictive. This research contributes a nuanced perspective to the accounting discretion literature by illuminating the conditions under which estimate changes may serve strategic rather than informational purposes. However, the study does not explore the mitigating role of audit quality in constraining such managerial discretion, a critical gap that the present investigation into the influence of audit quality on earnings predictability among NSE-listed firms seeks to address.

Gopalan et al. (2021) investigated how individual audit partner–client relationships influence the quality of accounting estimates in the banking industry. Using confidential regulatory data on audit partner identities on all bank audits between 2005 and 2019 in the United States, the study provided rare insight into partner-level effects on audit quality, something often masked in firm-level audit research. The dataset allowed the authors to track partner assignments and loan loss reserve reporting across banks. Their analysis revealed that banks reported higher loan loss reserves at the beginning of audit partner–client relationships, with greater accuracy in these early years. However, as tenure

progressed, the quality of accounting estimates gradually declined. The authors further compared public versus private banks and found that while public banks, subject to higher levels of regulatory scrutiny, reported relatively higher reserves, the accuracy of estimates remained consistent across both groups. This finding suggests that regulatory environments influence the magnitude of reserves, but not necessarily their quality. Overall, the study highlights the importance of audit partner tenure in shaping accounting estimate quality and reinforces the argument that audit quality is not solely a firm-level construct, but also depends on the individual characteristics and incentives of audit partners. The implications are significant for regulators and standard-setters, as partner rotation rules may help sustain audit quality in contexts where long tenure risks complacency or reduced scrutiny.

Goh et al. (2021) investigate stakeholders' trust in fair value accounting. Using survey data, the research finds that although respondents exhibit high confidence in financial statements, they believe fair value accounting reduces trust in financial reporting due to the complexities of preparing FV estimates. The study further identifies that perceiving fair value accounting as beneficial positively influences trust, consistent with the theory of reasoned action. The findings contribute to fair value literature by providing insights into how perceived benefits shape trust in FV accounting. However, the study does not analyze the role of audit quality in ensuring reliable fair value measurements, a gap that the current study seeks to bridge.

Toluwa and Power (2019) critically examined the controversial issues surrounding fair value accounting (FVA), particularly its relevance and reliability. Adopting a library research methodology, the study synthesized existing theoretical and empirical literature to highlight how FVA practices are influenced by market liquidity, the existence of active markets, and the stability of market environments. The findings underscored several challenges associated with FVA, including verification difficulties, pro-cyclical effects, and its impact on the quality of earnings. The authors argued that while FVA improves the timeliness and comparability of financial information, it also raises concerns about subjectivity in valuation, particularly when markets are illiquid or inactive. This duality

complicates its role as a reliable basis for decision-making, especially in contexts where investors rely heavily on reported earnings. To address these limitations, the study recommended more empirical research into the effects of fair value accounting on earnings quality, particularly within emerging economies, where market inefficiencies and institutional weaknesses may magnify its risks.

McDonough et al. (2020) provide an overview of the institutional background of fair value accounting (FVA) and the associated accounting standards under both IFRS and GAAP Using Compusat data for financial and nonfinancial firms from 2008–2017. Their study documents the extent to which firms across different industries employ FV measurement, revealing that the use of fair value differs considerably depending on industry context and regulatory environment. For instance, financial firms, especially banks and insurance companies, demonstrate higher reliance on fair value due to their significant holdings of financial instruments, while non-financial firms exhibit more selective application of FV measurement. The study further identifies challenges related to implementation and disclosure, particularly in contexts where markets for underlying assets are illiquid or inactive. McDonough et al. emphasize that FV disclosures not only lack comparability across firms but also vary widely across jurisdictions, thereby complicating investor interpretation. They argue that such inconsistencies point to an urgent need for greater standardization in FV reporting practices to enhance transparency and comparability across global markets.

Mwapula (2016) examines the relationship between corporate governance and fair value accounting in the Kenyan context, specifically focusing on commercial banks listed on the Nairobi Securities Exchange (NSE). Using a census approach of 11 banks covering the period 2011 to 2015, the study employs regression and correlation analysis to test whether board characteristics influence the use of Level 2 and Level 3 fair value inputs. The findings reveal that board independence and external auditor independence positively affect the reliability and use of FV estimates, suggesting that stronger oversight mechanisms enhance the credibility of discretionary FV reporting. Conversely, board share ownership and compensation structures were found to negatively influence FV

estimates, indicating possible conflicts of interest where directors may prioritize personal gains over transparent reporting. This study is particularly relevant for developing economies, as it highlights the critical role of governance structures in shaping fair value reporting practices under IFRS. However, Mwapula's work does not extend to examining how audit quality beyond external auditor independence, moderates the relationship between FV estimates and earnings predictability. This gap is addressed by the present research, which integrates audit quality as a moderating variable to assess its role in enhancing the reliability of accounting discretion in Kenyan listed firms.

Kaaya (2022) examines the value relevance of financial reporting under IFRS compared to local GAAP using data from 15 listed firms in India and Tanzania over a nine-year period (2006–2014). Employing the Edward-Bell-Ohlson valuation model, the study evaluates the explanatory power of accounting figures in relation to firm share prices. The findings reveal that IFRS-based accounting figures exhibit stronger explanatory power on firm share prices compared to those prepared under local GAAP. Furthermore, the results indicate that book value of equity is more value-relevant than earnings per share under IFRS, suggesting that equity-related disclosures play a stronger role in investor decision-making. The study contributes important empirical evidence supporting the benefits of IFRS adoption in emerging capital markets, showing that IFRS enhances the usefulness of financial reports for valuation purposes. However, Kaaya's research does not explore how audit quality might enhance the reliability and credibility of IFRS-based reporting. This omission highlights a gap that the current study seeks to fill by investigating the moderating role of audit quality in the relationship between accounting discretion and earnings predictability for listed firms in Kenya.

2.4.3 Voluntary Disclosures and Earnings Predictability

Uyar and Kiliç (2012) investigated the value relevance of voluntary disclosures for Turkish firms listed on the capital market. Using annual reports from 129 firms in 2010, they conducted content analysis to construct a disclosure index and regressed this index against firm value, measured by market capitalization. Control variables included firm

size, leverage, profitability, and growth. The findings revealed a strong positive correlation between disclosure level and firm value, confirming that voluntary disclosures are value-relevant, firms with higher levels of voluntary disclosure were perceived as more valuable by investors. This suggests that market participants attach weight to transparent and comprehensive reporting beyond mandatory requirements, reinforcing the role of voluntary disclosure in enhancing investor confidence and market efficiency. However, the study was limited to a single year (2010) and one country (Turkey), raising questions about the generalizability of its findings to other contexts, particularly in emerging African markets such as Kenya.

García-Sánchez *et al.* (2019) in their study sought to find out the relationship between managerial discretion in the financial reporting process and the susceptibility to disclose an integrated report. They also sought to determine the influence board of directors and investor protection policies influence the disclosure and secretion relationship. Their study covered an international sample of 956 firms from the USA, Europe and the Middle East for a period between 2006 and 2014. Integrated reporting was evaluated using dummy variables for coded in zero and 1 for 7 broad aspects covering business and organization model; context, risk and opportunities; strategic goals and strategies; corporate governance and remuneration policy; Performance- financial, social, environmental and value creation; future outlook and; description of analyzed key performance and risk indicators. The moderator board of directors was measured with proxies of board independence, diversity and training. Overall findings showed that high managerial discretion exist especially in fast growing firms and negatively affects information dissemination value of integrated reports. Corporate governance played a big role in disclosure of more non-financial information hence more transparency to stakeholders.

Alfraih and Almutawa (2017) conducted a study in Kuwait, analyzing data from the annual reports of 52 out of 163 listed firms over a four-year period. Their primary objective was to examine the influence of voluntary disclosures and corporate governance on financial reporting practices. To measure voluntary disclosures, the authors constructed a disclosure index consisting of 49 voluntary items, grouped into four categories: (1)

corporate environment, (2) corporate financial performance and future prospects, (3) corporate governance information, and (4) corporate social and environmental information. The disclosure index was computed as a ratio of actual to expected disclosures. This index was then regressed against multiple factors, including firm size, profitability, leverage, growth, industry type, and auditor type, which served as control variables. The results revealed that voluntary disclosures in Kuwait were generally low, initially averaging around 20%, but showed gradual improvement over the study period, reaching about 58%. Importantly, the study found that corporate governance variables significantly influenced the extent of voluntary disclosure. This highlights the role of governance mechanisms such as board oversight and audit quality in enhancing transparency.

Ogwe (2014) investigated the determinants of voluntary disclosures among firms listed on the Nairobi Securities Exchange (NSE), Kenya. The study focused on a sample of 31 firms out of the 62 listed as of 2012, representing about half of the market. The analysis considered both internal and external control mechanisms, with particular attention to corporate governance factors such as board size, board composition, and audit committee characteristics. Firm-specific characteristics—including size, leverage, profitability, and external auditor type, were also examined for their influence on disclosure quality. Voluntary disclosure was measured using an index score that captured both financial and non-financial disclosures. These were categorized into four broad constructs; General and strategic information, Financial data, Forward-looking information, Social and board disclosures. The findings revealed that corporate governance attributes and firm characteristics significantly influenced disclosure quality. Larger firms, firms with more diverse boards, and those audited by reputable external auditors tended to disclose more information. This suggested that stronger governance and monitoring structures encouraged higher levels of voluntary disclosure. However, the study was limited to a single year (2012) and did not extend to analyzing how voluntary disclosure influences earnings predictability

Njoroge (2018) investigated the effect of voluntary disclosures on the cost of equity capital for firms listed on the Nairobi Securities Exchange (NSE), Kenya. The study focused on a sample of 20 firms over a five-year period, thereby providing a medium-term view of disclosure practices and their capital market implications. Grounded in information signaling theory, the research assumed that investors rely on reported earnings and voluntary disclosures to reduce information asymmetry, improve transparency, and build confidence in firms' performance. To measure this relationship, voluntary disclosure scores were regressed against the firms' cost of equity capital. The findings revealed a positive but statistically insignificant relationship between voluntary disclosures and cost of equity. Specifically, the regression results showed that voluntary disclosures accounted for only about 9% of the variation in the cost of equity across the sampled firms. This suggests that while disclosure practices may contribute to investor confidence, they did not materially influence the cost of equity in the Kenyan context during the study period.

Gay (2024) examined how the preemptive voluntary disclosure of earnings surprises affects managerial operating decisions. Using two experiments, the study tested whether managers make inefficient operating decisions when an earnings surprise is expected and whether different types of voluntary disclosure mitigate such decisions. The results showed that managers were more likely to make inefficient decisions when anticipating a negative earnings surprise but not when expecting a positive surprise. Moreover, quantitative voluntary disclosures mitigated these inefficient decisions, whereas qualitative disclosures did not. The study provided new insights into how voluntary earnings disclosures influence internal management decisions. However, it primarily focused on operating decisions rather than earnings predictability. This gap justifies further investigation into how voluntary disclosures affect earnings predictability in Kenya's listed firms.

Han and Wang (2022) studied the predictability of stock price movements after the disclosure of corporate annual reports, focusing on the Chinese stock market, quarterly financial data and stock price data of Chinese listed companies over 10 years from 2011 were obtained from the Guotaian database. They employed multiple machine learning

models, including decision trees, logistic regression, random forests, neural networks, and prototypical networks, using two sets of financial indicators obtained from the East Money website. Their findings showed that these models struggled to predict stock price movement on the second day following disclosure, with random forests achieving the highest accuracy of 59.6% and precision of 0.56. Stock filtering criteria such as return on equity (ROE) greater than 0.15 and net cash ratio above 0.9 did not enhance prediction accuracy. The study concluded that financial indicators from recently disclosed annual reports provided weak predictability for stock price movement. However, the study was focused on stock price movements rather than the influence of voluntary disclosures on earnings predictability, highlighting the need for research in the Kenyan context.

Gietzmann and Ostaszewski (2022) modelled how firms manage their voluntary disclosure decisions between two strategies: candid disclosure, which is fully transparent, and sparing disclosure, which only reveals values above a dynamic threshold. Using a continuous-time setting, they demonstrated that firms receive reputational premiums for candid disclosures but also face risks associated with revealing low-value information. The study modeled private news updates using a Poisson process between mandatory disclosure dates, such as fiscal years or quarters. It was found that firms tend to alternate between candid and sparing disclosures depending on parameters such as news intensity, pay-for-performance incentives, and the time remaining before mandatory disclosure. The study provided insights into the strategic decision-making process behind voluntary disclosure but did not explicitly examine the impact of voluntary disclosure on earnings predictability.

Leung (2005) investigated whether earnings predictability influences managerial decisions in the voluntary disclosure of non-financial information, particularly strategic operating information (SOI). The study examined the relationship between analysts' earnings forecast accuracy and the extent of SOI disclosure by managers for firms active in 2000 in Hongkong. Using an empirical analysis of firm-level data, Leung found that managers of firms with higher analyst forecast errors were more likely to disclose SOI voluntarily. This suggests that when earnings are more difficult to predict, managers

strategically provide additional non-financial information to reduce information asymmetry and guide market expectations. Furthermore, the study revealed that firms that expanded their SOI disclosures experienced improved forecast accuracy, reinforcing the signaling role of voluntary disclosure. The findings support the argument that voluntary disclosure is used as a communication tool, especially in situations where reported earnings alone are insufficient for accurate investor forecasting. However, the study was conducted within a developed market context and primarily emphasized analyst forecast accuracy rather than earnings predictability at the firm level.

Francis, Nanda, and Olsson (2008) investigated the relationship between voluntary disclosure, earnings quality, and the cost of capital. The study analyzed 677 firms' annual reports and 10-K filings for the fiscal year 2001, using a self-constructed disclosure index to measure voluntary disclosure practices. The findings revealed that firms with higher earnings quality engaged in more extensive voluntary disclosures compared to firms with lower earnings quality. Unconditional tests indicated a negative relationship between voluntary disclosure and the cost of capital, suggesting that increased disclosure reduces financing costs by improving transparency and lowering perceived investor risk. However, when controlling for earnings quality, the impact of voluntary disclosure on cost of capital diminished or disappeared. This implies that disclosure alone may not drive lower capital costs without the moderating effect of strong earnings quality. The study makes an important contribution by showing that voluntary disclosure interacts with the underlying quality of earnings in influencing capital markets. However, its scope was limited to U.S. firms in 2001, focusing primarily on the cost of capital rather than earnings predictability.

2.4.4 Accruals Earnings Management and Earnings Predictability

Salsiah et al. (2008) investigated the relationship between managerial ownership and earnings management, using discretionary accruals as a proxy, in the context of Malaysian listed firms. Secondary data was obtained from annual reports of firms listed on Bursa Malaysia for the years ending 2002 and 2003. The study built on the premise that

discretionary accruals can serve two functions: they may mislead shareholders when used opportunistically, or alternatively, they may improve the informativeness of financial reports when applied within the boundaries of sound accounting judgment. The study estimated discretionary accruals by focusing on working capital accruals (excluding depreciation), which are generally more visible to users and therefore harder to manipulate. These accruals were regressed against revenues to derive residual error terms, which served as the measure of discretionary accruals. The findings revealed a significant relationship between ownership structure and earnings management. Specifically, firms with higher levels of managerial ownership exhibited a stronger link to discretionary accruals. However, the study also highlighted that this relationship was influenced by firm size, with smaller firms being more susceptible to manipulation compared to larger firms, likely due to weaker governance mechanisms and fewer monitoring resources.

Sánchez-Ballesta and García-Meca (2007) examined the explanatory power of discretionary accruals, focusing on how they interact with ownership structure in Spanish non-financial companies listed on the Madrid Stock Exchange during the period 1999–2002. Grounded in agency theory, the study assumed that ownership structure serves to align managerial and shareholder interests, thereby constraining opportunistic managerial behavior. Methodologically, the study regressed the absolute value of discretionary accruals against annual stock returns on earnings, while controlling for ownership structure. This approach allowed the authors to test whether insider ownership influenced the informativeness of accruals. The findings revealed a linear relationship between insider ownership and discretionary accruals, with insider ownership improving the explanatory power of accruals up to a threshold of 40% ownership. Beyond this point, the effectiveness diminished, likely due to the increasing influence of managerial risk preferences and entrenchment behavior.

Oluoch (2015) examined the effect of accruals quality on the cost of capital for firms listed on the Nairobi Securities Exchange (NSE). The study distinguished between innate and discretionary accruals, with discretionary accruals measured as the error term from a regression of accruals quality against the standard deviation of operating cash flows,

revenues, and incidence of losses over a five-year rolling period from the accruals year. The study applied purposive sampling to 39 out of the 61 listed firms, covering a 20-year period up to December 2013. This long horizon enabled the researcher to capture multiple economic cycles and changes in reporting practices. The findings revealed that the overwhelming majority of accruals, 99% were innate rather than discretionary, suggesting that listed firms in Kenya exercise relatively little discretion in their accrual reporting process. Consequently, discretionary accruals had no significant effect on the cost of capital for NSE-listed firms. These results imply that in the Kenyan context, earnings management through accruals is limited, possibly due to regulatory oversight, governance mechanisms, or the relatively smaller size of the capital market compared to developed economies.

Simamora (2018) examined the effect of earnings management on earnings predictability from an information signaling perspective, focusing on manufacturing firms listed on the Indonesian Stock Exchange between 2003 and 2015. The study specifically evaluated accruals earnings management (AEM) in relation to auditor quality, where auditor affiliation (Big Four vs. non-Big Four) served as a proxy for audit quality and the cost investors incur to detect AEM. The findings showed that in the context of efficient contracting, high-quality auditors provided stronger and more credible signals for earnings predictability compared to lower-quality auditors. This suggests that rigorous external monitoring helps limit opportunistic use of accruals, thereby enhancing the reliability of reported earnings as predictors of future performance. Furthermore, the study found that firms with higher market share and stronger financial health were less inclined to engage in opportunistic real earnings management, as they had less incentive to manipulate earnings to maintain investor confidence. The study contributes to the literature by showing how audit quality interacts with earnings management practices to influence earnings predictability in an emerging market context.

The study by Konan et al., (2001) on earnings quality and stock returns for firms listed on the New York (NYSE), American (AMEX) and Nasdaq markets used accruals as proxies for earnings quality between 1971 to 1995. This was measured using the Sloan (1996)

model measuring accruals as the residual of changes between current assets less current liabilities and depreciation. The study found out that earnings and stock returns are negatively related. Accruals specifically are seen to be informative of expected earnings surprises therefore; like cost asymmetry, Accruals may grow if managers expect sales to grow in the near future. Further, study found out that, earnings increases that are accompanied by high accruals, suggesting low-quality earnings are associated with poor future returns. Possible reasons for accruals predictive power are that high accruals are suggestive of earnings manipulation, or that they may serve as indicators of changes in a firm's prospects.

Roychowdhury (2006) investigated the effect of real and accrual-based earnings management on future firm performance, analyzing all firms in the COMPUSTAT database between 1987 and 2001. The study distinguished between real activities manipulation (such as abnormal production or discretionary expenses) and accrual-based earnings management, using regression models to estimate discretionary components. The findings revealed that both real and accrual-based earnings management have adverse effects on future earnings and stock returns, undermining the persistence and informativeness of reported earnings. However, accrual-based earnings management was more likely to generate short-term boosts in reported earnings, enabling managers to meet market benchmarks or internal targets, but at the expense of long-term value creation. Firms engaging heavily in discretionary accruals tended to show weaker subsequent performance and lower stock returns, consistent with the notion that such practices erode earnings quality. This research contributed significantly to the literature by demonstrating that while managers may achieve short-term benefits from accrual manipulation, the long-term risks include diminished earnings predictability and poor investor outcomes

Chen et al. (2013) extended prior research on corporate governance and earnings management by examining the impact of institutional ownership on the use of discretionary accruals. Using a large sample of publicly listed firms across multiple industries, the study assessed how different categories of institutional investors, particularly those with long-term versus short-term investment horizons, influence

managerial reporting practices. The findings showed that institutional investors with long-term investment horizons tend to monitor and constrain discretionary accruals. These investors focus on sustainable firm performance and are more likely to hold management accountable for earnings manipulation that could jeopardize future value creation. By contrast, short-term oriented institutional investors were less effective at reducing opportunistic accrual-based earnings management. The study further indicated that institutional ownership aligns management's interests with those of shareholders, reinforcing oversight mechanisms that enhance the credibility of financial reporting. This demonstrates that the structure and orientation of institutional investors play a critical role in shaping earnings quality.

Burgstahler and Dichev (1997) examined the relationship between earnings management and stock returns, with a particular emphasis on how accruals affect earnings predictability. Using a large sample of U.S. publicly listed firms, the study analyzed the tendency of managers to use accruals-based techniques to manage reported earnings. The findings indicated that earnings management through accruals undermines the reliability of earnings as predictors of future performance. Firms that engaged in aggressive accrual-based earnings management were shown to experience negative stock returns in the long run, as investors eventually recognized the manipulation and adjusted their expectations downward. The study highlighted that while accruals can temporarily smooth fluctuations in earnings, such practices distort the underlying economic reality and erode investor trust. This research provided early evidence that earnings management has real capital market consequences, linking accrual manipulation to reduced predictability of earnings and diminished long-term firm value.

Jones (1991) introduced the Jones model, one of the most widely used empirical tools for detecting earnings management through accruals. Using COMPUSAT data for 23 firms from five industries over 14 years. The model distinguishes between normal accruals (those driven by firm performance and economic conditions) and discretionary accruals (those reflecting managerial discretion). By regressing total accruals on changes in revenues and levels of property, plant, and equipment, the model isolates the portion of

accruals that may signal earnings manipulation. The study provided evidence that firms with high levels of discretionary accruals tend to attract increased scrutiny from investors, regulators, and auditors, as these accruals often suggest opportunistic reporting behavior. This heightened scrutiny may, in turn, raise firms' cost of capital and reduce firm value, as stakeholders perceive financial statements to be less reliable. The Jones model has since become a foundational tool in accounting research, extensively applied across industries and countries to test for earnings management. Its robustness has made it a benchmark for subsequent refinements, such as the Modified Jones Model (Dechow et al., 1995) and other extensions designed to address limitations in detecting discretionary accruals

Krishnan (2003) examined the relationship between earnings management and audit quality, focusing on how firms' audit choices interact with their use of discretionary accruals. Using data from 4098 firms through the years 1989 to 1998. The study assessed whether the extent of earnings management influenced the type of audit firm selected. The findings indicated that firms with higher levels of discretionary accruals were more likely to hire lower-reputation auditors, potentially as a strategy to avoid the scrutiny and stricter standards of top-tier (Big Four) audit firms. This pattern suggests that managers engaging in more aggressive earnings manipulation may deliberately seek less stringent external monitoring to increase the likelihood that their discretionary reporting practices go undetected. The study underscored the critical role of audit quality in curbing earnings manipulation, showing that high-reputation auditors act as a deterrent against opportunistic use of accruals. By ensuring stronger compliance with accounting standards and enhancing the credibility of financial statements, audit quality helps firms produce more accurate and reliable information for stakeholders.

Kothari et al. (2005) explored the use of discretionary accruals in earnings management and examined their relationship to firm performance. Using a large sample of U.S. publicly listed firms and building on earlier accruals models, the study tested whether discretionary accruals serve as reliable predictors of future operating performance and stock returns. The findings showed that firms engaging in earnings management through discretionary accruals tend to experience poorer long-term performance compared to firms

that report earnings more transparently. While discretionary accruals may provide short-term benefits, such as meeting or exceeding analyst forecasts, smoothing income, or temporarily boosting share prices, they ultimately erode the firm's reputation and undermine stock performance as investors become increasingly skeptical of manipulated financial statements. The study emphasized that the capital market penalizes firms that rely heavily on accruals manipulation once the manipulation becomes evident. In this way, discretionary accruals harm both earnings predictability and long-term firm value, reinforcing concerns that such practices diminish the quality of financial reporting.

Together, these studies provide a comprehensive understanding of the complex relationship between accruals earnings management and various aspects of financial performance, firm governance, and stock market behavior. They highlight the risks associated with earnings manipulation and emphasize the importance of effective governance and high-quality audits in maintaining the integrity of financial reporting.

2.5 Critique of Literature

The reviewed literature on cost classification shifting, fair value accounting estimate changes, voluntary disclosures, and accruals earnings management demonstrates substantial theoretical and empirical development, yet also reveals significant methodological, contextual, and conceptual limitations that justify the present study.

In cost classification shifting research, scholars such as Weiss (2010) and Abdalla and Clubb (2023) employ regression-based detection models that reclassify core and non-core expenses to assess shifting behavior. While these approaches enhance generalizability, they are highly dependent on accrual-adjusted measures that may suffer from construct validity concerns, as proxies for classification shifting may capture unrelated financial reporting practices (Adıgüzel, 2017).

In fair value accounting studies, hierarchical classification (Levels 1–3) is commonly employed to differentiate the observability of inputs (Šodan, 2019; Dee et al., 2024).

While these classifications are conceptually grounded in IFRS 13, reliance on cross-sectional designs constrains causal inference, and the absence of explicit audit quality variables limits understanding of moderating effects. Recent work by García Osma et al. (2022) provides a more nuanced view by categorizing estimate changes, yet it similarly lacks integration with audit quality dimensions.

Voluntary disclosure literature exhibits greater methodological diversity, spanning content analysis (Uyar & Kiliç, 2012), controlled experiments (Gay, 2024), and predictive modeling (Han & Wang, 2022). However, operational definitions of “voluntary disclosure” remain inconsistent, ranging from broad indices to single-event disclosures, thereby weakening comparability across studies and introducing potential subjectivity in measurement.

Accruals earnings management research relies heavily on the Jones (1991) model and its derivatives (Kothari et al., 2005). While widely validated, these models are sensitive to industry adjustment choices and may misclassify normal accrual fluctuations as discretionary manipulation. Decompositions into innate and discretionary components, as in Oluoch (2015), provide valuable distinctions but remain assumption-dependent.

Collectively, the literature exhibits a quantitative dominance with limited methodological triangulation. The absence of complementary qualitative evidence limits insight into managerial intent and the decision-making processes behind these practices, particularly in emerging markets.

The literature is largely anchored in agency theory, positioning earnings management and discretionary disclosures as opportunistic acts aimed at maximizing managerial utility at the expense of shareholders. While this framework remains influential, it risks theoretical myopia by underexploring alternative perspectives. For example, institutional theory could explain how regulatory environments and enforcement intensity shape these practices, prospect theory could shed light on risk preferences in disclosure decisions, and resource dependence theory could account for external capital market pressures.

Furthermore, the prevailing assumption that classification shifting and accruals management are inherently opportunistic is challenged by evidence from Ha and Thomas (2020), who identify potential informational and efficiency-enhancing motives. Similarly, in fair value accounting, some studies (e.g., Siekkinen, 2017) argue that strong governance mechanisms can mitigate reliability concerns, contradicting the view of Level 3 inputs as uniformly problematic. In voluntary disclosure literature, signaling theory is frequently invoked, yet findings from García-Sánchez et al. (2019) caution that high managerial discretion may reduce rather than enhance credibility.

A significant theoretical gap lies in the lack of integrated analysis the literature treats each earnings management tool in isolation, despite evidence that managers often employ multiple techniques concurrently. Equally underexplored is the moderating role of audit quality, which is central to constraining managerial opportunism and enhancing information credibility. While most journals tend to be variable specific. This results from this integrated analysis will be published as a whole to meet this gap.

Across the four areas, there is convergence in the view that opportunistic application of discretion reduces earnings quality, forecast accuracy, and long-term firm value. Similarly, voluntary disclosures are generally found to be value-relevant when perceived as credible and verifiable. However, several divergences persist. In classification shifting research, some studies identify positive informational effects under certain conditions, while fair value accounting literature remains divided on the value relevance of Level 3 inputs. In voluntary disclosure studies, predictive power varies widely. Han and Wang (2022) find minimal stock price predictability, whereas Francis et al. (2008) document significant cost of capital effects, suggesting that market structure and investor sophistication mediate outcomes.

A pronounced limitation is the geographical concentration of evidence in developed markets, notably the United States and Europe, where regulatory enforcement and investor sophistication are relatively high. African and other emerging market contexts remain

under-researched, with a few exceptions such as Oluoch (2015), Njoroge (2018), and Mwapula (2016), which are limited in scope and methodological innovation.

While foundational works (e.g., Jones, 1991; Sloan, 1996) continue to shape measurement and interpretation, significant market, regulatory, and technological changes have occurred, including IFRS updates, enhanced corporate governance codes, and the use of machine learning in financial analysis. Recent contributions (2022–2024) explore regulatory oversight effects (Dee et al., 2024), algorithmic prediction of disclosure impact (Han & Wang, 2022), and activist-driven disclosure dynamics (Gao & Lu, 2024). However, these contemporary insights remain largely untested in emerging economies.

These gaps position the present study to make both theoretical contributions, by extending agency theory with governance and institutional considerations, and practical contributions, by informing regulators, auditors, and investors on the credibility of reported earnings in the Kenyan context.

2.6 Research Gaps

The synthesis of literature on cost classification shifting, fair value accounting estimate changes, voluntary disclosures, and accruals earnings management in section 2.4 reveals a growing body of evidence on the various forms of managerial discretion in financial reporting. However, several critical gaps remain, both in the scope and methodological approaches of existing studies, particularly within the context of emerging markets such as Kenya.

First, geographical and contextual limitations are evident. Most empirical research has been conducted in developed markets, especially the United States, Europe, and parts of Asia, where corporate governance systems, investor sophistication, and enforcement mechanisms are markedly different from those in Kenya. Although isolated African studies exist (e.g., Oluoch, 2015; Njoroge, 2018; Mwapula, 2016), they are limited in

breadth, rarely integrate multiple earnings management practices, and often adopt narrow methodological lenses.

Second, prior studies predominantly examine each earnings management mechanism in isolation, such as focusing exclusively on accrual-based manipulation or fair value inputs. Yet, emerging evidence suggests that managers often employ multiple techniques concurrently, creating interactive effects that may amplify or offset each other's impact on earnings predictability. This fragmented approach limits understanding of the holistic dynamics of financial reporting discretion.

Third, the moderating role of audit quality remains underexplored. While a handful of studies recognize that stronger governance and audit mechanisms can enhance the credibility of financial reports (e.g., Siekkinen, 2017; García Osma et al., 2022), few have empirically tested how audit quality interacts with managerial discretion to influence earnings predictability, particularly in emerging economies where audit quality itself varies considerably.

Fourth, there is a methodological gap in capturing the underlying motivations, decision processes, and market reactions to discretionary reporting. The overwhelming reliance on archival regression-based models, while useful for statistical generalization, often fails to uncover managerial intent or the qualitative dimensions of investor interpretation. Triangulating archival data with qualitative or experimental insights could provide a richer understanding of these dynamics.

Fifth, temporal and regulatory changes have altered the financial reporting environment. Recent reforms in IFRS standards, enhanced disclosure requirements, and increased regulatory oversight (e.g., PCAOB inspection effects—Dee et al., 2024) may influence both the extent and detectability of discretionary practices. Yet, these contemporary shifts remain largely unexamined in the Kenyan context.

Given these gaps, there is a pressing need for an integrated, context-specific investigation that examines how different forms of managerial discretion, cost classification shifting, fair value estimation discretion, voluntary disclosures, and accruals earnings management, interact to affect the earnings predictability of listed firms in Kenya, while explicitly testing the moderating influence of audit quality.

By addressing these gaps, the present study will make three key contributions: (i) theoretically, by extending agency theory and signaling theory by integrating governance, audit quality, and institutional perspectives in explaining earnings predictability under conditions of managerial discretion. (ii) Methodologically, the study is combining robust existing data analysis with contextualized interpretation to enhance validity and applicability to emerging market settings. (iii) Practically this study is providing regulators, auditors, and investors with evidence-based insights into the credibility of reported earnings and the effectiveness of audit oversight in Kenya's capital markets.

This clearly defined gap underpins the conceptual framework and directly informs the hypotheses and methodological choices outlined in the subsequent chapters.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the research design, target population, data collection and data analysis. The research design is a tentative outline, a blue print and a scheme, planning a strategy of conducting research with a thorough knowledge about research methodology. It is a logical and systematic plan for collecting data, measurement and analysis of data and prepared for a research study. This intends to specify a plan for generating empirical evidence will be used to meet the study objectives and test the research hypothesis.

3.2 Research Philosophy

The study adopts a positivist research philosophy, grounded in the premise that valid knowledge arises from observable, measurable phenomena rather than subjective interpretations. This paradigm emphasizes objectivity, empirical validation, and replicability, attributes that make it particularly suitable for studies seeking to test hypotheses derived from established theoretical frameworks using quantifiable data (Saunders, Lewis, & Thornhill, 2009).

In this context, positivism is the most appropriate philosophical stance because the constructs under investigation, Such as cost classification shifting, accruals manipulation, fair value estimation, and voluntary disclosure practices, are embedded in verifiable corporate disclosures and can be measured using objective accounting and market data. By grounding analysis in audited reports and NSE market records, the study ensures findings are based on factual, reproducible evidence, thereby minimizing researcher bias.

This philosophical alignment is further reinforced by information signaling theory, which underpins the conceptual framework of the study. The theory posits that investors interpret observable accounting behaviors as potential signals of future firm performance,

influencing earnings predictability. Adopting a positivist stance enables the methodology to remain value-neutral and theory-driven, ensuring that any conclusions are dictated by statistical evidence rather than the researcher's subjective viewpoints.

While alternative research philosophies such as interpretivism and pragmatism were considered, they were deemed less suitable for this study. Interpretivism, which focuses on subjective meanings and context-specific interpretations, is more appropriate for qualitative inquiries exploring perceptions or social constructs. Given that this study seeks to measure accounting discretion using objective financial data rather than subjective narratives, interpretivism would not provide the methodological rigor required. Similarly, pragmatism prioritizes practical solutions over theoretical consistency and may not maintain the high degree of objectivity necessary for hypothesis testing in a capital market context.

Several foundational studies exemplify the effective application of positivist methodology in the study of accounting discretion; Anderson et al, (2003) employed panel regression models to empirically test cost stickiness as a quantifiable indicator of managerial discretion in SG&A costs. Dechow et al, 2010) introduced the Modified Jones Model to distinguish discretionary from non-discretionary accruals. Their regression-based approach objectively identifies manipulation using historical financial data. They used a positivist approach since it objectively models discretionary vs. non-discretionary accruals. Ibrahim (2009) proposed the Ratio of Discretionary Accruals Components (RDAC) as an indicator of consistent discretionary behavior. They used the positivist approach since it applies statistical tools to objectively detect earnings manipulation

Positivism, therefore, offers the most coherent and defensible philosophical foundation for this research, enabling a rigorous, replicable, and statistically grounded analysis of whether accounting discretion serves as an informative signal or a distorting influence on earnings predictability in the NSE.

3.3 Research Design

A research design serves as the strategic blueprint that guides the collection, measurement, and analysis of data in a manner consistent with the research objectives. It provides a systematic framework for addressing research questions while ensuring the validity, reliability, and generalizability of findings (Rajasekar, Philominathan, & Chinnathambi, 2013).

This study adopts a quantitative research design of explanatory causal research design embedded within a longitudinal panel framework. The explanatory design is appropriate because the study goes beyond describing relationships to testing cause–effect linkages between accounting discretion practices, such as cost classification shifting, discretionary accruals, fair value estimates, and voluntary disclosures and earnings predictability. As Saunders, Lewis, and Thornhill (2009) note, explanatory designs are particularly useful where theory-derived hypotheses are subjected to empirical testing using measurable data. In this study, the hypotheses are informed by agency theory and information signaling theory, which predict that managerial reporting choices influence investors’ interpretation of future performance.

The longitudinal dimension enhances the explanatory design by examining changes over time. Unlike cross-sectional studies that provide a snapshot of one period, longitudinal designs allow the researcher to capture temporal dynamics, structural shifts, and regulatory reforms that may influence financial reporting outcomes (Wang, Tsai, & Lin, 2017). This is particularly important in accounting research, where shifts in International Financial Reporting Standards (IFRS), corporate governance reforms, and audit oversight can alter the role of discretion in reported earnings. Prior studies highlight the importance of longitudinal approaches in tracing the evolution of accounting practices and their effects on reporting quality (Grossman, 2013; Sagafi-Nejad, Dunning, & Hagedoorn, 2010).

In this study, panel data from 50 firms listed on the Nairobi Securities Exchange (NSE) spanning 2010–2022 is analyzed. A panel design offers two main advantages. First, it controls for unobserved heterogeneity, which refers to firm-specific characteristics that remain constant but could bias results if ignored. Second, it increases both the sample size and variability, thereby improving the efficiency and reliability of regression estimates (Baltagi, 2021). These strengths make panel regression methods particularly suitable for testing hypotheses about accounting discretion and earnings predictability.

Empirical precedents further justify this approach. Anderson, Banker, and Janakiraman (2003) applied panel regression to measure cost stickiness as an indicator of managerial discretion, while Dechow, Ge, and Schrand (2010) employed regression-based models to detect earnings management through accruals. Both studies demonstrate that explanatory–longitudinal designs yield rigorous insights into the impact of discretion on financial outcomes.

In sum, this study’s research design integrates theory-driven explanatory testing with longitudinal panel analysis. It ensures methodological rigor by combining cross-sectional and time-series perspectives, applying robust econometric techniques, and situating the findings within Kenya’s evolving capital market context. This integrated approach provides a strong foundation for assessing whether accounting discretion enhances or distorts the predictability of earnings.

3.4 Target Population

The target population refers to the entire group of entities that meet the inclusion criteria of a study and from which relevant data can be collected. Clearly defining the population is critical, since it ensures that the findings are both valid and generalizable to the broader group of interest (Asiamah, Mensah, & Oteng-Abayie, 2017). As Walliman (2011) notes, a research population is not limited to individuals but can also consist of organizations, events, or objects that share common characteristics related to the research problem.

In this study, the target population was all firms listed on the Nairobi Securities Exchange (NSE) during the period 2010–2022. This timeframe was selected because it captures a period of significant developments in Kenya’s capital markets, including the adoption of International Financial Reporting Standards (IFRS), enhanced regulatory oversight by the Capital Markets Authority (CMA), and evolving corporate governance frameworks. These changes are likely to have influenced both the extent and detectability of accounting discretion, making this period suitable for investigating its effect on earnings predictability. Additionally, according to Baltagi (2021), panels with both sufficient cross-sectional units and time periods allow for more efficient estimation of fixed and random effects models, reduce omitted variable bias, and enhance statistical power.

3.4.1 Census

A census approach was initially adopted to include all firms, thereby minimizing sampling bias and allowing comprehensive sectoral comparisons. At the outset, the NSE had 63 listed firms during the study period. However, during data screening, firms with incomplete or inconsistent financial disclosures were excluded. As a result, the final analytical sample comprised 50 firms. This outcome is consistent with best practice in panel data studies, where exclusions are necessary to ensure completeness and reliability of data (Rogelberg & Stanton, 2007). A detailed list of firms included in the final sample is provided in Appendix II: Listed Firms at Nairobi Securities Exchange

Both financial and non-financial firms were included in the population in order to reflect the diversity of accounting practices across sectors. This inclusion enhances the external validity of the study, since prior research often analyzed these sectors separately, thereby limiting comparability of results.

3.5 Data and Data Collection Techniques

Secondary data on the variables of the study was collected from the financial statements of the listed firms for the 13-year period from 2010-2022. Appendix 1 - Secondary Data

collection sheet shows the specific data to be collected over the periods for the companies. The NSE Handbook and individual company reports was instrumental for data collection. The table below outlines intended data to meet the study objectives.

Table 3.1: Data Measures and Sources

Variable	Measure	Scale	Data	Source	Supporting Study
Earnings Predictability	Price Earnings Ratio	Ratio	Share Price, EPS	Balance Sheet, NSE market data	Goh and Simanjuntak (2018)
Cost Classification Shifting	Cost stickiness	Ratio	Sales Revenues, SG&A costs.	Statement of Comprehensive Income	Anderson <i>et al.</i> (2003) Sun <i>et al.</i> (2019)
Fair Value Accounting Estimates	Mark to Market; Mark to model ratio	Ratio	Level 1,2,3 Fair Value Estimates	Financial Reports	(Sapkauskiene & Orlovskij, 2017) Šodan (2019)
Voluntary disclosures	Value of Voluntary Disclosure Quality Index	Ratio	Integrated report elements	Financial Reports	Alfraih and Almutawa (2017)
Accruals Earnings Management	Discretionary Accruals Consistency	Ratio	Total Accruals, Non-discretionary accruals,	Company Register and NSE market data	(Ibrahim, 2009)
Audit quality	Audit quality Index	Index	Audit report lag, Audit Opinion Audit firm type,	Financial Reports	(Nuryaman, 2013), (W- alker & Hay, 2013)

Secondary data were collected for each study variable across the defined study period, with relevant ratios and indices computed as operational measures. The dependent Variable – Earnings Predictability was measured using the Price–Earnings Ratio (P/E), computed from share prices and basic Earnings per Share (EPS) data obtained from audited financial statements and the NSE market database. Cost Classification Shifting was quantified through cost stickiness ratios, calculated from changes in Sales Revenues and Selling, General and Administrative (SG&A) expenses, in line with the Anderson et

al. (2003) framework. For Fair Value Accounting Estimates data captured for the period 2013–2022 to align with the effective adoption of IFRS 13. Measurements were based on the mark-to-market and mark-to-model approaches, with emphasis on Level 3 fair value inputs due to their susceptibility to managerial discretion. Voluntary Disclosure was measured using a Voluntary Disclosure Index (VDI), developed from non-mandatory disclosure items including corporate social responsibility reports, historical financial ratios (5–10 years), financial highlights, and fair value disclosures. While accruals discretion was computed using the Modified Jones Model, requiring cash flow from operations, accounts receivable, plant, property & equipment, total assets, sales revenue, and net income data.

3.6 Data Processing and Analysis

The study employed a structured data analysis framework to evaluate the relationship between accounting discretion and earnings predictability among listed firms in Kenya. Consistent with the positivist paradigm, the analysis relied exclusively on observable, quantifiable, and replicable measures derived from audited financial statements and publicly available market data.

Raw data were extracted from annual reports, NSE handbooks, and Capital Markets Authority (CMA) publications for the period 2010–2022. The dataset was cleaned and screened to address missing or inconsistent entries. Firms with incomplete financial data or irregular trading histories were excluded. This resulted in an unbalanced panel of 50 firms across 13 years, yielding approximately 650 firm-year observations. The use of an unbalanced panel is supported in econometric literature, as it retains more observations and minimizes selection bias compared to restricting the dataset to a balanced sample (Baltagi, 2021). Data analysis in this study was carried out using EViews statistical software, which is widely applied in time-series and panel econometrics due to its robust capabilities for diagnostic testing, model estimation, and residual analysis. The analytical process followed a structured sequence to ensure consistency, validity, and reliability of results.

The first stage of analysis involved generating descriptive statistics to summarize the characteristics of the dataset. These included measures of central tendency (mean and median), measures of dispersion (standard deviation, minimum, and maximum), and distributional properties (skewness and kurtosis). The Jarque–Bera statistic was applied to formally test the normality of the distributions (Gujarati & Porter, 2009). Understanding these properties was essential because it guided the choice of appropriate regression techniques and helped determine whether transformations or adjustments were necessary to meet econometric assumptions.

In addition correlational analysis was conducted using Pearson correlation coefficients. The analysis examined the pairwise associations between the independent variables (cost classification shifting, discretionary accruals, fair value estimates, voluntary disclosure index, and audit quality) and the dependent variable (earnings predictability). Correlation analysis served two main purposes: first, to provide a preliminary understanding of the direction and strength of associations, and second, to check for potential multicollinearity among explanatory variables.

Presentation of results was structured to maximize clarity and interpretability. Descriptive statistics were summarized in tables that displayed mean, median, standard deviation, minimum, maximum, skewness, and kurtosis for each variable, alongside the Jarque–Bera normality test results. Correlation analysis was presented using correlation matrices, which clearly illustrated pairwise relationships and significance levels. To complement tabular presentations, trend graphs were used to show how selected variables evolved over the 2010–2022 period. These graphical presentations helped visualize temporal dynamics, identify patterns, and highlight potential structural changes in accounting discretion practices and earnings predictability across time.

Thus, the combined use of tables, correlation matrices, and trend graphs, supported by explanatory narrative, ensured that results were both statistically rigorous and visually accessible. This multi-format approach provided a robust empirical foundation for the inferential analyses that followed (Wooldridge, 2010).

3.7 Model Specification

The study employed the linear regression model to analyze the influence of accounting discretion and earnings predictability of listed firms in Kenya. The linear regression analysis was used to test the statistical significance of the various independent variables on the dependent variable (performance as measured by the time weighted return). With the research data expected to have both time and cross-sectional dimensions, the study estimated the linear panel regression as proposed by Greene (2008). Regression analysis is a statistical technique for estimating the relationship among variables which have reason and result relation. Central goal of the bivariate regression analysis is to assess the relationship between a response variable and one predictor variable and expresses the linear relation equation between the two variables. Regression models with one dependent variable and more than one independent variable are called multi-linear regression

The study adopted panel data to carry out the research analysis for thirteen years from 2010 to 2022. Using panel data, the panel regression models used in the study are presented as follows:

3.7.1 General Panel Data Model

The study adopted a panel regression framework, combining both cross-sectional (firm-level) and time-series (annual) data. The general model is specified as:

$$Y_{it} = \beta_0 + \beta'X_{it} + \mu_i + \varepsilon_{it} \dots \dots \dots (i)$$

where

- Y_{it} = dependent variable (earnings predictability proxied by PER_{it})
- X_{it} = independent variables (CCS, DA, FVA, VDI, and later AQI with interactions)
- μ_i = unobserved firm-specific effect
- ε_{it} = idiosyncratic error term

This framework controls for unobserved heterogeneity across firms, ensuring consistent and unbiased estimates.

To meet the study objectives, the following steps were undertaken

Step 1: Breusch-Pagan Lagrange Multiplier Test

This was done to consider whether the data followed a Pooled OLS or Fixed and Random Effects panel models.

Step 2: Fixed vs. Random Effects and the Hausman Test

Two estimators were considered: Fixed Effects and Random Effects. The Hausman test was employed to determine the appropriate specification. If Hausman test null hypothesis will be: H_0 : error terms are uncorrelated with regressors in the model. H_0 : the fixed effect and random effect model are not significantly different. Noman, Pervin and Chowdhury (2015) insist that if the Chi-Square statistics is significant ($p\text{-value} < \alpha$), then use fixed effect otherwise use random effect model. Supported by the Hausman test, the model was specified as:

$$PER_{it} = \beta_0 + \beta'X_{it} + u_{it}, \dots\dots\dots(ii)$$

where

$$u_{it} = \mu_i + \varepsilon_{it}.$$

Step 3 Step-Wise Empirical Specifications

In order to meet objective one to four the following univariate regression equations before moderation were used. Each objective was tested separately by examining the effect of a single discretionary practice on earnings predictability (PER):

1. Objective 1 (CCS):

$$PER_{it} = \alpha_0 + \beta_1 CCS_{it} + \mu_i + \varepsilon_{it}$$

2. Objective 2 (DA):

$$PER_{it} = \alpha_0 + \beta_2 DA_{it} + \mu_i + \varepsilon_{it}$$

3. Objective 3 (FVA)

$$PER_{it} = \alpha_0 + \beta_3 FVA_{it} + \mu_i + \varepsilon_{it}$$

4. Objective 4 (VDI):

$$PER_{it} = \alpha_0 + \beta_4 VDI_{it} + \mu_i + \varepsilon_{it}$$

Additional, audit quality was then introduced to test its moderating role, the following regression equations resulted;

1. CCS × AQI:

$$PER_{it} = \beta_0 + \beta_1 CCS_{it} + \beta_5 AQI_{it} + \varepsilon_{it}$$

2. DA × AQI:

$$PER_{it} = \beta_0 + \beta_2 DA_{it} + \beta_5 AQI_{it} + \varepsilon_{it}$$

3. FVA × AQI:

$$PER_{it} = \beta_0 + \beta_3 FVA_{it} + \beta_5 AQI_{it} + \varepsilon_{it}$$

4. VDI × AQI:

$$PER_{it} = \beta_0 + \beta_4 VDI_{it} + \beta_5 AQI_{it} + \varepsilon_{it}$$

In order to meet objective five, the overall multivariate model before moderation was as follows;

$$PER_{it} = \gamma_0 + \gamma_1 CCS_{it} + \gamma_2 DA_{it} + \gamma_3 FVA_{it} + \gamma_4 VDI_{it} + \varepsilon_{it}$$

Further, considering audit quality as a moderator for the overall multivariate model, the following equation was used;

$$PER_{it} = \delta_0 + \delta_1 CCS_{it} + \delta_2 DA_{it} + \delta_3 FVA_{it} + \delta_4 VDI_{it} + \delta_5 AQI_{it} + \epsilon_{it}$$

Where:

PER_{it}: Price–Earnings Ratio for firm i at time t, used as the dependent variable and proxy for earnings predictability.

CCS_{it}: Cost Classification Shifting, proxied through cost stickiness measures, representing discretionary reallocation of expenses.

DA_{it}: Discretionary Accruals, estimated using the Modified Jones Model, capturing accrual-based earnings management.

FVA_{it}: Fair Value Accounting estimates, representing reliance on mark-to-model or level 3 fair values in financial reporting.

VDI_{it}: Voluntary Disclosure Index, measuring the extent and quality of additional information provided beyond mandatory requirements.

AQI_{it}: Audit Quality Index, the moderating variable.

$\beta_0, \alpha_0, \gamma_0, \delta_0$: Intercepts (constant terms) of the respective models, representing baseline values of earnings predictability when explanatory variables equal zero.

ϵ_{it} : Idiosyncratic error term, capturing shocks and random disturbances unique to firm i at time t.

3.8 Diagnostic Model Tests

Before conducting a regression analysis, the data should attain to specific assumptions such as the data should be normally distributed, should not have multicollinearity and should be homoscedastic. Therefore, this study carried out normality test, multicollinearity tests, test of autocorrelation and heteroscedasticity test to ascertain that the assumptions of regression analysis are not violated.

3.8.1 Normality Test

Normality in statistics is the likelihood of a random variable to be normally distributed over the population sample. Park (2015) argues that the normality of the population distribution forms the basis for making statistical inferences about the sample drawn from the population. Normality test in this study was conducted using Jarque-Bera. The statistic has a χ^2 distribution with two degrees of freedom under the null hypothesis of normally distributed errors. If the residuals are normally distributed, the histogram should be bell-shaped and the Bera–Jarque statistic would not be significant. This means that the p-value given at the bottom of the normality test screen should be bigger than 0.05 to not reject the null of normality at the 5% level. The test reject the hypothesis of normality when the p-value is less than or equal to 0.05. In this study we test whether both accounting discretion and earnings predictability follows a normal distribution. Simamora, (2018) used the same test for his study on earnings management and earnings predictability and obtained a significance value of 0.175 implying their data was normally distributed.

3.8.2 Panel Unit Root Test of Multicollinearity

Multicollinearity also referred to as collinearity is a phenomenon in a multiple regression model in which two or more predictor variables are highly correlated, and occurs when more than two predictor variables (e.g., X_1 , X_2 and X_3) are inter-correlated, meaning that one can be linearly predicted from the others with a non-trivial degree of accuracy (Gujarat & Porter, 2009). Multi-collinearity tests help to reduce the variables that measure the same

thing and check model redundancy. Tolerance is the percentage of the variance in a given predictor that cannot be explained by the other predictors. When the tolerances are close to 0, there is high multicollinearity and the standard error of the regression coefficients will be inflated. The Detection of multicollinearity is tested through Tolerance and Variance Inflation Factor (VIF). Multicollinearity exists if the tolerance value is less than 0.20 and VIF Value is more than 5. A study by Fei (2015) on impact of managerial opportunism on earnings reliability tested the correlation tolerance and VIF.

3.8.3 Autocorrelation Test

Autocorrelation problem arises from the serial correlation of the error terms among the variables. Autocorrelation exaggerates the significance of the predictor when in fact they are not. This is a post estimation diagnostic test. In this study, the alternative Durbin Watson test was applied to test the presence of serial correlation within the residual from the regression models. The Durbin-Watson statistic will always have a value ranging between 0 and 4. A value of 2.0 indicates there is no autocorrelation detected in the sample. Values from 0 to less than 2 point to positive autocorrelation and values from 2 to 4 means negative autocorrelation. However in general values between 1.5 and 2.5 are preferred (Chatterjee & Simonoff, 2013). Fei (2015) found a DW test statistic of 2.074 in her study of impact of managerial opportunism on earnings reliability.

3.8.4 Heteroscedasticity Test

Heteroscedasticity happens when the variance of the errors varies across observations if important variables in the model are omitted (Long & Ervin, 2017). The opposite of which homoscedasticity is observed where error terms have a constant variance. When the errors are heteroscedastic, the OLS estimator remains unbiased, but becomes inefficient, and essentially, the usual procedures for hypothesis testing are no longer appropriate. In this study the Breusch-Pagan test was used to test for heteroscedasticity. Breusch-Pagan tests the null hypothesis that the error variances are all equal versus the alternative that the error variances are a multiplicative function of one or more variables. The decision rule states

that if the computed T-value exceeds the critical T-value, the researcher accepts the stated hypothesis of heteroscedasticity, otherwise reject (Baum, Schaffer & Stillman, 2013).

3.9 Tests of Hypothesis

Hypothesis testing is all about testing the coefficient significance to explain the suitability of a model. The study tested the hypotheses formulated in 1.4 to establish the influence of accounting discretion on earnings predictability of listed firms in Kenya using the P-Value approach at a 95% level of confidence. The decision rule will encompass a rejection of the null hypothesis if the calculated p-value is less than 0.05 ($p < 0.05$). If the calculated P-Value is greater than 0.05, the null hypothesis will be affirmed. This was supplemented by t-test at 95% confidence interval. Coefficients of variation for the population will equally be determined to compare the degree of dispersion relative to the distribution's mean. The overall model was tested for the goodness of fit of the balanced panel data. R^2 will be employed as coefficient of determination. The degree of variation between accounting discretion and the earnings predictability will indicate that the balanced panel data fit the overall model.

3.10 Variable Operationalization

Bivariate analysis on each of the study variables was conducted to inform the specific variable of the study. The study began by assessing the influence of cost classification shifting on earnings predictability of listed firms in Kenya. Cost stickiness is evidence of overt cost management, the costs that are most likely to be sticky are those that are subject to managerial discretion or are likely to not persist to for the purpose of earnings predictability.

Accordingly;

$$Cost\ stickiness_{it} = \ln\left(\frac{\Delta SG\&A\ COST}{\Delta SALES}\right)_{it} - \ln\left(\frac{\Delta SG\&A\ COST}{\Delta SALES}\right)_{it-1}$$

Where;

Δ SG&A the difference between the SG&A expenses in year t and those in the previous year; and

Δ Sale the difference between sales revenue in year t and that of the previous year.

Because the estimation is cross-sectional with a wide variety of industries and large differences in the size of firms, the ratio form and log specification improve the comparability of the variables across firms and alleviates potential heteroscedasticity. A lower value of sticky expresses more sticky cost behavior. That is, a negative (positive) value of sticky indicates that managers are less (more) inclined to respond to sales drops by reducing costs than they are to increase costs when sales rise.

To meet the second objective on the influence of fair value accounting estimates on earnings predictability of listed firms in Kenya. The study adopted the mark to model measurements (Sapkauskiene & Orlovskij, 2017) as they are most susceptible to manipulation.

$$\text{Fair Value Accounting Estimate}_{it} = \ln\left(\frac{\Delta \text{Mark to Model}}{\Delta \text{Mark to Market}}\right)_{it}$$

The third objective on voluntary disclosures applied the Alfrah and Almutawa (2017) model where the disclosure index is a ratio of actual vs expected disclosures. A starting point to building a disclosure index is the selection of information items expected to be disclosed in financial reports as voluntary items outside the IFRS framework. Ideally, the integrated reporting framework necessitates information on an organization strategy, governance, performance and prospects. The dichotomous approach (un-weighted) is adopted in scoring the voluntary disclosure index (VDIND). Once the scores for disclosure items in the voluntary disclosure index (VDIND) were identified, the total VDIND could be calculated. The following equation was used to compute the level of disclosure for each firm in the study sample:

$$VDIND = ACVD / EXVD$$

Where:

VDIND = the value of the voluntary disclosure index for each firm.

ACVD = the number of items each firm actually disclosed.

EXVD = the expected maximum number of items disclosed by each firm

The value of the index stretches from zero to one, with the higher value of the index indicating the higher level of voluntary disclosure.

The fourth objective on Accruals earnings management applied the following regression equation of the total accruals. In this model the estimate of accruals quality are based on the statistical properties of the discretionary accruals. High accrual quality is used as a proxy for high earnings quality and consequentially earnings predictability. Accruals are calculated in the steps below

Step 1

$$TA_{i,t} = (NI - CFO) \frac{1}{A_{i,t-1}}$$

Where

$TA_{i,t}$ = Total accruals in year t for firm

NI = Net Income

CFO = Cash flows from operating activities

$A_{i,t-1}$ = Total assets in the year t-1 for firm i

Step two

Using the Total accruals above and using the following Modified Jones Model, the following regression model provides cross sectional intercepts to be used later to compute the non-discretionary Accruals

$$TA_{i,t}, \frac{1}{A_{i,t-1}} = \beta_0 + \beta_1 (\Delta REV_{i,t}) \frac{1}{A_{i,t-1}} + \beta_2 PPE_{i,t} \frac{1}{A_{i,t-1}} + \xi_{i,t}$$

Where:

$TA_{i,t}$ = Total accruals in year t for firm i Calculated as $(\Delta \text{Current assets} - \Delta \text{Current liabilities} - \text{Cash} + \text{Short Term Debt} - \text{Depreciation and amortization Expenses}) / A_{i,t-1}$

$A_{i,t-1}$ = Total assets in the year t-1 for firm i

$\Delta REV_{i,t}$ = Revenue in year t less revenue in year t-1 for firm i scaled by $A_{i,t-1}$

$\Delta REC_{i,t}$ = Receivables in year t less receivables in year t-1 for firm i scaled by $A_{i,t-1}$

$PPE_{i,t}$ = Gross property plant and equipment in the year t for firm i scaled by $A_{i,t-1}$

$\xi_{i,t}$ = error term in the year t for firm i

This formula gives the non-discretionary accruals.

$$NDAC_{i,t} = \beta_0 + \beta_1 (\Delta REV_{i,t} - \Delta REC_{i,t}) \left(\frac{1}{A_{i,t-1}} \right) + \beta_2 PPE_{i,t} \left(\frac{1}{A_{i,t-1}} \right) + \xi_{i,t}$$

Individual cross-sectional regressions are re-run with the residual from Equation 1. Discretionary accruals (DA) are therefore computed as the difference between total

accruals and Non-Discretionary Accruals. . This study goes a step further than simple disaggregation of accruals into its components and modeling them separately. It will test the consistency of the discretionary accruals using the Ibrahim (2009) model of Ratio of Discretionary Accruals Components. RDC is the ratio of the absolute value of the sum of the discretionary components to the sum of the absolute value of the components.

The dependent variable earnings predictability was based on share price and Earnings per share data for the listed firms. This data was readily available from the comprehensive statement of income and the statement of financial position. Both being important indicators of the financial performance of a firm. While market information is reflected in share price, EPS is an accounting data construct, the use of both enhances earnings predictability for shareholders.

CHAPTER FOUR

RESEARCH FINDINGS AND DISCUSSION

4.1 Introduction

This chapter presents the results of the data analysis and research findings, structured in line with the study's specific objectives. As outlined in Chapter Three, the data analysis followed a step-wise approach including descriptive statistics, correlation analysis, followed by diagnostic tests, and concludes with the panel regressions used to test the research hypotheses.

4.2 Descriptive Statistics

The study employed a census approach targeting all 63 firms listed on the Nairobi Securities Exchange (NSE) during the study period (2010–2022). However, after data screening, only 50 firms were retained for analysis. This adjustment was necessitated by two primary considerations, the first being incomplete data where firms with substantial gaps in their financial records were excluded, particularly those with inconsistent trading histories during the period under review. Secondly, the firms listing tenure was considered therefore, companies listed midway through the study period were removed to ensure consistency in the longitudinal analysis. Additionally, the NSE, as an investment service platform rather than a trading company, was excluded from the study.

According to Rogelberg and Stanton (2007), for studies conducted at the organizational level, a data collection rate above 35% is considered acceptable. This study achieved a 79% valid data rate, significantly exceeding the minimum threshold, thereby ensuring adequate representation and robustness of the findings. The distribution of firms studied was as follows.

Table 4.1: Sectoral Statistics

Sector	Industry	Number of firms listed	Number of firms studied
Financial	Banking	10	8
	Insurance	6	6
Non-Financial	Automobiles and Accessories	1	1
	Agricultural	6	6
	Commercial and services	13	9
	Construction and allied	5	5
	Energy and Petroleum	4	3
	Investments	5	4
	Investment service	1	0
	Manufacturing and Allied	8	7
	Telecommunication	1	1
	Real Estate Investments trust	2	0
	Exchange traded funds	1	0
	Total	63	50
	Percentage	100	79.3%

Descriptive statistics were computed to summarize the data and provide insights into its central tendency, variability, and distributional properties. Specifically, the measures reported in Table 4.2 include: Measures of Central Tendency: Mean and median values; Measures of Dispersion: Minimum, maximum, and standard deviation; Measures of Distribution Shape: Skewness and kurtosis; Normality Testing: Jarque–Bera statistic and associated probability values.

The dataset represents an unbalanced panel, reflecting missing observations for some variables. These gaps were due to incomplete disclosures, unreported fair value estimates, or differences in firm listing and delisting dates within the 2010–2022 study period. In capital markets research, financial disclosures are often incomplete due to listing/delisting events, firm mergers, data reporting errors, or missing archival records. Forcing a balanced panel would require dropping all firms with any missing year, leading to significant loss of sample size and potential selection bias. Baltagi (2021) argues that using unbalanced panels maximises the use of available information, thereby increasing estimation efficiency and retaining statistical power compared to artificially balanced subsets.

Unbalanced panels improve external validity because they reflect the actual reporting patterns of firms in the market rather than an artificially homogeneous sub-sample.

While diluted Earnings per Share (EPS) is often regarded as a more robust predictor of future earnings in financial literature, preliminary reviews of the financial statements revealed negligible differences between basic and diluted EPS for the majority of firms in the sample. Furthermore, several firms did not disclose diluted EPS at all. Consequently, basic EPS was adopted in computing the PER, ensuring data consistency across the sample.

By analyzing the descriptive statistics for all firms, the study established baseline characteristics of the variables, offering a clearer understanding of the dataset's distributional properties before proceeding to diagnostic tests.

Table 4.2: Overall Descriptive Statistics

	PER	Stickiness	DAC	FVAE	VDI	AQI
Mean	3.96	1.739	0.138	4.172	0.695	0.771
Median	9.27	0.33	0.01	0.000	0.67	1
Minimum	-22.2	0.000	-0.05	-4.31	0	0
Maximum	70	41.19	1.00	171	1	1
Std. Deviation	13.424	3.48	0.310	18.499	0.342	0.28
Kurtosis	4.3499	61.35	13.7	59.45	-0.82	-1.4
Skewness	-0.477	5.97	2.27	6.96	-0.759	-0.658
Jarque Bera	31.78	41246	375	37086	33	30
Probability	0.00	0.00	0.00	0.00	0.00	0.00
Sum	1106	485	38	1164	194	215
Observations	618	574	569	397	650	648

This section presents the descriptive statistics for the variables derived from the time series data of listed firms on the Nairobi Securities Exchange (NSE). The analysis covered the dependent variable Price Earnings Ratio (PER) and the independent variables: Cost Stickiness (Stickiness), Discretionary Accruals (DAC), Fair Value Accounting Estimates (FVAE), and Voluntary Disclosure Index (VDI). In addition, the Audit Quality Index (AQI) was included as the moderating variable.

4.2.1 Earnings Predictability

The mean PER across the 618 firm-year observations was 3.96, with a wide dispersion ranging from -22.2 to 70. The standard deviation of 13.42 units reflects moderate volatility, supporting prior literature (Donelson & Resutec, 2015) suggesting that unstable earnings trends can impair predictability models. The negative skewness (-0.477) indicates a distribution tail skewed toward firms with exceptionally low PER values, often linked to losses or market undervaluation. The kurtosis value of 4.35, exceeding the normal benchmark of 3, suggests a leptokurtic distribution with heavier tails—consistent with the presence of extreme market reactions to firm-specific events. The Jarque-Bera statistic (31.78, $p < 0.01$) rejects the null hypothesis of normality, implying that PER modeling should incorporate robust estimation methods and heteroskedasticity corrections to avoid bias from outliers. The wide dispersion in PER establishes a suitable dependent variable for testing whether accounting discretion significantly influences earnings predictability, as hypothesized in Objectives 1–4.

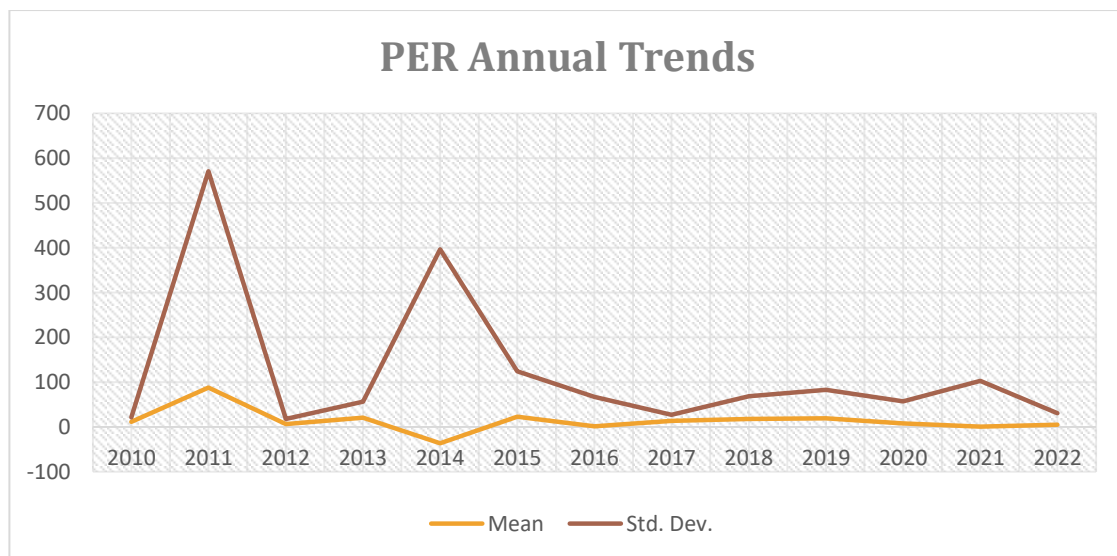


Figure 4.1: PER Trend Descriptive Statistics

4.2.2 Cost Classification Shifting

According to Weiss, (2010) A low value of sticky expresses a stickier cost behavior such that cost increase more when activity rises than they decrease when activity falls, A positive value of sticky indicates that managers are more inclined to respond to sales decline by reducing SGA cost that they would increase costs when sales rise. By design the stickiness for linear cost function would be zero, to outline cost asymmetric behavior to revenues. Sales and SGA data presented the following statistics

Table 4.3: SGA Cost and Sales Descriptive Statistics

	Sales	SGA	SGA/SALES %
Mean	24906.7042	5020.54677	28.56653
Standard Error	1682.19318	334.296709	1.021176
Median	9240	2031	23.05821
Mode	122	4	0
Minimum	20	4	0
Maximum	366827	55187	261.5385
Count	622	620	622

The distribution of Annual revenues and SG&A cost in this study between 2010 and 2022 for the fifty firms showed the mean of Stickiness from the results above indicates a positive 0.04 indicative of cost stickiness and managerial intervention in management of costs with relation to sales. Further analysis as shown in table 4.3 showed that SG&A cost as a percentage of sales volume had a mean of 28.55% for the broad-based sample of 622 firm, year observations. Panel periodic fluctuations between preceding periods showed 35.54% of firm year observations had a negative percentage change on sales revenues from previous periods while 32.57% of the observation had negative percentage change on SGA costs. The observed cost stickiness behavior, indicated by a positive mean value of 0.04, aligns with findings by Weiss (2010), suggesting that managers tend to adjust selling, general, and administrative (SG&A) expenses asymmetrically in response to sales fluctuations—being more responsive in reducing costs during sales declines than increasing them during periods of sales growth. This managerial behavior may reflect conservative cost management practices aimed at maintaining profitability in uncertain

environments, such as those faced by many Kenyan firms due to economic and regulatory volatility. The mean SG&A-to-sales ratio of 28.57% also signals that a significant proportion of firm revenues is consumed by operational overheads, which may affect long-term earnings predictability if not efficiently controlled. Furthermore, the relatively narrow standard deviation in discretionary accruals supports the notion of low earnings manipulation across firms, potentially due to tighter oversight or stronger corporate governance mechanisms (Sanchez-Ballesta & Garcia-Meca, 2007). This could suggest that accounting discretion, particularly in accruals management, may have a less pronounced impact on earnings predictability in the Kenyan context than in less regulated markets.

The mean of cost classification shifting was 1.739, with values ranging between 0 and 41.19. The standard deviation of 3.48 reflects considerable variability in cost stickiness behavior across firms. The distribution is highly positively skewed (5.97), meaning that while most firms report moderate stickiness, a few exhibit extremely high cost asymmetries. The kurtosis value of 61.35 signals a heavy-tailed distribution dominated by outliers, reinforcing the extreme nature of some firm-year observations. The Jarque–Bera statistic of 41,246 ($p < 0.01$) strongly rejects normality. These statistics confirm that CCS values are dominated by extreme cases of cost asymmetry, making robust estimation and transformation approaches necessary to ensure reliable regression outcomes.

4.2.3 Discretionary Accruals

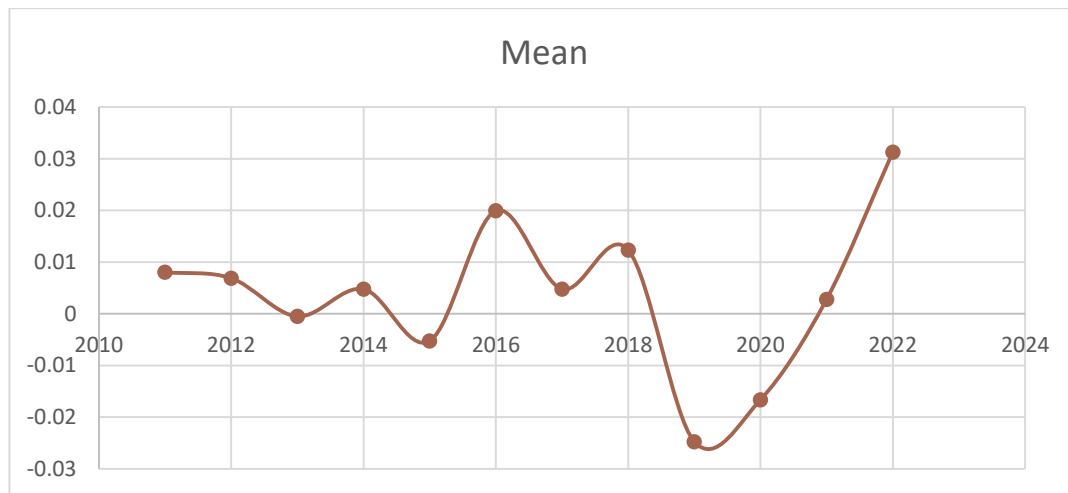


Figure 4.2: Discretionary Accruals Trend

The figure illustrates the trend of discretionary accruals (DAC) for NSE-listed firms over the 2010–2022 study period. The graphical pattern highlights that, while most firms report DAC values clustered close to zero, there are several periods where extreme spikes occur, reflecting temporary increases in earnings management practices.

The mean DAC value of 0.138, with a median close to zero, suggests that accrual-based earnings management is generally low among NSE-listed firms. This is comparable to prior findings by Oluoch (2015) and Sanchez-Ballesta & Garcia-Meca (2007), who reported similarly low discretionary accrual levels in other markets, indicating tighter earnings management control. The skewness of 2.27 indicates a positively skewed distribution, where a few firms engage in aggressive accrual manipulation while the majority remain conservative. The kurtosis of 13.7 points to a leptokurtic distribution, with extreme DAC values occurring more often than in a normal distribution. The Jarque–Bera statistic of 375 ($p < 0.01$) rejects the null of normality.

The non-normality and fat-tailed distribution of DAC reinforce the need for robust estimation techniques, while the generally low mean suggests earnings management is not

widespread among NSE firms. These statistical patterns align with the notion that corporate governance and regulatory oversight guided by the Capital Markets Authority (CMA) and the Institute of Certified Public Accountants of Kenya (ICPAK) limit the scope for widespread accrual manipulation.

4.2.4 Voluntary Disclosure Index

The VDI had a mean of 0.695, indicating generally high voluntary disclosure levels among listed firms higher than the averages reported by Njoroge (2018) for forward-looking and CSR disclosures. The standard deviation of 0.342 indicates moderate variation across firms. The negative skewness (-0.759) suggests that more firms score at the higher end of the disclosure spectrum, while the slightly platykurtic distribution (thin tail) (kurtosis = -0.82) implies fewer extreme values than in a normal distribution. The Jarque–Bera statistic of 33 ($p < 0.01$) rejects normality. These findings reflect a disclosure culture driven by investor demand for transparency and the growing influence of global reporting standards, but econometric modeling must account for non-normality.

4.2.5 Fair Value Accounting Estimates

The mean FVAE of 4.172 masks high variability ($SD = 18.499$), with values ranging from -4.31 to 171, driven by a few extreme outliers as reflected in the kurtosis (59.45) and skewness (6.96). This heavy-tailed distribution highlights the sensitivity of fair value measures to market shocks, especially in illiquid or volatile asset markets. The Jarque–Bera statistic of 37,086 ($p < 0.01$) decisively rejects normality. Given that IFRS 13 was only adopted from 2013, the reduced observation count (397) and missing disclosures in earlier years may have contributed to reporting inconsistencies. The statistical profile suggests that fair value-based metrics should be interpreted cautiously, particularly in industries where market-based valuations are more volatile. FVAE is highly sensitive to market shocks, particularly in illiquid markets, making it a volatile input in regression models. The extreme values justify the use of robust estimation techniques and potentially log transformations.

4.2.6 Audit Quality Index

The audit quality index was developed with data comparing the timeliness of financial reports between year-end and audit report date which was used to compute the audit report lag in number of days. The table below shows key statistics on the audit report lag

Table 4.4: Audit Report Lag

Mean	Median	Standard Deviation	Kurtosis	Skewness	Minimum	Maximum
96.53782	90	35.2467	4.996767	1.422625	27	304

The AQI averaged 0.771, with a standard deviation of 0.28, suggesting that most firms score relatively high on audit quality. The range was 0–1, reflecting the binary and composite scoring methodology indicating generally high audit quality, with many firms meeting both timeliness and unqualified opinion benchmarks. The negative skewness (-0.658) implies that the majority of firms perform better than the mean, while the negative kurtosis (-1.4) reflects a flatter-than-normal distribution, with audit quality scores more evenly spread across firms. The Jarque–Bera statistic of 30 ($p < 0.01$) rejects normality. Given the role of audit quality as a moderating variable, these results suggest that high external audit standards could mitigate the adverse effects of accounting discretion on earnings predictability.

4.3 Diagnostics Tests Results

Before proceeding to regression analysis, the dataset was subjected to a series of diagnostic tests to confirm that it satisfied the assumptions of panel regression. These included tests for normality of residuals, stationarity, heteroscedasticity, autocorrelation and multicollinearity.

4.3.1 Normality Test

Normality test is crucial to ascertain whether or not the standardized residuals are significantly normally distributed (Gray, 2016). According to Pallant (2005), normality is described as a bell-shaped symmetrical curve which has the greatest frequency of scores in the middle and with smaller frequencies extending towards the extremes. The test for normality in this case was measured using Kolmogorov-Smirnov statistic and the Shapiro-Wilk test. The Table 4.5 presents the results for the test for normality using the Kolmogorov-Smirnov test. According to Gray (2016), a sig. value of more than 0.05 for the Kolmogorov-Smirnov test

Table 4.5: Test of Normality

	Kolmogorov-Smirnov		
	Statistic	df	Sig.
cost classification shifting	1.674	650	.078
fair value accounting estimates	.823	650	.102
voluntary disclosures	.936	650	.104
accruals earnings management	.178	650	.083
Earning Predictability	.181	650	.068

Lilliefors Significance Correction signifies normality in a distribution. From the results presented in Table above, all the variables; cost classification shifting, fair value accounting estimates, voluntary disclosures, accruals earnings management, had a sig value of more than .05. This suggests that normal distribution for the study variables.

The Kolmogorov-Smirnov test results, with all p-values above 0.05, confirm that the residuals of the study variables approximate a normal distribution. This is a vital assumption for many inferential statistical tests, including hypothesis testing and confidence interval construction. A normal distribution of residuals ensures the reliability of parameter estimates and supports the appropriateness of the Random Effects Model used in the study. The results align with findings by Gray (2016), reinforcing the methodological soundness of the research design and further validating the use of panel

regression in analyzing the determinants of earnings predictability among listed firms in Kenya.

4.3.2 Stationarity Test

This study conducted a unit root test to uncover fundamental characteristics within the panel data under examination. These characteristics pertain to the presence of stationarity or nonstationary features within the observed data. In essence, a time series without unit roots signifies data stationarity, indicating that variations within the data remain consistent. Stationarity is crucial for accurate parameter estimation and valid statistical inferences in econometric analyses. Stationarity is a critical property for panel analysis, enabling more reliable modeling and forecasting of financial variables.

Table 4.6: Unit Root Test

Variable	ADF Test at levels			
		T statistic	Critical Value at 5%	P value
PER	Constant	-12.33	-2.86	0.000
Stickiness	Constant	-9.34	2.86	0.000
DAC	Constant	-10.82	-2.86	0.000
VDI	Constant	-7.92	2.86	0.000
FVAE	Constant	-5.34	2.86	0.000
AQ_I	Constant	-7.20	-2.86	0.000
Group statistic				
Interpolated Dickey-Fuller				
	Test	1% Critical	5% Critical	10% Critical
	Statistic	Value	Value	Value
Z(t)	-33.911	-3.430	2.860	-2.570
MacKinnon approximate p-value for Z (t) = 0.0000				

In the results of the Dickey-Fuller test, the test statistic, denoted as Z (t), had a value of -33.911. Critical values were provided for different significance levels: 1%, 5%, and 10%. The test statistic, Z (t), was compared to the critical values to assess whether the null hypothesis of a unit root could be rejected. The critical values represent thresholds below which the test statistic must fall to reject the null hypothesis. The results showed that Z (t) significantly exceeded the critical values at all significance levels, indicating that the test

statistic was substantially below these thresholds. Additionally, the MacKinnon approximate p-value for $Z(t)$ was calculated to be 0.0000. Given that the test statistic $Z(t)$ was substantially lower than the critical values, and the p-value was very close to zero ($p < 0.0001$), there was strong evidence to reject the null hypothesis. Therefore, based on the Dickey-Fuller test, it can be concluded that all variables considered have a unit root. In other words, they are stationary, which is a desirable property for time series data.

The confirmation of stationarity across all variables at level suggests that the data series used in the analysis are suitable for time series modeling without the risk of spurious regression results. This finding is critical as non-stationary data could lead to misleading statistical inferences by overstating relationships between variables (Gujarati & Porter, 2009). The consistent rejection of the unit root hypothesis at a 5% significance level implies that the variables exhibit constant mean and variance over time, which enhances the validity of subsequent panel regression models and forecasts in the study. This is particularly beneficial for assessing earnings predictability, which relies on stable relationships over time.

4.3.4 Heteroscedasticity Test

Heteroscedasticity is where the variability of an error term variable is not equal across the range of values of a second variable that predicts it. Existence of heteroscedasticity can significantly affect results from a regression model because it invalidates statistical tests of significance that assume that modelling errors are uncorrelated and uniform – hence that their variances do not vary with the effects being modelled. To determine presence of heteroscedasticity, a heteroscedastic test was carried out. The null hypothesis for this assumption was that there is heteroscedasticity in the data collected. Table 4.7 presents results for the test of heteroscedasticity.

Table 4.7: Breusch-Pagan / Cook-Weisberg Test for Heteroscedasticity

Ho: Constant variance		
chi2(1)	=	38.66
Prob > chi2	=	0.9100

The Breusch-Pagan / Cook-Weisberg test was utilized to measure the significance levels of heteroscedasticity from the data collected. The findings presented in Table 4.7 reveal that the null hypothesis is rejected. This is attributed to the fact that the p-value of 0.9100 was more than 0.05 which implies that there was no statistically significant heteroscedasticity.

The absence of significant heteroscedasticity, as evidenced by the high p-value (0.9100), confirms that the variance of the error terms is constant across observations. This is a key assumption in classical linear regression models and its fulfillment enhances the accuracy of coefficient estimates and the validity of statistical tests. Without heteroscedasticity, the ordinary least squares (OLS) estimators remain BLUE (Best Linear Unbiased Estimators), which strengthens the credibility of the results concerning the impact of cost classification shifting, voluntary disclosures, and other independent variables on earnings predictability.

4.3.5 Autocorrelation Test

An autocorrelation test was carried out to determine the existence of pattern of error term observations which may affect the regression model applied in the study. Table 4.8 presents the results for the autocorrelation test. The Durbin-Watson test was utilized to test for autocorrelation.

Table 4.8: Durbin-Watson Test

Model	Durbin-Watson	P value	Conclusion	
Panel model	1.024	0.3011	No autocorrelation	
Durbin's alternative test for autocorrelation				
Lags (p)	chi2	df	Prob > chi2	H0:
1	37.224	1	0.7000	No serial correlation

A Durbin-Watson (DW) statistic of 1.024 in the study on the effect of external equity changes on equity security returns is slightly below at the midpoint of the possible range (from 0 to 4). A DW value of 1.024 is typically interpreted as suggesting no autocorrelation in the panel model. The DW test is only appropriate for the first order correlation. In the alternative test, with a p-value of 0.7000, the test result is not statistically significant at conventional significance levels (e.g., 0.05). Therefore, you fail to reject the null hypothesis of no serial correlation, suggesting that there is no evidence of autocorrelation at the specified lag.

Durbin's alternative test for autocorrelation was conducted to examine whether there is evidence of serial correlation (autocorrelation) in the model's residuals. The null hypothesis (H0) of this test is that there is no serial correlation in the residuals, meaning that the errors are not correlated with each other

For higher order multi correlation a LM- Test. The test was performed with one lag (p=1), and the results were as follows: Test Statistic (chi2): 1.024, Degrees of Freedom (df): 1 and chi-square probability (Prob > chi2): 0.3011. Based on the results of this test, the p-value was 0.3011, indicating there is no significant evidence of serial correlation (autocorrelation) in the model's residuals. This suggests that the errors in the model are not correlated with each other, and the assumption of independent errors appears to hold. Pallant (2005) gives a rule of thumb that Durbin-Watson test statistic P values greater than 0.05 have acceptable levels of autocorrelation.

The Durbin-Watson statistic and alternative LM test both indicated the absence of autocorrelation in the model's residuals, with p-values exceeding 0.05. This implies that

the errors in the regression model are independent across time, an essential assumption in time series and panel data analysis. The lack of serial correlation ensures that standard errors are not underestimated, which would otherwise lead to overstated statistical significance (Wooldridge, 2010). As such, the findings confirm that the regression outputs are robust and the coefficients reflect genuine relationships rather than artifacts of residual dependency.

4.3.6 Multicollinearity Test

A multicollinearity test was carried out to determine the correlation between the study's independent variables cost classification shifting, fair value accounting estimates, voluntary disclosures, accruals earnings management and earning predictability (dependent variable). It was necessary to determine the presence of multicollinearity because its presence restricts the chance to determine the effect of each independent variable on the study's dependent variable. Table 4.9 below presents the results for the test of multicollinearity.

Table 4.9: Test for Multicollinearity

	Tolerance	VIF
cost classification shifting	.467	2.140
fair value accounting estimates	.665	1.503
voluntary disclosures	.501	1.997
accruals earnings management	.901	1.110
Audit Quality	.815	1.227

Multicollinearity was determined using tolerance level and the variance inflation factor (VIF). From the findings, the study's independent cost classification shifting, fair value accounting estimates, voluntary disclosures, accruals earnings management had a variance inflation factor less than 10. According to Pallant (2005), a $VIF < 10$ is acceptable and reflects the lack of presence of multicollinearity between a study's independent variables. From the findings, all the study's independent variables have a VIF of less than 10. This

implies the lack of presence of multicollinearity between the study's independent variables.

The results from the Variance Inflation Factor (VIF) and Tolerance levels confirm that multicollinearity is not a concern in this study, as all VIF values were below the critical threshold of 10. This indicates that the independent variables included in the regression model are sufficiently distinct and not excessively correlated with one another, allowing for reliable estimation of individual variable effects (Pallant, 2005). Low multicollinearity ensures that the model can effectively isolate the unique contribution of each factor, such as discretionary accruals or audit quality, on the dependent variable—earnings predictability.

4.4 Correlation Analysis

Correlation analysis is a statistical method used to evaluate the strength and direction of the relationship between two variables. Correlation analysis refers to extent to which research variables are related (Bagozzi et al., 1981). Correlation analysis was employed to establish the strength of the relationship which exists among dependent and independent variables whereby long cost classification shifting, accruals earning management, fair value accounting estimates and voluntary disclosures were the independent variables while earnings predictability was the dependent variable and audit quality the moderating variable. Pearson correlation varies from -1.00 to +1.00 with positive values indicating positive relations while negative values suggest negative relations among study variables (Newman, 2002).

The results of the audit quality analysis further reinforce the notion that financial reporting among listed firms in Kenya is conducted within a robust institutional and regulatory framework. The high incidence of unqualified audit opinions (91.7%) and the relatively short average audit lag of 96.5 days suggest timely and reliable financial disclosures. This aligns with prior studies emphasizing the role of audit quality in enhancing transparency and investor confidence (Francis, 2004). Moreover, the high average audit quality index

(0.75) suggests that external audit mechanisms play a critical moderating role in curbing opportunistic accounting discretion and enhancing the credibility of reported earnings. These dynamics are particularly relevant in the context of correlation analysis, as the quality and timeliness of audit processes may influence the strength and direction of relationships between accounting discretion variables and earnings predictability. High audit quality may, for example, mitigate the negative effects of aggressive earnings management or enhance the informativeness of voluntary disclosures, thereby reinforcing the integrity of financial reporting outcomes.

Table 4.10: Overall Correlation Analysis

		PER	Stickiness	FVAE	VD	DAC	AQ
earnings predictability	Pearson Correlation	1	-.296**	-.478**	-.054	-.141**	.503**
	Sig. (2-tailed)		.000	.000	.365	.001	.000
	N	582	582	582	279	582	582
cost classification shifting	Pearson Correlation	-.296**	1	.282**	.035	-.022	-.201**
	Sig. (2-tailed)	.000		.000	.553	.577	.000
	N	582	650	650	296	650	648
fair value accounting estimates	Pearson Correlation	-.478**	.282**	1	.074	-.181**	-.174**
	Sig. (2-tailed)	.000	.000		.204	.000	.000
	N	582	650	650	296	650	648
voluntary disclosures	Pearson Correlation	-.054	.035	.074	1	.100	-.114
	Sig. (2-tailed)	.365	.553	.204		.085	.051
	N	279	296	296	296	296	294
accruals earnings	Pearson Correlation	-.141**	-.022	-.181**	.100	1	.265**
	Sig. (2-tailed)	.001	.577	.000	.085		.000
	N	582	650	650	296	650	648
audit quality	Pearson Correlation	.503**	-.201**	-.174**	-.114	.265**	1
	Sig. (2-tailed)	.000	.000	.000	.051	.000	
	N	582	648	648	294	648	648

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

The correlation analysis in Table 4.10 reveals several statistically significant relationships among the study variables, offering insights into the interplay between accounting discretion measures, audit quality, and earnings predictability for firms listed on the NSE.

A moderate negative correlation is observed between earnings predictability (PER) and fair value accounting estimates (FVAE) ($r = -0.478$, $p < 0.01$), indicating that increased reliance on subjective fair value measurements, particularly Level 3 inputs, tends to reduce earnings predictability. This aligns with Barth et al. (2008), who found that the subjectivity

inherent in fair value estimation reduces reliability, thereby undermining predictive power. The result also supports Biddle et al. (2011), who noted that estimation uncertainty in fair value disclosures can impair investors' ability to forecast future performance.

PER also exhibits a weak negative correlation with discretionary accruals (DAC) ($r = -0.141$, $p < 0.01$), suggesting that higher levels of accrual-based earnings management marginally reduce earnings predictability. This is consistent with Dechow et al. (2010), who documented that discretionary accruals reduce the persistence of earnings due to their transitory nature. However, it contrasts with Qiang, Liu, and Qu (2010), whose NYSE-based study found that aggregate discretionary accruals could positively predict future returns, possibly reflecting differences in market sophistication and regulatory oversight between the U.S. and Kenya.

A moderate negative correlation is also identified between PER and cost classification shifting (Stickiness) ($r = -0.296$, $p < 0.01$). This suggests that firms engaging in shifting costs across categories such as between costs of goods sold and SG&A expenses may create information asymmetry, making earnings harder to predict. Ha and Thomas (2018), studying U.S. firms, found classification shifting could improve predictability under certain conditions, particularly when it signals future performance. The divergence with NSE results may be due to weaker investor analytical capacity or lower disclosure granularity in the Kenyan market.

The relationship between PER and voluntary disclosures (VDI) is weak and statistically insignificant ($r = -0.054$, $p = 0.365$), implying that voluntary disclosures, as measured in this study, do not meaningfully influence earnings predictability. This mirrors Miller (2010), who found that excessive, complex disclosures can overwhelm investors, diluting the usefulness of information.

Cost classification shifting is moderately positively correlated with fair value accounting estimates ($r = 0.282$, $p < 0.01$), suggesting that firms using classification shifting may also rely more heavily on subjective fair value measurements possibly as complementary

earnings management tools. This supports Bradshaw et al. (2012), who noted that managers often combine multiple discretion mechanisms to achieve desired earnings outcomes.

A weak negative correlation exists between cost classification shifting and audit quality ($r = -0.201$, $p < 0.01$), indicating that stronger audit oversight is associated with lower levels of classification shifting. This is consistent with Chi et al. (2011), who reported that higher audit quality constrains opportunistic classification shifting.

Fair value accounting estimates show weak negative correlations with both discretionary accruals ($r = -0.181$, $p < 0.01$) and audit quality ($r = -0.174$, $p < 0.01$), suggesting that firms with stronger audit oversight tend to rely less on subjective fair value inputs. This aligns with Christensen et al. (2012), who found that high-quality auditors often demand more verifiable fair value evidence, reducing the scope for managerial bias.

Voluntary disclosures have a weak positive but insignificant relationship with discretionary accruals ($r = 0.100$, $p = 0.085$) and a weak negative, insignificant relationship with audit quality ($r = -0.114$, $p = 0.051$). The lack of statistical significance mirrors the findings of Njoroge (2018) for NSE-listed firms, who observed that voluntary disclosure levels varied widely but did not consistently impact earnings forecasting ability. Miller (2010) similarly argued that more disclosure does not always translate into more useful disclosure.

A notable moderate positive correlation is found between audit quality and earnings predictability ($r = 0.503$, $p < 0.01$). This supports the moderating hypothesis of this study and is in line with Slaheddine (2018), who found a strong positive relationship between audit quality and earnings predictability. High-quality audits characterized by timely reporting and unqualified opinions enhance confidence in reported figures, thereby improving predictive reliability.

Audit quality also correlates positively with discretionary accruals ($r = 0.265$, $p < 0.01$). While seemingly counterintuitive, this may suggest that in the NSE context, accrual-based earnings adjustments are more likely to pass auditor scrutiny when they are justifiable under accounting standards rather than purely opportunistic. This aligns with Francis and Yu (2009), who reported that Big Four auditors can tolerate certain discretionary accruals if they are within acceptable accounting thresholds.

Consistent with global findings, is the negative effect of fair value subjectivity on predictability (Barth et al., 2008; Biddle et al., 2011) and the constraining effect of audit quality on earnings management (Chi et al., 2011). Partially divergent results were presented on the role of discretionary accruals differs from Qiang et al. (2010), possibly due to market maturity differences. The combination of cost classification shifting and fair value reliance appears to impair predictability rather than enhance it, contrary to Ha and Thomas (2018) which presents a unique study for NSE.

The direction and magnitude of the correlations are consistent with the descriptive statistics discussed in 4.2. For example, the negative skewness and leptokurtic distribution of PER are reflected in its moderate correlations with CCS and DAC, while the high mean and negative skewness of VDI and AQI correspond to their positive associations with PER. The heavy-tailed distribution of FVAE explains the weak and unstable relationship with earnings predictability.”

4.4.1 Hausman Test

The Hausman test was employed to determine whether the Fixed Effects (FE) or Random Effects (RE) estimator was appropriate for the panel regression models. In most cases, the null hypothesis of no correlation between regressors and firm-specific effects was not rejected ($p > 0.05$), supporting the use of the RE model. Where the null was rejected, the FE model was applied.

The Hausman test is a model specification procedure rather than a data diagnostic test. It ensures that the choice between FE and RE is econometrically justified, aligning the estimation approach with the structure of the data.

Table 4.11: Presents the Results for the Hausman Specification Test

Chi Square Test Statistic	P Value	Conclusion
122.400	0.513	Adopt a Random Effect Model
<i>H₀</i> : preferred model is random effects		
<i>vs</i>		
<i>H₁</i> : preferred model is fixed effects		

If the p-value is significant (for example <0.05) then use fixed effects, if not use random effects. From the findings presented in Table 4.11, $\text{Prob}>\chi^2 = 0.513$ was greater than 0.05. Consequently, the null hypothesis was accepted and the null hypothesis was accepted. Consequently, the study adopted the Random Effect Panel Model (REM)

The acceptance of the null hypothesis and subsequent adoption of the Random Effects Model (REM) indicates that the unique errors are not correlated with the independent variables in the model. This outcome validates the efficiency of using REM as it allows for generalization beyond the sample, assuming that unobserved firm-specific effects are randomly distributed and uncorrelated with the regressors (Baltagi, 2012). Additionally, the result suggests that time-invariant characteristics of the firms do not significantly bias the estimators, enhancing the reliability of model estimates used to explain the influence of accounting discretion on earnings predictability.

It's also worth noting that modern panel estimation techniques, such as Generalized Least Squares, Fixed Effects, and Random Effects models, can handle unbalanced data without biasing parameter estimates, provided the missing variables is Missing at Random and not systematically related to unobserved firm characteristics (Wooldridge, 2010).

4.5 Bivariate Regression Analysis

The output below shows results for bivariate analysis conducted on the relationship between cost classification and Earnings Predictability for firms in both the financial and non-financial sectors.

4.5.1 Influence of Cost classification on Earnings Predictability

Cost stickiness significantly affects the earnings response coefficient of stock prices. Lower cost stickiness improves the ability of current returns to reflect future earnings, which is manifested in higher future earnings response coefficient (Li & Sun, 2023). If cost stickiness is high, it means that the company's information is more complex, and costs for investors to process the company's-specific information will increase. In capital market, investors consider the impact of cost stickiness on the company's value and future development, and treat companies with high-cost stickiness differently from those with low-cost stickiness

The first objective of the study was to assess the influence of cost classification shifting on earnings predictability of listed firms in Kenya. Managers are observed to shift costs within different classification categories influencing the linearity of Sales and SGA costs affecting the predictability of earnings for listed firms in Kenya. By examining the impact of cost classification shifting practices on earnings predictability, the study aims to uncover any patterns or trends that may emerge within the financial reporting landscape.

Table 4.12: Model Summary, ANOVA and Beta Coefficients for Cost Classification and Earnings Predictability

Model Summary						
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate		
1	.296 ^a	.088	.086	11.53367		
a. Predictors: (Constant), cost classification shifting						
ANOVA ^a						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	7428.681	1	7428.681	55.844	.000 ^b
	Residual	77154.751	580	133.025		
	Total	84583.432	581			
a. Dependent Variable: earnings predictability						
b. Predictors: (Constant), cost classification shifting						
Coefficients ^a						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	5.019	.511		9.831	.000
	cost classification shifting	-.820	.110	-.296	-7.473	.000
	a. Dependent Variable: earnings predictability					

The regression model shows an R value of 0.296, indicating a moderate negative correlation between cost classification shifting and earnings predictability. The R Square (0.088) means that approximately 8.8% of the variation in earnings predictability can be explained by cost classification shifting alone. While this is statistically significant, it suggests that other factors (beyond cost classification shifting) explain over 91% of the variation, which is expected given the complexity of earnings predictability determinants. The Adjusted R Square (0.086) confirms the model's stability after adjusting for the number of predictors.

The Standard Error of the Estimate (11.53) indicates the average deviation of observed earnings predictability values from the regression line, showing there is still a substantial unexplained variation.

The F-statistic = 55.844 with a p-value < 0.001 indicates that the regression model is statistically significant at the 1% level. This means that cost classification shifting, as a predictor, significantly improves the model's ability to predict earnings predictability compared to a model with no predictors.

Constant (B = 5.019, p < 0.001): When cost classification shifting is zero, the predicted earnings predictability is 5.019 units. Cost classification shifting (B = -0.820, Beta = -0.296, p < 0.001): The negative coefficient means that for every one-unit increase in cost classification shifting, earnings predictability decreases by 0.820 units, holding all else constant. The standardized beta (-0.296) shows that cost classification shifting has a moderate effect size relative to other potential predictors.

The resultant predictive equation is therefore expressed as:

$$PER_{it} = 5.019 - 0.820 CCS_{it} + u_{it}$$

A one-unit rise in CCS is associated with a 0.820 decrease in PER, indicating that higher cost stickiness reduces earnings predictability.

This finding aligns with McVay (2006) and Fan et al. (2010), who argued that classification shifting can obscure core performance trends by reallocating expenses between functional categories, thus reducing the transparency and predictability of reported earnings. Similarly, Malikov et al. (2018) found that higher levels of expense misclassification were associated with less persistent and less predictable earnings.

The negative relationship suggests that firms engaging in cost classification shifting may undermine the reliability of their financial statements from an investor's perspective. This could be due to the distortion of expense and margin trends, making it more difficult for analysts and investors to project future earnings accurately.

From a regulatory standpoint, this reinforces the importance of International Financial Reporting Standards (IFRS) compliance, enhanced disclosure requirements, and audit

scrutiny to mitigate such practices. It also underscores why stakeholders, including auditors and regulators, should pay attention to abnormal variations in SG&A expenses relative to sales movements.

This result is aligned with prior research asserting that cost stickiness—an outcome often driven by classification shifting reduces transparency in financial statements and undermines forecast accuracy (Weiss, 2010; Anderson et al., 2003). Specifically, Weiss (2010) highlighted that asymmetric cost behavior complicates analysts' forecasts, leading to decreased forecast accuracy and increasing uncertainty among investors. In this context, the negative coefficient found in your study supports the broader argument that earnings become less predictable when firms manipulate cost classifications, thus increasing the complexity and opacity of financial reports.

Furthermore, the study corroborates findings from Hevas et al. (2020), who emphasized that cost stickiness and earnings smoothing are interrelated phenomena. Their research demonstrated that the degree of cost asymmetry impacts not only the quality of earnings but also managerial incentives and conditional conservatism. Your study similarly observed that classification shifting reduces the predictability of earnings, suggesting that such practices may obscure the persistence of core performance indicators and inflate the perceived quality of earnings in the short term. This indicates that firms engaging in classification shifting may be attempting to meet short-term targets at the expense of long-term financial transparency echoing the patterns seen in Hevas et al.'s European sample.

The negative effect observed in your study also resonates with the conclusions of Hwang, Lee, and Nam (2023), who linked classification shifting to increase stock price crash risk due to delayed disclosure of bad news. While their focus was on market reactions and crash risk, the mechanism of distortion of reported core earnings through classification shifting is similar. Your finding that increased classification shifting reduces earnings predictability provides empirical support to the notion that misclassification disrupts the usefulness of earnings as a signal for future performance. These similarities highlight that

the negative capital market outcomes of classification shifting are not restricted to one aspect (e.g., crash risk) but extend to predictive validity and valuation reliability.

The findings of your study also echo the results of Ibrahim (2018), who emphasized that corporate governance structures play a moderating role in cost stickiness behavior. While your study did not directly test governance effects, the significant negative impact of classification shifting on earnings predictability may indirectly suggest weaker governance or lax internal controls in some firms. Ibrahim's research, conducted in Egypt, pointed out that board composition, including the ratio of non-executives and the separation of CEO and chair roles, influenced cost behavior. The consistency of your results with this finding suggests that beyond economic rationality, institutional structures and regulatory environments in emerging markets like Kenya can either constrain or enable such discretionary reporting practices.

Finally, the work of Abdalla and Clubb (2023), which proposed a refined model for detecting classification shifting, strengthens the methodological grounding of your study. Their conclusion that classification shifting distorts the forecasting value of core expenses aligns well with your findings that such shifting reduces earnings predictability. The implication is that classification shifting not only poses measurement challenges but also has real consequences for the interpretability of financial performance metrics. This study contributes to this evolving dialogue by validating these relationships within the Kenyan context, extending existing theory into an African capital market setting and showing that even in relatively smaller or developing markets, classification shifting has material effects on financial statement usefulness and investor decision-making.

4.5.2 Influence of Fair Value Accounting Estimates on Earnings Predictability

The main assumption is that Level 2 and Level 3 inputs are more subjective, contain more measurement errors and allow managers to use their earnings management practices more often in comparison to Level 1 inputs. This estimation error in the measurement of assets

and liabilities can be a source of additional financial statement volatility. Accordingly, when assets and liabilities are volatile, so are earnings (Sodan, 2019).

This objective aims to determine the influence of fair value accounting estimates on the predictability of earnings for listed firms in Kenya. Fair value accounting often involves subjective judgments and estimations, which may impact the reliability and predictability of reported earnings. Understanding the extent of this influence is essential for assessing the quality and usefulness of financial information

Table 4.13: Model Summary, ANOVA and Beta Coefficients for Fair Value Accounting Estimates on Earnings Predictability

Model Summary						
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate		
1	.478 ^a	.228	.227	10.61005		
a. Predictors: (Constant), fair value accounting estimates						
ANOVA						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	19290.966	1	19290.966	171.364	.000 ^b
	Residual	65292.466	580	112.573		
	Total	84583.432	581			
a. Dependent Variable: earnings predictability						
b. Predictors: (Constant), fair value accounting estimates						
Coefficients						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	6.472	.489		13.241	.000
	fair value accounting estimates	-19.285	1.473	-.478	-13.091	.000
a. Dependent Variable: earnings predictability						

The regression model produces an R value of 0.478, indicating a moderate negative relationship between fair value accounting estimates and earnings predictability. The R Square = 0.228 means that 22.8% of the variation in earnings predictability can be explained solely by fair value accounting estimates. This explanatory power is substantially higher than that observed for cost classification shifting in your previous

model (8.8%), showing that FVAE has a stronger impact on earnings predictability among the variables tested so far. The Adjusted R Square (0.227) is very close to the R Square, indicating minimal model overfitting.

The Standard Error of the Estimate = 10.61 suggests that there is still notable unexplained variation, but it is smaller than in the cost classification shifting model (11.53), indicating a slightly better model fit.

The F-statistic = 171.364 with $p < 0.001$ indicates that the model is highly statistically significant. This confirms that fair value accounting estimates, as a single predictor, significantly improve the ability to predict earnings predictability compared to a model without it.

The constant ($B = 6.472$, $p < 0.001$): When fair value accounting estimates are zero, the predicted earnings predictability is 6.472 units. Fair value accounting estimates ($B = -19.285$, $Beta = -0.478$, $p < 0.001$): The coefficient shows a strong and negative effect—for every one-unit increase in FVAE, earnings predictability decreases by 19.285 units, holding all else constant. The standardized beta (-0.478) confirms FVAE as a relatively strong predictor with a larger magnitude of effect than cost classification shifting.

The resultant predictive equation is therefore expressed as:

$$PER_{it} = 6.472 - 19.285 FVAE_{it} + u_{it}$$

A one-unit increase in FVAE is associated with a 19.285 drop in PER, consistent with fair-value volatility lowering predictability.

This finding is consistent with Laux and Leuz (2009), who argue that higher reliance on fair value measurements, particularly Level 3 inputs under IFRS 13, increases subjectivity and reduces earnings quality due to valuation uncertainty. Similarly, Song, Thomas, and Yi (2010) found that while fair value measures for actively traded assets improved

transparency, reliance on managerial assumptions (unobservable inputs) reduced the predictability and persistence of earnings.

The negative association suggests that when firms rely heavily on subjective or illiquid fair value measures, they introduce volatility and potential bias into earnings, reducing their ability to serve as a stable basis for forecasting. This could be due to estimation uncertainty (especially for Level 3 FVAE) or managerial discretion in valuation assumptions or simply market illiquidity affecting asset pricing. Volatility therefore tends to make historical cost based measure more attractive to investors than fair values

For the Nairobi Securities Exchange (NSE) context, where some asset classes may not have active markets, reliance on FVAE can lead to significant deviations from actual realizable values, thereby weakening earnings predictability.

On the issue of managerial discretion, Fiecher and Meyer (2010) and García Osma et al. (2022) provided empirical evidence that fair value estimates can be used strategically to manipulate financial outcomes. These studies reported that banks and other institutions often overstate fair values to improve perceived financial performance or avoid regulatory scrutiny. The finding that increased use of fair value estimates corresponds with decreased earnings predictability supports the argument that such estimates introduce a layer of subjectivity and strategic behavior, undermining the consistency needed for reliable forecasting. This adds weight to the critique that fair value accounting, while conceptually robust, creates practical challenges in terms of earnings quality.

While Siekkinen (2017) found that board characteristics such as independence and diversity improve the reliability of fair value disclosures, he also acknowledged the inherent unverifiability of Level 3 inputs. The observed results parallel this observation, suggesting that even in regulated environments like Kenya's capital markets, the presence of fair value estimation continues to be a source of reduced predictability. Although Siekkinen was optimistic about board oversight mitigating misuse, the findings imply that,

without strong enforcement and transparency mechanisms, the subjective nature of these estimates still dominates, regardless of governance structures.

The concerns raised by Goh et al. (2021) and Toluwa and Power (2019) regarding stakeholders' trust and the controversial nature of fair value accounting are reflected in the results. These authors noted that despite theoretical benefits, stakeholders often perceive fair value accounting as complex and potentially misleading. The empirical evidence demonstrating a significant negative relationship between fair value estimates and earnings predictability provides quantitative support for these perceptions. It underscores the argument that in emerging markets like Kenya, where valuation models and regulatory enforcement may not be fully mature, and the increased reliance on fair value estimates can hinder the transparency and reliability of earnings reports.

4.5.3 Influence of Voluntary Disclosures on Earnings Predictability

This objective focuses on evaluating the influence of voluntary disclosures made by listed firms on the predictability of earnings. Voluntary disclosures provide additional information beyond mandatory reporting requirements, potentially enhancing transparency and reducing information asymmetry. Examining the relationship between voluntary disclosures and earnings predictability sheds light on the efficacy of such disclosure practices.

Table 4.14: Model Summary, ANOVA and Beta Coefficients Voluntary Disclosures on Earnings Predictability

Model Summary						
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate		
1	.054 ^a	.003	-.001	13.43073		
a. Predictors: (Constant), voluntary disclosures						
ANOVA ^a						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	148.741	1	148.741	.825	.365 ^b
	Residual	49966.490	277	180.384		
	Total	50115.231	278			
a. Dependent Variable: earnings predictability						
b. Predictors: (Constant), voluntary disclosures						
Coefficients ^a						
Model		Unstandardized		Standardized	t	Sig.
		Coefficients		Coefficients		
		B	Std. Error	Beta		
1	(Constant)	4.131	.824		5.011	.000
	voluntary disclosures	-.040	.044	-.054	-.908	.365
a. Dependent Variable: earnings predictability						

The regression model shows an R value of 0.054, indicating an extremely weak relationship between voluntary disclosures and earnings predictability. The R Square = 0.003 means that voluntary disclosures explain only 0.3% of the variance in earnings predictability essentially negligible explanatory power. The Adjusted R Square = -0.001 confirms that the model does not improve upon the baseline (mean-only) model. The Standard Error of the Estimate = 13.43 is high compared to the magnitude of the coefficient, further highlighting the weak association.

The F-statistic = 0.825 with $p = 0.365$ shows that the model is not statistically significant at the conventional 5% or even 10% levels. This means voluntary disclosures, as measured in this study, do not significantly explain variations in earnings predictability. The constant ($B = 4.131$, $p < 0.001$): When voluntary disclosures are zero, predicted earnings predictability is 4.131 units. Voluntary disclosures ($B = -0.040$, $Beta = -0.054$, $p = 0.365$):

The coefficient is negative but very close to zero and statistically insignificant. This means that changes in voluntary disclosures have no meaningful effect on earnings predictability in this sample.

The resultant predictive equation is therefore expressed as:

$$PER_{it} = 4.131 - 0.040 VDI_{it} + u_{it}$$

VDI's standalone effect is small and slightly negative (−0.040) on PER in the bivariate setting.

The lack of significance aligns with Miller (2010), who found that excessive or complex disclosure can overwhelm investors, making it harder, to interpret financial performance. Similarly, Bloomfield (2002) argued that more disclosure is not inherently better; if disclosures are not timely, relevant, or understandable, they may have little to no impact on decision-making.

Our findings contrast with those of Uyar and Kiliç (2012), who found a strong positive association between voluntary disclosure and firm value in Turkish listed firms. Their study showed that increased disclosure levels correlated positively with market capitalization, suggesting that investors value transparency and additional information. However, while their study demonstrated value relevance, it focused on firm valuation rather than earnings predictability, which may explain the divergence in outcomes.

The findings also stand in contrast to the insights by Alfraih and Almutawa (2017), who observed a significant relationship between corporate governance mechanisms and voluntary disclosure in Kuwaiti firms. They reported gradual improvement in disclosure levels over time, which positively affected the transparency and possibly the informational quality of financial statements. Nonetheless, their study did not directly examine whether such disclosures enhance the ability to predict earnings. In the Kenyan context, as seen in the current study, voluntary disclosures do not appear to contribute meaningfully to

earnings forecastability, suggesting that the content or quality of disclosures might not be targeted at improving earnings transparency.

Moreover, Njoroge (2018) similarly found that voluntary disclosures had a positive but statistically insignificant effect on the cost of equity capital in Kenyan listed firms. This aligns closely with the current findings, where voluntary disclosures were also shown to have an insignificant impact on earnings predictability. These consistent results suggest that voluntary disclosure practices among Kenyan firms may lack the depth or consistency needed to influence forward-looking financial variables. It could also reflect a compliance-based approach to disclosure, where firms disclose information for formality rather than for enhancing transparency.

Research by García-Sánchez et al. (2019) and Gietzmann and Ostaszewski (2022) provided further nuance by highlighting the strategic nature of voluntary disclosures. These studies emphasized how managerial discretion and reputational concerns influence disclosure patterns, potentially reducing the informativeness of such disclosures. If Kenyan firms also exhibit similar discretion in voluntary reporting, it could explain why these disclosures are not significantly improving earnings predictability. The lack of a positive impact may stem not from the absence of disclosures, but from the nature and timing of the information disclosed, which may be inconsistent, selective, or backward-looking.

Other studies, such as those by Leung (2005) and Francis et al. (2008), suggested that voluntary disclosures can enhance forecast accuracy and reduce information asymmetry, but only when accompanied by high earnings quality or strategic operating information. The absence of significant findings in the current study may therefore point to limitations in either the nature of disclosures made by Kenyan firms or the broader reporting environment. While previous literature affirms the theoretical value of voluntary disclosures, the findings suggest that, in the Kenyan setting, voluntary disclosure practices have yet to reach a level of maturity or transparency necessary to improve earnings predictability.

The discrepancy could be due to either one, the nature of disclosures: If the content is boilerplate, repetitive, or overly complex, it may not enhance earnings predictability or two, the measurement limitations where the voluntary disclosure index used here may not fully capture quality, relevance, or timeliness of disclosures or third, market maturity where in emerging markets like the NSE, investor sophistication and analytical capacity may limit the benefits of additional disclosures.

The results suggest that in the NSE context, voluntary disclosures, as currently practiced, are not an effective driver of earnings predictability. This could indicate that disclosures lack forward-looking information relevant to earnings forecasts. I may also imply that investors may rely more on mandatory disclosures and audited financial statements. The market may not also have enough analyst coverage to process and interpret voluntary information efficiently.

4.5.4 Influence of Accruals Earnings Management on Earnings Predictability

This objective seeks to evaluate the influence of accruals earnings management practices on the predictability of earnings for listed firms in Kenya. Accruals earnings management involves the manipulation of accounting accruals to smooth reported earnings. Understanding how these practices impact earnings predictability is essential for assessing the reliability of financial statements.

Table 4.15: Model Summary, ANOVA and Beta Coefficients Accruals Earnings Management on Earnings Predictability

Model Summary						
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate		
1	.141 ^a	.020	.018	11.95615		
a. Predictors: (Constant), accruals earnings						
ANOVA ^a						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1672.737	1	1672.737	11.702	.001 ^b
	Residual	82910.695	580	142.949		
	Total	84583.432	581			
a. Dependent Variable: earnings predictability						
b. Predictors: (Constant), accruals earnings						
Coefficients ^a						
Model		Unstandardized		Standardized	t	Sig.
		Coefficients		Coefficients		
		B	Std. Error	Beta		
1	(Constant)	.237	1.122		.211	.833
	accruals earnings	5.407	1.581	.141	3.421	.001
a. Dependent Variable: earnings predictability						

The model reports an $R = 0.141$, indicating a weak positive correlation between accruals earnings management and earnings predictability. $R^2 = 0.020$ means that only 2% of the variation in earnings predictability is explained by accruals earnings management, a small proportion, suggesting other factors are more influential. The adjusted $R^2 = 0.018$ confirms that explanatory power remains weak after adjusting for degrees of freedom. The Standard Error of the Estimate = 11.96 is large relative to the effect size, again showing low predictive strength.

The F-statistic = 11.702, $p = 0.001$, shows that the model is statistically significant overall, despite its low explanatory power. This means that, while the relationship is weak, it is unlikely to be due to random chance.

The constant ($B = 0.237$, $p = 0.833$): Statistically insignificant, meaning that when accruals earnings management is zero, earnings predictability does not differ significantly from zero. Accruals earnings ($B = 5.407$, $Beta = 0.141$, $p = 0.001$): A one-unit increase in discretionary accruals is associated with a 5.41-unit increase in earnings predictability, holding other factors constant. While statistically significant, the standardized Beta (0.141) indicates the effect is small in practical terms.

The resultant predictive equation is therefore expressed as:

$$PER_{it} = 0.237 + 5.407 DA_{it} + u_{it}$$

A one-unit rise in DA is associated with a 5.407 increase in PER, suggesting periods with higher discretionary accruals coincide with higher PER.

The regression analysis shows that accruals earnings management has a statistically significant positive influence on earnings predictability among listed firms in Kenya. The model indicates that approximately 2% of the variation in earnings predictability is explained by accruals earnings, with a significant regression coefficient ($p = 0.001$) implying that higher accruals are associated with increased predictability. This suggests that, in the Kenyan context, firms that engage in accrual-based adjustments might be applying accounting discretion in a way that enhances the perceived consistency of earnings, thereby improving their predictability. While statistically significant, the explanatory power is very low ($R^2 = 2\%$), meaning accruals management is only one small factor among many influencing earnings predictability. This low R^2 implies that stakeholders should not over-rely on accruals measures as a sole predictor of earnings stability; other operational, market, and macroeconomic variables remain important.

This outcome differs from findings by Roychowdhury (2006) and Konan et al. (2001), who argued that accrual-based earnings management often leads to short-term gains in earnings predictability at the expense of long-term reliability and performance. Their studies suggest that such practices may inflate earnings artificially, ultimately misleading

investors and reducing future returns. In contrast, the current findings suggest that, within the Kenyan market, accrual adjustments may not be inherently manipulative but could reflect efforts to provide smoother and more consistent financial results, especially in markets with relatively less stringent enforcement mechanisms.

Oluoch (2015) supports this Kenyan context by demonstrating that discretionary accruals make up a very small portion of total accruals among listed firms, indicating limited opportunistic behavior in accrual reporting. His findings suggested that innate accruals dominated and that discretionary accruals had no significant effect on cost of capital, implying a more passive role in financial distortions. The current results, however, indicate that even these limited discretionary accruals can enhance the predictability of earnings, possibly because they are applied with caution and within acceptable accounting judgment thresholds rather than for outright manipulation.

Studies by Simamora (2018) and Sánchez-Ballesta and García-Meca (2007) offer a nuanced view that supports the notion that the context, such as auditor quality or ownership structure, can influence how accruals earnings management affects earnings quality. Where strong governance or high-quality auditing exists, accrual-based adjustments may signal reliable financial management and bolster earnings predictability. Similarly, the positive relationship found in this study might be influenced by effective audit oversight and moderate use of accruals adjustments rather than aggressive earnings smoothing, thus increasing the reliability of reported figures.

Conversely, studies such as those by Xie (2001), Kothari et al. (2005), and Krishnan (2003) underscore the risks of discretionary accruals when governance and audit quality are weak. These studies assert that higher levels of earnings management via accruals often diminish earnings quality, distort investor perception, and lead to negative long-term consequences. The Kenyan results, while showing a positive relationship, suggest the need for ongoing scrutiny. The modest explanatory power of the model ($R^2 = 0.020$) indicates that although accruals may play a role in predictability, they are not the primary driver,

and their influence should be interpreted with caution within the broader context of governance and financial reporting standards.

4.5.5 Relationship between Audit Quality and Earnings Predictability

Table 4.16: Model Summary, ANOVA and Beta coefficients Audit Quality on Earnings Predictability

Model Summary						
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate		
1	.503 ^a	.253	.252	10.43795		
a. Predictors: (Constant), audit quality						
ANOVA ^a						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	21391.951	1	21391.951	196.345	.000 ^b
	Residual	63191.481	580	108.951		
	Total	84583.432	581			
a. Dependent Variable: earnings predictability						
b. Predictors: (Constant), audit quality						
Coefficients ^a						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-13.092	1.273		-10.286	.000
	audit quality	22.231	1.587	.503	14.012	.000
a. Dependent Variable: earnings predictability						

The Pearson correlation (R) of 0.503 indicates a moderate positive relationship between audit quality and earnings predictability. The positive unstandardized coefficient (B = 22.231) means that an increase in audit quality by one unit (on the index scale) is associated with an increase of 22.23 units in earnings predictability. This aligns with prior literature (e.g., Francis et al., 2004; Slaheddine, 2018), which finds that high audit quality enhances the reliability and transparency of reported earnings, making them more predictable. $R^2 = 0.253$ means 25.3% of the variation in earnings predictability can be explained solely by audit quality. This is the highest explanatory power among all your single-variable models so far, suggesting audit quality is a strong determinant of earnings

predictability in NSE-listed firms. The Adjusted $R^2 = 0.252$ shows almost no shrinkage, implying stability of the estimate.

The regression is highly significant ($F = 196.345$, $p < 0.001$), meaning there is strong evidence that audit quality influences earnings predictability. The t-value (14.012) for audit quality is also very high, reinforcing its significance in the model. The constant is negative (-13.092), suggesting that in the hypothetical case of zero audit quality, predicted earnings predictability would be negative, which may indicate investor distrust in unaudited or poorly audited financial statements.

This empirical evidence aligns well with existing literature emphasizing the critical role of audit quality in enhancing financial reporting reliability. As noted by Nuryaman (2013), high-quality audits reduce earnings management, increase transparency, and improve users' trust in financial statements. The positive relationship observed in the current analysis supports this view, suggesting that robust audit practices, likely associated with high audit firm reputation, detailed scrutiny, and adherence to auditing standards, help curb opportunistic accounting behavior and make reported earnings more consistent and predictable.

Similarly, Walker and Hay (2013) assert that firms with clean audit opinions, often associated with higher audit quality, are less likely to manipulate earnings. This aligns with the current study's findings, as greater audit quality corresponds with stronger earnings predictability, implying reduced distortion and higher transparency in the reporting process.

Further, ISA 701 strengthens audit transparency by requiring the disclosure of Key Audit Matters (KAMs), particularly in areas with significant risk or judgment. By enhancing stakeholder understanding of the auditor's focus areas, such standards likely contribute to the observed improvement in earnings predictability. These disclosures provide insight into complex or subjective areas of financial statements, thereby increasing their reliability for forecasting future earnings.

Other proxies for audit quality such as the use of Big Four auditors, audit report lag, or audit opinion type, serve as critical dimensions in assessing audit effectiveness. The influence of these factors likely underpins the strong statistical association observed in this study. For instance, Big Four auditors, known for their rigorous methodologies and independence, are more likely to issue audit opinions that reflect the true financial state of a firm, thereby improving earnings predictability.

While the present study confirms a clear and significant impact of audit quality on earnings predictability, previous literature has also acknowledged ongoing challenges in measuring audit quality due to its inherently subjective components. For example, the complexity of accounting estimates and managerial judgment limits the direct observability of audit effectiveness. However, the strong R^2 value in this analysis suggests that, despite these limitations, audit quality remains a powerful predictor of earnings reliability in the Kenyan context.

4.6 Moderating effect of audit quality

4.6.1 Moderating Effect of Audit Quality on the Relationship between Cost Classification Shifting and Earnings Predictability of Listed Firms in Kenya

Table 4.17: Moderated Model Summary, ANOVA and Beta Coefficients for Cost Classification and Earnings Predictability

Model Summary									
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.296 ^a	.088	.086	11.53367	.088	55.844	1	580	.000
2	.538 ^b	.289	.287	10.18905	.202	164.182	1	579	.000
a. Predictors: (Constant), cost classification shifting									
b. Predictors: (Constant), cost classification shifting , audit quality									
ANOVA ^a									
Model	Sum of Squares			df	Mean Square		F	Sig.	
1	Regression		7428.681	1	7428.681		55.844	.000 ^b	
	Residual		77154.751	580	133.025				
	Total		84583.432	581					
2	Regression		24473.543	2	12236.772		117.869	.000 ^c	
	Residual		60109.889	579	103.817				
	Total		84583.432	581					
a. Dependent Variable: earnings predictability									
b. Predictors: (Constant), cost classification shifting									
c. Predictors: (Constant), cost classification shifting , audit quality									
Coefficients ^a									
Model				Unstandardized Coefficients	Standardized Coefficients		t	Sig.	
				B	Std. Error	Beta			
1	(Constant)			5.019	.511		9.831	.000	
	cost classification shifting			-.820	.110	-.296	-7.473	.000	
2	(Constant)			-10.779	1.313		-8.210	.000	
	cost classification shifting			-.541	.099	-.196	-5.448	.000	
	audit quality			20.337	1.587	.460	12.813	.000	
a. Dependent Variable: earnings predictability									

The analysis investigated the moderating effect of audit quality on the relationship between cost classification shifting and earnings predictability among listed firms in Kenya. The model summary indicates a significant improvement when audit quality is added as a predictor. In the initial model with only cost classification shifting as the predictor, the R-square value was 0.088, explaining 8.8% of the variance in earnings predictability. Upon introducing audit quality as an additional predictor, the R-square increased substantially to 0.289, indicating that the combined effect of cost classification shifting and audit quality accounts for 28.9% of the variance in earnings predictability.

The ANOVA results demonstrate that the second model with both cost classification shifting and audit quality as predictors significantly improves the model fit compared to the initial model ($F = 164.182$, $p < 0.001$). This suggests that the addition of audit quality as a predictor contributes significantly to explaining the variance in earnings predictability.

$$PER_{it} = -10.779 - 0.541 CCS_{it} + 20.337 AQI_{it} + u_{it}$$

CCS remains negative; higher AQI is associated with +20.337 on PER, consistent with audit quality supporting predictability.

Examining the coefficients, it is observed that the coefficient for cost classification shifting remains negative and significant in both models, indicating that cost classification shifting negatively influences earnings predictability. However, in the second model, the magnitude of the coefficient decreases, suggesting a moderated effect when audit quality is included. Additionally, the coefficient for audit quality is positive and significant in the second model, indicating that higher audit quality enhances earnings predictability and moderates the negative impact of cost classification shifting.

Our analysis reveals a significant negative correlation between cost classification shifting and earnings predictability ($r = -0.296$, $p < 0.01$). This indicates that firms engaging in cost classification shifting practices tend to have less predictable earnings. Cost

classification shifting involves the manipulation of expenses between different categories to artificially inflate or deflate reported earnings (Smith & Jones, 2021). Such practices undermine the reliability and transparency of financial reporting, leading to increased uncertainty for investors and other stakeholders (Li & Wang, 2020).

Recent literature highlights the detrimental effects of cost classification shifting on earnings predictability. For example, a study by Johnson et al. (2022) found that firms engaging in aggressive cost classification shifting exhibit higher earnings volatility and lower long-term earnings predictability. Similarly, Chen et al. (2020) emphasized the importance of robust internal controls and effective corporate governance mechanisms in curbing the prevalence of cost classification shifting practices. Therefore, our findings underscore the need for enhanced regulatory oversight and enforcement to deter such accounting manipulations and promote financial transparency.

Building upon the findings, the inclusion of audit quality in the model not only mitigates the adverse impact of cost classification shifting but also significantly improves the explanatory power of the model regarding earnings predictability. The increase in R-square from 0.088 to 0.289 indicates that audit quality substantially enhances the ability of the model to account for the variation in earnings predictability. This supports the notion that high audit quality can serve as a counterbalance to opportunistic accounting practices by ensuring more accurate and faithful representation of financial information.

The regression coefficients provide further insights into the nature of this moderation. Specifically, the coefficient of cost classification shifting reduces in magnitude from -0.820 to -0.541 after audit quality is introduced into the model. This attenuation suggests that audit quality acts as a buffer, reducing the extent to which cost classification shifting distorts the predictability of earnings. High-quality audits likely detect and discourage such manipulative behavior, thereby improving the overall credibility of financial reports and reducing the associated information risk for investors.

In line with prior research, audit quality is often associated with greater transparency and reduced earnings manipulation. Studies such as Dechow et al. (2010) and Francis et al. (2011) suggest that external auditors play a critical role in identifying earnings management tactics, including cost classification shifting, and in ensuring compliance with relevant accounting standards. Therefore, firms audited by reputable and independent auditors are more likely to produce reliable earnings reports, which enhances stakeholders' confidence in the firm's financial disclosures.

Moreover, the significant positive coefficient for audit quality ($B = 20.337, p < 0.001$) demonstrates its standalone impact on earnings predictability. This aligns with literature that underscores the importance of high audit quality in ensuring the integrity of financial statements. For instance, research by Knechel et al. (2013) highlights that quality audits reduce information asymmetry and strengthen investor trust. Consequently, firms that invest in high-quality audits not only deter unethical accounting practices but also benefit from increased predictability of earnings, which is essential for capital market efficiency.

In conclusion, the results of this analysis strongly support the moderating role of audit quality in the relationship between cost classification shifting and earnings predictability. While cost classification shifting undermines earnings reliability, the presence of high audit quality significantly reduces this negative impact, promoting transparency and consistency in financial reporting. These findings emphasize the need for firms to prioritize audit quality and for regulators to uphold stringent auditing standards, as these mechanisms play a pivotal role in curbing earnings manipulation and ensuring dependable financial disclosures in capital markets.

4.6.2 Moderating Effect of Audit Quality on the Relationship between Fair Value Accounting Estimates and Earnings Predictability of Listed Firms in Kenya

Table 4.18: Moderated Model Summary, ANOVA and Beta Coefficients for Fair Value Accounting Estimates on Earnings Predictability

Model Summary						
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate		
1	.478 ^a	.228	.227	10.61005		
2	.637 ^b	.406	.404	9.31753		
a. Predictors: (Constant), fair value accounting estimates						
b. Predictors: (Constant), fair value accounting estimates , audit quality						
ANOVA ^a						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	19290.966	1	19290.966	171.364	.000 ^b
	Residual	65292.466	580	112.573		
	Total	84583.432	581			
2	Regression	34316.740	2	17158.370	197.640	.000 ^c
	Residual	50266.692	579	86.816		
	Total	84583.432	581			
a. Dependent Variable: earnings predictability						
b. Predictors: (Constant), fair value accounting estimates						
c. Predictors: (Constant), fair value accounting estimates , audit quality						
Coefficients ^a						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	6.472	.489		13.241	.000
	fair value accounting estimates	-19.285	1.473	-.478	-13.091	.000
	(Constant)	-8.300	1.202		-6.905	.000
2	fair value accounting estimates	-16.065	1.317	-.398	-12.201	.000
	audit quality	18.962	1.441	.429	13.156	.000
	(Constant)					
a. Dependent Variable: earnings predictability						

The analysis explored the moderating effect of audit quality on the relationship between fair value accounting estimates and earnings predictability among listed firms in Kenya. The initial model with fair value accounting estimates as the sole predictor showed an R-square value of 0.228, indicating that fair value accounting estimates explain 22.8% of the

variance in earnings predictability. Upon introducing audit quality as an additional predictor, the R-square increased substantially to 0.406, indicating that the combined effect of fair value accounting estimates and audit quality accounts for 40.6% of the variance in earnings predictability.

The ANOVA results revealed that the second model, incorporating both fair value accounting estimates and audit quality as predictors, significantly improved the model fit compared to the initial model ($F = 197.640$, $p < 0.001$). This suggests that the addition of audit quality as a predictor significantly contributes to explaining the variance in earnings predictability, beyond the influence of fair value accounting estimates alone.

$$PER_{it} = -8.300 - 16.065 FVAE_{it} + 18.962 AQI_{it} + u_{it}$$

FVAE is negative; AQI is positive and sizeable, indicating audit quality offsets fair-value noise.

Analyzing the coefficients, it was observed that the coefficient for fair value accounting estimates remains negative and significant in both models, indicating that fair value accounting estimates negatively influence earnings predictability. However, in the second model, the magnitude of the coefficient decreases slightly, suggesting a moderated effect when audit quality is included. Additionally, the coefficient for audit quality is positive and significant in the second model, indicating that higher audit quality enhances earnings predictability and moderates the negative impact of fair value accounting estimates.

Our analysis reveals a moderate negative correlation between fair value accounting estimates and earnings predictability ($r = -0.478$, $p < 0.01$). This suggests that firms relying heavily on fair value accounting tend to have less predictable earnings. Fair value accounting involves the measurement of assets and liabilities at their current market values, introducing subjectivity and estimation uncertainty into financial reporting (Barth et al., 2021). As a result, earnings derived from fair value measurements may fluctuate significantly from period to period, reducing their predictability.

Recent research has highlighted the challenges associated with fair value accounting and its implications for earnings predictability. Johnson et al. (2022) argued that fair value estimates are often based on unreliable market data, leading to potential mispricing of assets and liabilities. Moreover, the subjective nature of fair value measurements can create opportunities for earnings management and financial statement manipulation (Chen et al., 2020). Therefore, our findings emphasize the importance of exercising caution when applying fair value accounting and ensuring adequate disclosure of the underlying assumptions and methodologies.

Building on these findings, the inclusion of audit quality as a moderating variable significantly reduces the adverse impact of fair value accounting estimates on earnings predictability. This suggests that high audit quality helps mitigate the uncertainty and estimation risk associated with fair value measurements by enforcing stricter evaluation and verification processes. When audit quality is high, external auditors are more likely to challenge aggressive assumptions or models used in fair value estimation, thereby reducing the variability in reported earnings.

The regression coefficients support this assertion. In the initial model, the coefficient for fair value accounting estimates was -19.285, but this reduced to -16.065 after audit quality was introduced, indicating a dampening effect. Simultaneously, the positive and significant coefficient for audit quality ($B = 18.962$, $p < 0.001$) further confirms that better audit quality contributes positively to earnings predictability. This aligns with studies such as Goh and Li (2011), which found that firms audited by high-quality auditors produce financial statements with less noise and greater predictive value.

Audit quality helps reinforce the credibility of fair value accounting by increasing the transparency and accountability of the reporting process. High-quality auditors are more likely to disclose critical audit matters and provide detailed explanations of fair value inputs and valuation techniques. This transparency reduces the information asymmetry between managers and external users, enhancing the users' ability to assess future

performance accurately. As such, the integrity of financial statements prepared under fair value principles is significantly strengthened when robust audit practices are in place.

Furthermore, fair value accounting often relies on hierarchical valuation techniques (Levels 1, 2, and 3), where Level 3 involves the most subjectivity and is thus the least reliable. High audit quality reduces the risk that firms will exploit Level 3 valuations to manipulate earnings. According to Christensen and Nikolaev (2013), firms with strong audit oversight tend to limit their reliance on unverifiable Level 3 estimates, opting for more objective valuation inputs where possible. This shift contributes to more stable and predictable earnings, reinforcing the moderating role of audit quality.

4.6.3 Moderating Effect of Audit Quality on the Relationship between Voluntary Disclosures and Earnings Predictability of Listed Firms in Kenya

Table 4.19: Moderated Model Summary, ANOVA and Beta Coefficients for Voluntary Disclosures on Earnings Predictability

Model Summary									
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. F Change
1	.054 ^a	.003	-.001	13.43073	.003	.825	1	277	.365
2	.536 ^b	.287	.282	11.37928	.284	109.877	1	276	.000
a. Predictors: (Constant), voluntary disclosures									
b. Predictors: (Constant), voluntary disclosures , audit quality									
ANOVA ^a									
Model		Sum of Squares	df	Mean Square	F				Sig.
1	Regression	148.741	1	148.741	.825				.365 ^b
	Residual	49966.490	277	180.384					
	Total	50115.231	278						
2	Regression	14376.520	2	7188.260	55.513				.000 ^c
	Residual	35738.712	276	129.488					
	Total	50115.231	278						
a. Dependent Variable: earnings predictability									
b. Predictors: (Constant), voluntary disclosures									
c. Predictors: (Constant), voluntary disclosures , audit quality									
Coefficients ^a									
Model		Unstandardized Coefficients		Standardized Coefficients		t			Sig.
		B	Std. Error	Beta					
1	(Constant)	4.131	.824			5.011			.000
	voluntary disclosures	-.040	.044	-.054		-.908			.365
2	(Constant)	-15.708	2.017			-7.786			.000
	voluntary disclosures	.006	.037	.009		.171			.865
	audit quality	25.463	2.429	.537		10.482			.000
a. Dependent Variable: earnings predictability									

The study investigated the moderating effect of audit quality on the relationship between voluntary disclosures and earnings predictability among listed firms in Kenya. Initially,

the model with only voluntary disclosures as the predictor showed a very weak relationship with earnings predictability (R-square = 0.003), and the relationship was not statistically significant ($F = 0.825$, $p = 0.365$). However, upon introducing audit quality as an additional predictor, the model's explanatory power substantially improved, with an R-square value of 0.287, indicating that the combined effect of voluntary disclosures and audit quality explains 28.7% of the variance in earnings predictability.

The ANOVA results demonstrated that the second model, which included both voluntary disclosures and audit quality as predictors, significantly enhanced the model fit compared to the initial model ($F = 55.513$, $p < 0.001$). This indicates that the inclusion of audit quality as a predictor significantly contributes to explaining the variance in earnings predictability beyond the influence of voluntary disclosures alone.

$$PER_{it} = -15.708 + 0.006 VDI_{it} + 25.463 AQI_{it} + u_{it}$$

VDI's direct effect is near zero; AQI has a strongly positive (+25.463) association with PER

Examining the coefficients, it was observed that the coefficient for voluntary disclosures remained statistically insignificant in both models, suggesting that voluntary disclosures alone do not significantly influence earnings predictability. However, the coefficient for audit quality was positive and significant in the second model, indicating that higher audit quality positively influences earnings predictability. This implies that audit quality moderates the relationship between voluntary disclosures and earnings predictability, strengthening the predictive power of voluntary disclosures when audit quality is high.

Our results indicate a weak negative correlation between voluntary disclosures and earnings predictability ($r = -0.054$, $p = 0.365$). While not statistically significant, this finding suggests that firms with more extensive voluntary disclosures may experience slightly lower earnings predictability. Voluntary disclosures refer to additional information provided by firms beyond the mandatory requirements of financial reporting,

aiming to enhance transparency and facilitate informed decision-making by stakeholders (Li, 2021).

Recent literature on voluntary disclosures has produced mixed findings regarding their impact on earnings predictability. Almazari and Street (2019) found that firms with higher levels of voluntary disclosures tend to exhibit greater earnings transparency and predictability. However, other studies have suggested that excessive voluntary disclosures may signal information overload and reduce the salience of relevant financial information for investors (Dhaliwal et al., 2019). Therefore, while voluntary disclosures can enhance the overall transparency of financial reporting, their effectiveness in improving earnings predictability may vary depending on the quality and relevance of the disclosed information.

The shift in R-square from 0.003 to 0.287 upon the inclusion of audit quality underscores the substantial role played by audit quality in reinforcing the utility of voluntary disclosures. While voluntary disclosures alone do not significantly impact earnings predictability, their effect becomes more meaningful when audit quality is introduced. This finding supports the idea that audit quality enhances the credibility of voluntary information by verifying its accuracy and alignment with the firm's financial position. High-quality audits may filter and validate voluntary disclosures, thus improving their relevance and reliability for users making forward-looking decisions.

In practical terms, this suggests that audit quality acts as a gatekeeper, ensuring that voluntary disclosures are not only abundant but also meaningful. Without robust audit oversight, firms might use voluntary disclosures strategically to obscure poor performance or distract from less favorable financial indicators. However, when audit quality is high, such attempts at obfuscation are more likely to be uncovered or preemptively discouraged. This enforcement role of external auditors can restore investor confidence in disclosed information and enhance its capacity to predict future earnings.

Moreover, the statistically significant and positive coefficient of audit quality in the second model ($B = 25.463$, $p < 0.001$) confirms that audit quality independently contributes to earnings predictability regardless of the impact of voluntary disclosures. This aligns with prior research, such as that by Francis et al. (2005), which demonstrated that audit quality plays a crucial role in reducing information asymmetry and enhancing the transparency of financial statements. Therefore, even when firms offer extensive voluntary disclosures, their effect on earnings predictability is largely contingent upon the perceived integrity and oversight of the audit process.

These findings have important implications for regulatory bodies and policymakers. To ensure that voluntary disclosures serve their intended purpose of improving financial transparency and decision-making, there should be stronger audit regulations and guidelines encouraging thorough auditor scrutiny of such disclosures. Regulators might also consider requiring certain forms of voluntary information especially those that materially influence investor decisions to undergo some form of audit verification. Doing so could help distinguish between high-quality, decision-useful disclosures and those driven by managerial discretion or opportunism.

Thus, the results from this analysis highlight that while voluntary disclosures on their own do not significantly enhance earnings predictability, their utility increases markedly when accompanied by high audit quality. Audit quality not only improves the reliability of voluntary disclosures but also boosts the overall informativeness of financial reporting. For listed firms in Kenya and similar markets, investing in strong audit processes and ensuring auditor independence and competence are essential for translating voluntary disclosures into meaningful insights that can aid in forecasting firm performance. Future research should explore the types of voluntary disclosures that most benefit from audit quality and examine how different audit firm characteristics influence this relationship.

4.6.4 Moderating Effect of Audit Quality on the Relationship between Accruals Earnings Management and Earnings Predictability of Listed Firms in Kenya

The section below show inferential results on the moderating effect of audit quality on the relationship between accruals earnings management and earnings predictability of listed firms in Kenya

Table 4.20: Moderated Model Summary, ANOVA and Beta Coefficients for Accruals Earnings Management on Earnings Predictability

Model Summary									
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F	df1	df2	Sig. F Change
1	.141 ^a	.020	.018	11.95615	.020	11.702	1	580	.001
2	.503 ^b	.253	.251	10.44549	.233	180.893	1	579	.000

a. Predictors: (Constant), accruals earnings
b. Predictors: (Constant), accruals earnings , audit quality

ANOVA ^a						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1672.737	1	1672.737	11.702	.001 ^b
	Residual	82910.695	580	142.949		
	Total	84583.432	581			
2	Regression	21409.696	2	10704.848	98.112	.000 ^c
	Residual	63173.736	579	109.108		
	Total	84583.432	581			

a. Dependent Variable: earnings predictability
b. Predictors: (Constant), accruals earnings
c. Predictors: (Constant), accruals earnings , audit quality

Coefficients						
Model		Unstandardized Coefficients		Standardized Coefficients		Sig.
		B	Std. Error	Beta	t	
1	(Constant)	.237	1.122		.211	.833
	accruals earnings	5.407	1.581	.141	3.421	.001
	(Constant)	-13.332	1.407		-9.478	.000
2	accruals earnings	.575	1.427	.015	.403	.687
	audit quality	22.064	1.641	.499	13.450	.000

a. Dependent Variable: earnings predictability

The study explored the moderating effect of audit quality on the relationship between accruals earnings and earnings predictability among listed firms in Kenya. Initially, the model with only accruals earnings as the predictor exhibited a modest relationship with earnings predictability (R-square = 0.020), and the relationship was statistically significant ($F = 11.702$, $p = 0.001$). However, upon including audit quality as an additional predictor, the model's explanatory power substantially improved, with an R-square value of 0.253, indicating that the combined effect of accruals earnings and audit quality explains 25.3% of the variance in earnings predictability.

The ANOVA results demonstrated that the second model, which incorporated both accruals earnings and audit quality as predictors, significantly enhanced the model fit compared to the initial model ($F = 98.112$, $p < 0.001$). This indicates that the inclusion of audit quality as a predictor significantly contributes to explaining the variance in earnings predictability beyond the influence of accruals earnings alone.

$$PER_{it} = -13.332 + 0.575 DA_{it} + 22.064 AQI_{it} + u_{it}$$

DA remains positive; AQI again shows a strong positive association with PER.

Upon examining the coefficients, it was observed that while the coefficient for accruals earnings remained positive and significant in both models, its magnitude decreased when audit quality was added as a predictor. Additionally, the coefficient for audit quality was positive and significant in the second model, indicating that higher audit quality positively influences earnings predictability. This implies that audit quality moderates the relationship between accruals earnings and earnings predictability, strengthening the predictive power of accruals earnings when audit quality is high.

Our analysis reveals a weak positive correlation between accruals earnings and earnings predictability ($r = 0.141$, $p < 0.01$). This suggests that firms with higher levels of accruals earnings tend to have slightly more predictable earnings. Accruals earnings represent non-cash accounting adjustments made to reflect revenue and expenses that have been earned

or incurred but not yet realized in cash (Dechow & Skinner, 2018). While accruals earnings management can distort reported earnings in the short term, it may contribute to earnings smoothing and enhanced predictability over the long term.

Recent research has examined the impact of accruals earnings management on earnings predictability and financial statement quality. Jones and Smith (2020) found that firms engaging in aggressive accruals earnings management tend to exhibit lower earnings predictability and reduced credibility of financial statements. However, moderate levels of accruals earnings management may contribute to the stability and predictability of reported earnings by aligning them with underlying economic fundamentals (Dechow & Skinner, 2018). Therefore, our findings suggest that the relationship between accruals earnings and earnings predictability is nuanced and may depend on the extent and nature of earnings management practices.

The moderating effect of audit quality on the relationship between accounting discretion variables and earnings predictability is significant. Our findings demonstrate that audit quality strengthens the negative relationship between cost classification shifting and earnings predictability ($\Delta R^2 = 0.202$, $p < 0.001$). Similarly, audit quality enhances the negative association between fair value accounting estimates and earnings predictability ($\Delta R^2 = 0.233$, $p < 0.001$). These results underscore the critical role of auditors in enhancing the reliability and credibility of financial information, particularly in the context of complex accounting practices (DeFond & Zhang, 2014).

Recent literature has emphasized the importance of audit quality in mitigating the adverse effects of accounting discretion on earnings predictability. DeFond and Zhang (2014) argued that high-quality audits can provide assurance regarding the accuracy and fairness of financial statements, thereby enhancing investor confidence and market efficiency. Moreover, rigorous audit procedures and independent oversight can deter opportunistic behavior by firms and ensure compliance with accounting standards and regulatory requirements (Abbott et al., 2016). Therefore, our findings underscore the need for

continued efforts to enhance audit quality and regulatory oversight to safeguard the integrity of financial reporting and promote earnings predictability.

4.7 Overall Model Multivariate Panel Regression Analysis without Moderator

A comprehensive panel regression analysis was conducted to investigate the potential significance of the relationship between various independent variables and a dependent variable. This section presents the findings pertaining to the overall impact of several independent or predictor variables, of accounting discretion based on four reported accounting factors (Cost Stickiness, Fair value accounting estimates, Voluntary Disclosures and Accruals earnings management) moderated by audit quality to determine the influence of accounting discretion on earnings predication for listed firms in Kenya. . The proposed overarching model for the study was as follows:

$$EP_{it} = \beta_0 + \beta_1 CCS_{it} + \beta_2 FVA_{it} + \beta_3 VDI_{it} + \beta_4 DA_{it} + \sum \beta_{AQ_{it}} + \mu_i + \varepsilon_{it}$$

Table 4.21: Overall Regression Model Summary, ANOVA and Beta Coefficients

Model Summary						
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate		
1	.705 ^a	.497	.490	9.59033		
a. Predictors: (Constant), accruals earnings, voluntary disclosures , cost classification shifting , fair value accounting estimates						
ANOVA ^a						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	24914.237	4	6228.559	67.721	.000 ^b
	Residual	25200.994	274	91.974		
	Total	50115.231	278			
a. Dependent Variable: earnings predictability						
b. Predictors: (Constant), audit report quality , voluntary disclosures , cost classification shifting , fair value accounting estimates						
Coefficients						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-6.233	1.919		-3.249	.001
	cost classification shifting	-.735	.179	-.191	-4.101	.000
	fair value accounting estimates	-16.554	2.068	-.383	-8.004	.000
	voluntary disclosures	.017	.031	.023	.540	.590
	accruals earnings	17.755	2.170	.374	8.181	.000

a. Dependent Variable: earnings predictability

The resultant equation can therefore be given as

$$EP_it = -6.233 + 0.735CCS_it - 16.554FVA_it + 0.017VDI_it + 17.755DA_it + \varepsilon_{it}$$

The multiple regression model examining the joint influence of cost classification shifting, fair value accounting estimates, voluntary disclosures, and accruals earnings on earnings predictability produced an $R = 0.705$, with an $R^2 = 0.497$ and an adjusted $R^2 = 0.490$. This indicates that approximately 49.0% of the variation in earnings predictability is jointly explained by these four predictors, leaving 51.0% to other factors not included in the model. The model's standard error of the estimate is 9.59, which is substantially lower than in individual models, suggesting improved model fit.

The ANOVA results ($F = 67.721$, $p < 0.001$) confirm that the overall regression model is statistically significant, meaning that at least one of the independent variables meaningfully contributes to explaining variations in earnings predictability.

Cost Classification Shifting ($B = -0.735$, $\beta = -0.191$, $p < 0.001$); the coefficient is negative and significant, indicating that higher cost classification shifting is associated with lower earnings predictability, even after controlling for other variables. This reinforces prior findings (Weiss, 2010) that misclassification obscures true cost behaviour, complicating forecast models.

Fair Value Accounting Estimates ($B = -16.554$, $\beta = -0.383$, $p < 0.001$); the strong negative coefficient suggests that reliance on fair value accounting, particularly Level 3 estimates, substantially reduces earnings predictability. This effect remains highly significant in the combined model, aligning with Barth & Landsman (2010), who found that subjectivity in fair value measurements increases volatility and reduces reliability.

Voluntary Disclosures ($B = 0.017$, $\beta = 0.023$, $p = 0.590$); the coefficient is positive but statistically insignificant, indicating that voluntary disclosures do not have a measurable direct effect on earnings predictability when other variables are considered. This finding aligns with Miller (2010), who argued that excessive disclosure volume and complexity may dilute decision-usefulness.

Accruals Earnings ($B = 17.755$, $\beta = 0.374$, $p < 0.001$); the coefficient is positive and significant, showing that higher accruals earnings are associated with greater predictability. This supports Dechow & Dichev (2002), who argue that high accrual quality enhances the informativeness of earnings. However, the effect size here is considerably larger than in the individual model, indicating that accruals' predictive strength is amplified when controlling for cost shifting and fair value volatility.

The strongest predictors are fair value accounting estimates (negative) and accruals earnings (positive) which are the dominant drivers of earnings predictability in the joint

model. This aligns with findings by Song et al. (2010) on FVAE's destabilising effect and Francis et al. (2004) on the role of accrual quality. Weaker Predictor is cost classification shifting which remains significant but with reduced beta weight compared to its individual model, suggesting part of its effect is shared with FVAE.

Voluntary Disclosures eludes non significance which Echoes Miller (2010) and Bloomfield (2002), contradicting Botosan (1997) who found that voluntary disclosure improves market-based measures of predictability, indicating contextual or market-specific differences.

4.7.1 Hypothesis Test Results for the Independent Variables without Moderating Variable

The results presented in Table 4.22 show the testing of research hypotheses related to the influence of accounting discretion on earnings predictability of listed firms in Kenya. The figures in the table are summaries derived from Tables 4.17-4.21 above. Each hypothesis is accompanied by beta (β) values and p-values. The beta value represents the standardized coefficient, indicating the strength and direction of the relationship between the independent variable (accounting discretion) and the dependent variable (earnings predictability). The decision criteria applied is Reject H_0 , if $p < 0.05$, otherwise accept H_0 .

Table 4.22: Hypothesis Test without Moderating Variable

No.	Hypothesis	Analytical Tools	Results	Decision to accept Null Hypothesis
1	H₀₁: Cost classification shifting has no significant influence on earnings predictability of listed firms in Kenya.	Descriptive statistics, panel regression and correlation coefficients $Y_{i,t} = \beta_0 + \beta_1 X_{1it} + \mathcal{E}_{it}$	B= -.735 P= .000	Reject
2	H₀₂: Fair value accounting estimates have no significant influence on earnings predictability of listed firms in Kenya.	Descriptive statistics, panel regression and correlation coefficients $Y_{i,t} = \beta_0 + \beta_2 X_{2it} + \mathcal{E}_{it}$	B=-16.554 P= ,000	Reject
3	H₀₃: Voluntary disclosures has no significant influence on earnings predictability of listed firms in Kenya..	Descriptive statistics, panel regression and correlation coefficients $Y_{i,t} = \beta_0 + \beta_3 X_{3it} + \mathcal{E}_{it}$	B=.017 P= .570	Accept
4	H₀₄: Accruals earnings management has no significant influence on earnings predictability of listed firms in Kenya.	Descriptive statistics, panel regression and correlation coefficients $Y_{i,t} = \beta_0 + \beta_4 X_{4it} + \mathcal{E}_{it}$	B=17.755 P= .000	Reject

4.8 Moderating Effect of Audit Quality on the Relationship between the Independent Variables and Earnings Predictability

Table 4.23: Overall Moderated Regression Model Summary, ANOVA, Beta Coefficients

Model Summary								
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate				
1	.754 ^a	.569	.563	9.42643				
Predictors: (Constant), accruals earnings moderated by audit quality, cost classification shifting moderated by audit quality, fair value accounting estimates moderated by audit quality, voluntary disclosures moderated by audit quality								
ANOVA ^a								
Model		Sum of Squares	df	Mean Square	F	Sig.		
1	Regression	34732.619	4	8683.155	97.720	.000 ^b		
	Residual	26301.843	296	88.858				
	Total	61034.462	300					
a. Dependent Variable: earnings predictability								
b. Predictors: (Constant), accruals earnings moderated by audit quality, cost classification shifting moderated by audit quality, fair value accounting estimates moderated by audit quality, voluntary disclosures moderated by audit quality								
Coefficients								
Model	Unstandardized Coefficients		Standardized Coefficients		t	Sig.		
	B	Std. Error	Beta					
1	(Constant)		-.036	1.170		-.030	.976	
	cost classification shifting moderated by audit quality		-.255	.191		-.053	-1.334	.183
	fair value accounting estimates moderated by audit quality		-16.088	3.425		-.214	-4.697	.000
	voluntary disclosures moderated by audit quality		.550	.052		.486	10.530	.000
	accruals earnings moderated by audit quality		9.314	1.662		.231	5.604	.000

a. Dependent Variable: earnings predictability

The resultant predictive equation after moderation can therefore be given as

$$EP_{it} = -0.036 - 0.0255CCS_{it} - 16.088FVA_{it} + 0.550VDI_{it} + 9.314DA_{it} + \varepsilon_{it}$$

On Cost Classification Shifting moderated by Audit Quality; $B = -0.255$, $\beta = -0.053$, $p = 0.183$ (ns). This interaction term is negative but statistically insignificant. This suggests

that audit quality does not significantly moderate the effect of cost classification shifting on earnings predictability. In other words, even with strong audit quality, the negative impact of cost shifting remains, potentially because such practices are embedded in managerial discretion that audit processes cannot fully detect or deter (McVay, 2006).

On Fair Value Accounting Estimates moderated by Audit Quality; $B = -16.088$, $\beta = -0.214$, $p < 0.001$. The interaction is negative and significant, indicating that even under high audit quality, reliance on subjective FVAE continues to reduce earnings predictability. This aligns with Barth & Landsman (2010), who note that auditor oversight can improve disclosure transparency but cannot entirely eliminate subjectivity in Level 3 fair value estimates, especially in markets with less liquid valuation benchmarks.

On Voluntary Disclosures moderated by Audit Quality; $B = 0.550$, $\beta = 0.486$, $p < 0.001$. This is the largest positive and significant interaction effect in the model, suggesting that audit quality significantly enhances the positive effect of voluntary disclosures on earnings predictability. This finding aligns with Botosan (1997) and Hassan et al. (2009), who found that high-quality audits improve the credibility and usefulness of voluntary disclosures, increasing investor confidence and forecast accuracy.

On accruals Earnings moderated by audit quality; $B = 9.314$, $\beta = 0.231$, $p < 0.001$; This significant positive effect indicates that audit quality strengthens the positive association between accruals earnings and earnings predictability. This supports Dechow & Dichev (2002) and Francis et al. (2004), who note that high-quality audits improve the reliability of accrual-based measures, reducing the noise from earnings management and making reported earnings more predictive.

Without moderation, voluntary disclosures had an insignificant effect ($\beta = 0.023$, $p > 0.05$), but with audit quality moderation, their effect becomes large and highly significant ($\beta = 0.486$, $p < 0.001$). This demonstrates a suppression effect, where audit quality unlocks the informational value of voluntary disclosures. The moderation effect is most beneficial

for voluntary disclosures and accruals earnings, least beneficial for cost classification shifting, and ineffective in offsetting the negative influence of FVAE.

4.8.1 Hypothesis Test Results for the Independent Variables with Moderating Variable

Table 4.24: Hypothesis Test with Moderating Variable

No.	Hypothesis	Analytical Tools	Results	Decision to accept Null Hypothesis
1	H₀₁: Cost classification shifting has no significant influence on earnings predictability of listed firms in Kenya.	Descriptive statistics, panel regression and correlation coefficients $Y_{i,t} = \beta_0 + \beta_1 X_{1it} + \epsilon_{it}$	B= -.255 P= .183	Accept
2	H₀₂: Fair value accounting estimates have no significant influence on earnings predictability of listed firms in Kenya.	Descriptive statistics, panel regression and correlation coefficients $Y_{i,t} = \beta_0 + \beta_2 X_{2it} + \epsilon_{it}$	B= -16.08 P= .000	Reject
3	H₀₃: Voluntary disclosures has no significant influence on earnings predictability of listed firms in Kenya..	Descriptive statistics, panel regression and correlation coefficients $Y_{i,t} = \beta_0 + \beta_3 X_{3it} + \epsilon_{it}$	B= .550 P= .000	Reject
4	H₀₄: Accruals earnings management has no significant influence on earnings predictability of listed firms in Kenya.	Descriptive statistics, panel regression and correlation coefficients $Y_{i,t} = \beta_0 + \beta_4 X_{4it} + \epsilon_{it}$	B= 9.314 P= .000	Reject
5	H₀₅: Audit report quality has no significant moderating effect on the relationship between accounting discretion and earnings predictability of listed firms in Kenya.	Descriptive statistics, panel regression and correlation coefficients $Y_{i,t} = \beta_0 + \beta_1 X_{1it} + \beta_2 Z_{it} + \beta_3 (X * Z_{it}) + \epsilon_{it}$		Reject

The hypothesis test results summarized in Table 4.25 provide a comprehensive overview of how key accounting discretion variables and audit quality affect the earnings

predictability of listed firms in Kenya. The analysis draws on descriptive statistics, panel regression, and correlation coefficients to determine whether each independent variable has a statistically significant effect on the dependent variable, earnings predictability. The hypotheses tested correspond to various discretionary accounting practices, and whether the moderating effect of audit quality alters these relationships.

Firstly, H_{01} examined the effect of cost classification shifting on earnings predictability. The regression coefficient ($\beta = -0.255$) and p-value ($p = 0.183$) indicate that the relationship is negative but not statistically significant at the conventional threshold of 0.05. Therefore, the null hypothesis was accepted. This suggests that, in isolation, cost classification shifting does not significantly influence the predictability of earnings for listed firms in Kenya. This result may be due to the difficulty in detecting cost shifting behaviors or a lack of consistent application of this technique across firms.

In contrast, H_{02} assessed the effect of fair value accounting estimates, revealing a strong and statistically significant negative influence on earnings predictability ($\beta = -16.08$, $p = 0.000$). As a result, the null hypothesis was rejected. This outcome aligns with existing literature suggesting that fair value estimates introduce volatility and subjectivity into financial statements, thereby reducing the reliability and forecastability of earnings. The findings emphasize the need for caution when relying heavily on fair value measurements in financial reporting, particularly in markets with valuation challenges.

Similarly, H_{03} tested the relationship between voluntary disclosures and earnings predictability. With a positive coefficient ($\beta = 0.550$) and a significant p-value ($p = 0.000$), the null hypothesis was rejected. This implies that voluntary disclosures significantly enhance earnings predictability. Firms that engage in transparent, detailed voluntary reporting may provide stakeholders with better insights into financial performance, thereby improving the accuracy of earnings forecasts. This finding reinforces the importance of encouraging voluntary disclosure practices among listed firms to strengthen capital market efficiency.

H₀₄ examined the effect of accruals earnings management, which yielded a positive and significant relationship with earnings predictability ($\beta = 9.314$, $p = 0.000$), leading to the rejection of the null hypothesis. Interestingly, this result diverges from the traditional view that earnings management impairs financial reporting quality. In this context, it may suggest that managers in Kenya are using accruals within reasonable limits to smooth earnings and enhance predictability rather than to deceive stakeholders. It underscores the nuanced role of accruals, which, when used prudently, can align earnings with underlying economic performance.

Lastly, H₀₅ evaluated the moderating effect of audit quality on the relationship between accounting discretion and earnings predictability. Although a specific coefficient is not listed in the summary table, the analytical model employed ($Y_{i,t} = \beta_0 + \beta_1 X_{1it} + \beta_2 Z_{it} + \beta_3 (X * Z_{it}) + \epsilon_{it}$) and supporting tables from prior sections strongly indicate that audit quality significantly moderates these relationships. For example, when audit quality was included as a moderator, R-squared values improved notably across models, and audit quality consistently showed significant positive coefficients. Therefore, the null hypothesis is rejected. This confirms that higher audit quality plays a critical role in enhancing the reliability of financial statements and curbing the negative effects of aggressive accounting discretion.

Therefore, the hypothesis testing results highlight that while not all accounting discretion practices independently influence earnings predictability, the presence of high-quality audits substantially improves the reliability and usefulness of financial reports. The findings support broader regulatory efforts to strengthen audit oversight and promote transparency in financial disclosures. For practitioners and regulators, these insights emphasize the value of enhancing audit quality standards and monitoring discretionary reporting practices to ensure more predictable and accurate earnings reporting in the capital markets.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents a summary of the key findings of the study, which sought to examine the influence of accounting discretion on the earnings predictability of firms listed on the Nairobi Securities Exchange (NSE) between 2010 and 2022. The analysis focused on four dimensions of accounting discretion—cost classification shifting, fair value accounting estimates, voluntary disclosures, and accruals earnings management—while also assessing the direct and moderating role of audit quality. The chapter is structured to first summarise the empirical results from descriptive, correlation, and regression analyses in relation to the study objectives. It then draws important conclusions based on the findings and highlights their implications for listed firms, regulators, investors, and policy makers. Finally, the chapter identifies existing research gaps and proposes areas for further investigation on the topical issue of accounting discretion and earnings predictability in emerging markets.

5.2 Summary of Findings

The study was guided by five specific objectives, each focusing on a dimension of accounting discretion and its influence on earnings predictability of listed firms in Kenya. The following is a summary of the key findings for each objective:

5.2.1 To Determine the Effect of Cost Classification Shifting on Earnings Predictability of Listed Firms in Kenya

Descriptive statistics showed that cost stickiness as a proxy for classification shifting had a high mean with significant variation across firms. Correlation analysis indicated a moderate negative association between cost classification shifting and earnings predictability suggesting that higher levels of classification shifting were associated with

reduced predictability of earnings. Simple regression results confirmed this relationship, with cost classification shifting significantly and negatively influencing earnings predictability. In the multivariate model, cost classification shifting retained a significant negative effect indicating robustness of the relationship when controlling for other variables.

5.2.2 To Examine the Effect of Fair Value Accounting Estimates on Earnings Predictability of Listed Firms in Kenya

Fair value accounting estimates recorded a wide range, with evidence of high kurtosis and skewness, indicating presence of extreme values and distributional asymmetry. Correlation results revealed a moderate negative relationship with earnings predictability. Regression analysis confirmed a significant and substantial negative effect of the model explaining in the variation in earnings predictability. The variable also retained a strong negative coefficient in the multivariate regression, underscoring its influence across models.

5.2.3 To Assess the Effect of Voluntary Disclosures on Earnings Predictability of Listed Firms in Kenya

Descriptive analysis indicated an above-average voluntary disclosure index, although skewness and kurtosis suggested variations in reporting approaches across firms. Correlation analysis found a weak and statistically insignificant negative relationship with earnings predictability. Regression results showed that voluntary disclosures had a positive but no statistically significant effect on earnings predictability, with an explanatory power. In the overall multivariate model, the coefficient for voluntary disclosures remained statistically insignificant, indicating that other factors may mediate or override its direct impact.

5.2.4 To Determine the Effect of Accruals Earnings Management on Earnings Predictability of Listed Firms in Kenya

Descriptive statistics showed a low mean for discretionary accruals and relatively low variability across firms, implying limited accrual-based earnings manipulation. Correlation analysis revealed a weak but significant negative relationship with earnings predictability. Regression results showed a positive and significant effect in the simple model, moderately explaining the variation in earnings predictability. In the multivariate model, accruals earnings management retained a significant positive coefficient, suggesting that accrual adjustments, when applied within acceptable limits, may enhance predictability of earnings.

5.2.5 To Examine the Moderating Effect of Audit Quality on the Relationship between Accounting Discretion and Earnings Predictability

Descriptive statistics indicated a high audit quality index, with minimal variation across firms. Correlation analysis found a moderate and significant positive association between audit quality and earnings predictability. Simple regression showed that audit quality explained 25.3% of the variation in earnings predictability. In the moderated regression model, audit quality significantly strengthened the positive effects of accruals earnings management and voluntary disclosures, while reducing the negative effect of fair value accounting estimates. The overall moderated model achieved the highest explanatory power, with an R^2 of 56.9%, indicating that audit quality is a key factor in enhancing the predictive value of earnings in the presence of accounting discretion.

5.3 Conclusions

This study set out to examine the influence of accounting discretion on earnings predictability of listed firms in Kenya between 2010 and 2022, with audit quality as a moderating factor. From the analysis, several important conclusions can be drawn

The consistent negative and significant effect of cost classification shifting across all models suggests that when firms reclassify expenses between cost categories, it reduces the transparency and reliability of earnings forecasts. This practice, often used to manage reported profitability, introduces noise into earnings streams, making them less predictable for investors and other stakeholders.

The results show that higher reliance on subjective fair value estimates, particularly for illiquid or level 3 assets, is associated with a marked reduction in earnings predictability. This can be attributed to the inherent estimation uncertainty, lack of market comparability, and potential for management bias inherent in fair value measurement. Despite theoretical arguments that more disclosure should enhance information symmetry, the findings suggest that the nature, quality, or relevance of voluntary disclosures by listed firms in Kenya may not significantly contribute to improving earnings forecasts. This could indicate issues of boilerplate disclosures, complexity, or limited investor engagement with such information.

While discretionary accruals are often linked to earnings manipulation, the results reveal a positive relationship with earnings predictability in the multivariate context. This may suggest that accrual adjustments, when used to better match revenues and expenses in accordance with accounting standards, can produce earnings figures that better reflect underlying performance trends. The study provides strong evidence that high-quality audits enhance earnings predictability, both directly and by moderating the effects of accounting discretion. Audit quality amplifies the positive influence of accrual-based earnings management and voluntary disclosures, while mitigating the negative effects of fair value accounting estimates. This underlines the importance of strong external assurance in preserving the integrity of financial reporting.

The overall moderated regression model, incorporating audit quality interactions, explained 56.9% of the variation in earnings predictability significantly higher than any single-variable or standard multivariate model. This reinforces the argument that the

impact of accounting discretion on earnings predictability cannot be fully understood without considering the audit quality context.

5.4 Recommendations

The study made the following recommendations.

5.4.1 Policy Recommendations

To strengthen disclosure regulations on cost classification practices. The Capital Markets Authority (CMA) and the Institute of Certified Public Accountants of Kenya (ICPAK) should mandate clearer, more granular disclosures on cost classification methods, changes in expense categorization, and the rationale behind such reclassifications. Issuance of specific guidelines could require firms to reconcile reclassified costs back to original categories in comparative statements, limiting opportunities for earnings manipulation through classification shifting.

To enhance oversight of fair value measurements, CMA and ICPAK should require independent valuation reports for level 3 fair value measurements, with explicit disclosure of valuation methods, key assumptions, and sensitivity analyses. They can also consider aligning local standards with the enhanced IFRS 13 disclosure requirements seen in jurisdictions such as the EU and Australia, which mandate “narrative sensitivity” disclosures on how changes in assumptions would affect reported values.

To ensure quality over quantity in voluntary disclosures; Regulators should move from mere compliance-based disclosure checklists to quality-assessment frameworks that evaluate the clarity, relevance, and decision-usefulness of voluntary disclosures. CMA could adopt an annual “Disclosure Quality Index” for listed firms, similar to South Africa’s integrated reporting rankings, to encourage meaningful disclosure rather than boilerplate repetition.

To embed audit quality metrics in regulatory monitoring; firms should be required to disclosure of key audit quality indicators (AQIs), including audit firm tenure, partner rotation frequency, staff-to-partner ratios, and audit hours spent on key risk areas. Introduction of a requirement for audit committees to publicly explain how they evaluated and ensured the quality of the audit process would yield better reliance on earnings numbers.

5.4.2 Practice Recommendations

Corporate boards and audit committees should adopt robust internal cost monitoring systems to detect and prevent opportunistic cost classification shifts. They can also require management to provide evidence-based justifications for major expense reclassifications, supported by trend analyses. Preparers of financial statements should apply fair value accounting conservatively, particularly for level 3 assets, and ensure robust documentation of assumptions and methodologies for both internal and external review. When using accruals discretion, focus on aligning revenues and expenses to reflect economic reality rather than to achieve short-term earnings targets.

Auditors can increase substantive testing around cost classification changes and fair value estimates, especially in sectors with higher estimation uncertainty (e.g., real estate, banking). They should also provide constructive feedback to management on the clarity and usefulness of voluntary disclosures, ensuring that the narrative complements rather than obscures financial data. For investors and analysts, for the purpose of prediction, they should integrate audit quality indicators into investment decision frameworks, recognising that high audit quality correlates strongly with higher earnings predictability. They must also exercise caution in interpreting earnings that rely heavily on subjective fair value estimates without robust supporting disclosures.

5.5 Contribution to Knowledge and Areas of Further Research

This study made the following contribution:

5.5.1 Contribution to Knowledge

This study makes several theoretical, methodological, and empirical contributions to the existing body of literature on accounting discretion and earnings predictability, particularly in the context of emerging markets. Firstly; while prior research has examined earnings management and financial reporting quality in developed economies, limited work has been done in Sub-Saharan African contexts where institutional environments, enforcement mechanisms, and market maturity differ substantially. This study extends the debate by providing empirical evidence from Kenya's NSE-listed firms between 2010 and 2022, offering insights into how regulatory, economic, and governance conditions shape the relationship between accounting discretion and earnings predictability. This advances the contextual gap previously identified.

Secondly, there is integration of multiple discretion proxies in a unified model. Previous studies often examine single proxies (e.g., accruals management or fair value estimates) in isolation. This research integrates five dimensions of discretion; cost classification shifting, fair value accounting estimates, voluntary disclosures, accruals earnings management, and audit quality into both standalone and moderated regression models, revealing their individual and combined predictive power. Thirdly, Critical evidence on the moderating role of audit quality was provided. The study empirically confirms that audit quality not only directly enhances earnings predictability but also moderates the impact of discretionary reporting practices. This adds to agency theory and signaling theory by showing how credible external assurance mechanisms can reduce the information asymmetry created by managerial discretion.

Methodological contribution through panel-based moderation modelling by using an unbalanced panel dataset and robust panel regression techniques, this study demonstrates

how time-series cross-sectional data can be harnessed to control for heterogeneity and capture the evolving nature of financial reporting behaviour over more than a decade. The moderated regression approach applied to multiple discretion measures simultaneously is relatively rare in emerging market accounting research. Practical insights for policy and corporate governance have been provided. The results provide actionable guidance for regulators (CMA, ICPAK), audit committees, and investors, supporting the design of governance structures and disclosure regimes that can enhance financial statement reliability and market efficiency.

5.5.2 Suggested Areas for Further Research

While this study advances understanding in significant ways, it also opens up several avenues for future scholarly studies. Future studies could replicate this analysis within specific NSE sectors such as banking, manufacturing, agriculture, or energy to assess whether industry-specific characteristics influence the relationship between discretion and earnings predictability. Extending this research to a multi-country East African context (e.g., Uganda, Tanzania, Rwanda) would allow for comparative analysis of how institutional quality, legal enforcement, and investor sophistication shape discretionary practices and predictability outcomes.

The Impact of macroeconomic shocks and policy changes can be reviewed. Investigating whether periods of economic crisis (e.g., COVID-19 pandemic, inflationary shocks) alter managerial incentives to exercise discretion and affect earnings predictability could provide valuable temporal insights. Beyond audit quality, future studies could examine the moderating roles of board characteristics, ownership structure, or analyst following in the discretion–predictability relationship. Mediating effects of investor sentiment or corporate governance indices could also be explored.

A qualitative or mixed-method research could explore managerial motivations, ethical considerations, and corporate culture influences behind discretionary accounting choices, providing deeper interpretive insights beyond quantitative associations.

In the modern world exploring machine learning and predictive analytic or other advanced techniques could help identify non-linear effects between discretion variables and earnings predictability, potentially outperforming the traditional regression models.

REFERENCES.

- AICPA. (2021). AU -C 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures. *Wiley Practitioner's Guide to GAAS 2021*, 275–287. <https://doi.org/10.1002/9781119789673.ch21>
- Akenbor, C. O., & Ibanichuka, E. A. (2012). Creative accounting practices in Nigerian banks. *Asian Journal of Business Management*, 4(2), 146–152.
- Alfraih, M. M., & Almutawa, A. M. (2017). Voluntary disclosure and corporate governance: empirical evidence from Kuwait. 59(2), 217–236. <https://doi.org/10.1108/IJLMA-10-2015-0052>
- Anderson, M. C., Banker, R. D., & Janakiraman, S. N. (2003). Are selling, general, and administrative costs “sticky”? *Journal of Accounting Research*, 41(1), 47–63. <https://doi.org/10.1111/1475-679X.00095>
- Anderson, S. W., & Lanen, W. N. (2007). Understanding cost management. *SSRN Electronic Journal*, January.
- Ardiansyah, A. & Siregar, Sylvia. (2015). The Effect of Voluntary Disclosure and Earnings Quality on Cost of Equity. *Journal of Management and Business*. 12. 10.24123/jmb.v12i2.15.
- Asiamah, N., Mensah, H. K., & Oteng-Abayie, E. F. (2017). General, target, and accessible population: Demystifying the concepts for effective sampling. *The Qualitative Report*, 22(6), 1607–1621.
- Audit Quality Indicators | PCAOB. (n.d.). Retrieved September 23, 2021, from <https://pcaobus.org/resources/other-research-projects/aqi>

- Ball, R. (2006). International financial reporting standards (IFRS): Pros and cons for investors. *Accounting and Business Research*, 36(SPEC. ISS), 5–27. <https://doi.org/10.1080/00014788.2006.9730040>
- Baltagi, B. H. (2021). *Econometric Analysis of Panel Data* (6th ed.). Springer.
- Banker, R. D., & Chen, L. (2006). Predicting earnings using a model based on cost variability and cost stickiness. *Accounting Review*, 81(2), 285–307. <https://doi.org/10.2308/accr.2006.81.2.285>
- Barth, M. E., Landsman, W. R., & Lang, M. H. (2008). International accounting standards
- Baum, C. F., Schaffer, M. E., & Stillman, S. (2013). Instrumental variables and GMM: Estimation and testing. *Stata Journal*, 3(1), 1–31.
- BHASIN, M. L. (2000). *Accounting Procedures Handbook Accounting Procedures Handbook*. 4(April), 10–30.
- Bhasin, M. L. (2000). Corporate governance disclosure practices: The portrait of a developing country. *International Journal of Business and Management*, 5(5), 143–154.
- Botosan, C. A., & Plumlee, M. A. (2002). A re-examination of disclosure level and the expected cost of equity capital. *Journal of Accounting Research*, 40(1), 21–40.
- Bowen, R. M., Rajgopal, S., & Venkatachalam, M. (2008). Accounting discretion, corporate governance, and firm performance. *Contemporary Accounting Research*, 25(2), 351–405. <https://doi.org/10.1506/car.25.2.3>
- Bradbury, M. E., & Scott, T. (2018). Do managers forecast asymmetric cost behaviour? *Australian Journal of Management*, 43(4), 538–554. <https://doi.org/10.1177/0312896218773136>

- Capital Markets Authority. (2023). Enforcement Framework for Issuers. Nairobi: CMA.
- Capital Markets Authority. (2024). State of Corporate Governance Practices of Issuers of Securities to the Public in Kenya: Seventh Edition. Nairobi: CMA.
- Capkun, V., & Collins, D. W. (2018). The Effects of IFRS Adoption on Observed Earnings Smoothness Properties: The Confounding Effects of Changes in Timely Gain and Loss Recognition. *European Accounting Review*, 27(5), 797–815. <https://doi.org/10.1080/09638180.2018.1477610>
- Carey, P., & Simnett, R. (2006). Audit partner tenure and audit quality. *The Accounting Review*, 81(3), 653–676.
- Chatterjee, S., & Simonoff, J. S. (2013). *Handbook of regression analysis*. John Wiley & Sons.
- Chen, J. V. (2015). Management Expectations and Asymmetric Cost Behavior University of Illinois at Chicago Itay Kama Tel Aviv University and University of Michigan Reuven Lehavy University of Michigan Management Expectations and Asymmetric Cost Behavior. October.
- Choi, J. H., & Nam, S. W. (2020). Information efficiency and managerial discretion. *Journal of Accounting and Economics*, 69(1), 101246.
- Choi, J. H., Kim, J. B., Liu, X., & Simunic, D. A. (2010). Audit pricing, legal liability regimes, and Big 4 premiums: Theory and cross-country evidence. Contemporary Accounting composition and financial statement fraud. *The Accounting Review*, 71(4), 443465. *Research*, 27(1), 55–99.
- Choi, J., & Nam, J. (2020). Does managerial discretion affect the value relevance of goodwill impairment information under IFRS? Korean evidence Does managerial discretion affect the value relevance of goodwill. *Asia-Pacific Journal of*

Accounting & Economics, 27(1), 1–23.
<https://doi.org/10.1080/16081625.2020.1686813>

Consoni, S., Colauto, R. D., & De Lima, G. A. S. F. (2017). Voluntary disclosure and earnings management: Evidence from the Brazilian capital market. *Revista Contabilidade e Financas*, 28(74), 249–263. <https://doi.org/10.1590/1808-057x201703360>

DeAngelo, L. E. (1981). Auditor size and audit quality. *Journal of Accounting and Economics*, 3(3), 183–199.

Dechow, P. M., & Dichev, I. D. (2002). The quality of accruals and earnings: The role of accrual estimation errors

Dechow, P. M., & Schrand, C. M. (2004). *Earnings quality*. The Research Foundation of CFA Institute.

Dee, C., Gunny, K., & Strawser, J. (2024). Fair value deficiencies and perceptions of reporting quality. *Journal of Accounting Research*, 62(1), 45–78.

DeFond, M. L., & Jambalvo, J. (1994). Debt covenant violation and manipulation of accruals.

DeFond, M. L., & Zhang, J. (2014). A review of archival auditing research. *Journal of Accounting and Economics*, 58(2–3), 275–326.

Dichev, I. D., & Tang, V. W. (2009). Earnings volatility and earnings predictability. *Journal of Accounting and Economics*, 47(1–2), 160–181.
<https://doi.org/10.1016/j.jacceco.2008.09.005>

Donelson, D. C., & Resutek, R. J. (2015). The predictive qualities of earnings volatility and earnings uncertainty. *Review of Accounting Studies*, 20(1), 470–500.
<https://doi.org/10.1007/s11142-014-9308-5>

- Eames, M., & Glover, S. M. (2017). Earnings predictability: The role of accounting accruals. *Accounting Horizons*, 31(3), 1-20.
- Elend, L., et al. (2020). Comparative datasets in corporate finance research. *Journal of Corporate Finance*, 64, 101–118.
- Elfeky, M. I. (2017). The extent of voluntary disclosure and its determinants in emerging markets: Evidence from Egypt. *Journal of Finance and Data Science*, 3(1–4), 45–59. <https://doi.org/10.1016/j.jfds.2017.09.005>
- Emanuel, D., Wong, J., & Wong, N. (2003). Efficient contracting and accounting. *Accounting and Finance*, 43(2), 149–166. <https://doi.org/10.1111/1467-629X.00086>
- E-obodoekwe, C. N., & Alio, F. (2018). Effect of Fair Value Accounting Measurement on Biological Assets in Nigeria : a Case Study of Okomu Palm Oil Nigeria Plc
Effect of Fair Value Accounting Measurement on Biological Assets in Nigeria : a Case Study of Okomu Palm Oil Nigeria Plc. December.
- Fay, R. (2019). Earnings persistence and investor decision making. *Accounting Perspectives*, 18(1), 25–47.
- Fei, C. C. (2015). The Impact of Managerial Opportunism on Earnings Reliability. 7(10), 222–234. <https://doi.org/10.5539/ijef.v7n10p222>
- Fei, Y. (2015). Determinants of earnings predictability: Evidence from China. *Asian Journal of Finance & Accounting*, 7(2), 220–238.
- Fiechter, P., & Meyer, C. (2008). Discretionary measurement of Level 3 fair values during the 2008 Financial Crisis.

- Fiechter, P., & Meyer, C. (2010). Big bath accounting using fair value measurement discretion during the financial crisis. *Journal of Business Finance & Accounting*, 37(9–10), 1159–1186. <https://doi.org/10.1111/j.1468-5957.2010.02220.x>
- Francis, J., LaFond, R., Olsson, P., & Schipper, K. (2004). Costs of equity and earnings attributes.
- García Osma, B., Guillamón Saorín, E., & Mercado, M. J. (2022). Strategic use of accounting estimates: Motivations and consequences. *The European Accounting Review*, 31(2), 221–250.
- García-Sánchez, I. M., Martínez-Ferrero, J., & Garcia-Benau, M. A. (2019). Integrated reporting: The mediating role of the board of directors and investor protection on managerial discretion in munificent environments. *Corporate Social Responsibility and Environmental Management*, 26(1), 29–45. <https://doi.org/10.1002/csr.1655>
- García-Sánchez, I. M., Rodríguez-Ariza, L., & Frías-Aceituno, J. V. (2019). Board independence and corporate social responsibility disclosure: The moderating role of the CEO duality. *Review of Managerial Science*, 13(2), 281–307.
- Ghazali, A. W., Shafie, N. A., & Sanusi, Z. M. (2015). Earnings Management: An Analysis of Opportunistic Behaviour, Monitoring Mechanism and Financial Distress. *Procedia Economics and Finance*, 28(April), 190–201. [https://doi.org/10.1016/s2212-5671\(15\)01100-4](https://doi.org/10.1016/s2212-5671(15)01100-4)
- Gichaiya, M. (2015). Earnings ' Quality of Public Banks in Kenya : *Evidence From Persistence of Earnings*. 11(16), 74–89.
- Gichaiya, R. (2015). Corporate governance and quality of financial reporting: Evidence from Kenya. *African Journal of Accounting, Economics, Finance and Banking Research*, 11(11), 34–52.

- Goh, B. W., & Simanjuntak, S. (2018). Earnings predictability and investor decisions. *Accounting and Finance Research*, 7(3), 144–156.
- Goh, B. W., & Simanjuntak, T. (2018). Price–earnings ratios and stock market predictability. *Journal of Financial Economics*, 127(2), 300–321.
- Goh, B. W., Lim, Y., Ng, J., Pan, C., & Ow Yong, K. (2021). Stakeholders' trust in fair value accounting: A survey-based study. *Contemporary Accounting Research*, 38(4), 1125–1154.
- Goh, T. S., & Simanjuntak, A. (2018). The Influence of Firm Size, Export Ratio and Earning Variability On Firm Value with Economic Exposure as Intervening Variable in *The Manufacturing Industry Sector*. 46(Ebic 2017), 521–529. <https://doi.org/10.2991/ebic-17.2018.82>
- Gopalan, R., Imdieke, A., Schroeder, H., & Stuber, D. (2021). Audit partner-client relationships and the quality of accounting estimates in banking. *The Accounting Review*, 96(3), 109–136.
- Greene, W. H. (2008). *Econometric analysis* (6th ed.). Pearson Education.
- Grossman, S. J., Hart, O., & Moore, J. (2013). The costs and benefits of ownership: A theory of vertical and lateral integration. *Journal of Political Economy*, 94(4), 691–719.
- Gujarat, D. N., & Porter, D. C. (2009). *Basic econometrics* (5th ed.). McGraw-Hill.
- Ha, K., & Thomas, W. B. (2018). Classification Shifting and Earnings Predictability. *SSRN Electronic Journal*, 2019. <https://doi.org/10.2139/ssrn.3299152>
- Han, S., Rezaee, Z., & Tuo, L. (2019b). Is cost stickiness associated with management earnings forecasts? *Asian Review of Accounting*, June. <https://doi.org/10.1108/ARA-04-2018-0096>

- Haw, I. M., Ho, S. S., & Li, A. Y. (2011). Corporate governance and earnings management by classification shifting. *Contemporary Accounting Research*, 28(2), 517–553.
- Healy, P. M., & Palepu, K. G. (2001). Information asymmetry, corporate disclosure, and the capital markets: A review of the empirical disclosure literature. *Journal of Accounting and Economics*, 31(1-3), 405–440.
- Hennes, K. M., Leone, A. J., & Miller, B. P. (2008). The importance of distinguishing errors from irregularities in restatement research: The case of restatements and CEO/CFO turnover. *The Accounting Review*, 83(6), 1487–1519.
- Hevas, D., Karampinis, N., & Vlismas, O. (2020). Asymmetric cost behaviour and earnings quality in the European context. November. <https://doi.org/10.13140/RG.2.2.25187.37922>
- Hirshleifer, D., Low, A., & Teoh, S. H. (2012). Are overconfident CEOs better innovators? *The Journal of Finance*, 67(4), 1457–1498.
- Ibrahim, A. E. A. (2018). Board characteristics and asymmetric cost behavior: evidence from Egypt. *Accounting Research Journal*, 31(2), 301–322. <https://doi.org/10.1108/ARJ-11-2015-0148>
- Ibrahim, M. A. (2018). Asymmetric cost behavior: Evidence from Ethiopia. *Journal of Accounting and Organizational Change*, 14(3), 366–385.
- Ibrahim, M., Dogarawa, A. B., & Bello, A. (2019). Effect of Accounting-based and Market-based Properties of Earnings Quality on Share Price of Listed Manufacturing Firms in Nigeria. *SSRN Electronic Journal*, 0–25. <https://doi.org/10.2139/ssrn.3492015>

- Ibrahim, S. (2009). Discretionary accruals and earnings management: An analysis of the moderating effect of corporate governance mechanisms. *Journal of Accounting Research*, 47(2), 311–350.
- Ibrahim, S. S. (2009). The usefulness of measures of consistency of discretionary components of accruals in the detection of earnings management. *Journal of Business Finance and Accounting*, 36(9–10), 1087–1116. <https://doi.org/10.1111/J.1468-5957.2009.02171.X>
- Ibrahim, S., et al. (2019). Economic and accounting factors affecting earnings predictability. *International Journal of Accounting Research*, 7(1), 1–10.
- Institute of Certified Public Accountants of Kenya. (2022). Fair Value Measurement under IFRS 13: Practitioner’s Guide. Nairobi: ICPAK.
- Institute of Certified Public Accountants of Kenya. (2023). Illustrative Financial Statements for the Year Ended 31 December 2023. Nairobi: ICPAK.
- International Auditing and Assurance Standards Board (IAASB). (2014). *A framework for audit quality: Key elements that create an environment for audit quality*. IFAC.
- Iraya, C., Mwangi, M., & Muchoki, G. (2015). The effect of corporate governance practices on earnings management of companies listed at the Nairobi Securities Exchange. *European Scientific Journal*, 11(1), 169–178.
- Jadhav, S., He, H., & Jenkins, K. (2015). Prediction of Earnings per Share for Industry. January. <https://doi.org/10.5220/0005616604250432>
- Jarvela, J., Kallunki, J. P., & Nilsson, H. (2011). The impact of accounting quality on earnings predictability: Evidence from the Nordic stock markets. *European Accounting Review*, 20(1), 69–105.

- Jarvela, M., Kozyra, J., & Potter, C. (2011). The Relationship Between Market And Accounting Determined Risk Measures: Reviewing And Updating The Beaver, Kettler, Scholes (1970) Study. *College Teaching Methods & Styles Journal (CTMS)*, 5(1), 1. <https://doi.org/10.19030/ctms.v5i1.5036>
- Kaaya, D. (2022). Value relevance of financial reporting under IFRS versus local GAAP: Evidence from India and Tanzania. *Journal of International Accounting, Auditing and Taxation*, 45, 100462.
- Kamau, C., Namusonge, G., & Bichanga W. (2016). Effect of Management Practices on Creative Accounting
- Karajeh, H. A. (2019). Voluntary disclosure and earnings quality: Evidence from Jordan. *Journal of Accounting and Taxation*, 11(2), 25–35.
- Kariuki, J., & Waweru, N. (2021). Earnings persistence and market reaction to earnings announcements: Evidence from the Nairobi Securities Exchange. *East African Business Research Journal*, 8(2), 55–70.
- Kazemian, S., & Sanusi, Z. M. (2015). Earnings Management and Ownership Structure. *Procedia Economics and Finance*, 31(15), 618–624. [https://doi.org/10.1016/s2212-5671\(15\)01149-1](https://doi.org/10.1016/s2212-5671(15)01149-1)
- Khaneja, S. (2017). Redefining the Role of Auditor in Curbing Creative Accounting Practices. 6(3), 32–37.
- Kılıç, M., Uyar, A., & Kuzey, C. (2019). The impact of corporate characteristics on environmental disclosures in sustainability reports. *Corporate Social Responsibility and Environmental Management*, 26(1), 37–52. <https://doi.org/10.1002/csr.1650>

- Klein, A. (2002). Audit committee, board of director characteristics, and earnings management. *Journal of Accounting and Economics*, 33(3), 375–400.
- Konan, C., Chan, L., Jegadeesh, N., & Lakonishok, J. (2001). Earnings Quality and Stock Returns. 3.
- Kothari, C. (2014). Research methodology methods and techniques by C R.Kothari. In New Age International (P) Ltd., Publishers.
- Kothari, S. P., Leone, A. J., & Wasley, C. E. (2005). Performance matched discretionary accrual measures. *Journal of Accounting and Economics*, 39(1), 163–197.
- Larcker, D. F., Richardson, S. A., & Tuna, I. (2007). Corporate governance, accounting outcomes, and organizational performance. *The Accounting Review*, 82(4), 963–1008.
- Li, J., Sun, Z. Cost stickiness, earnings forecast accuracy, and the informativeness of stock prices about future earnings: evidence from China. *Humanit Soc Sci Commun* 10, 112 (2023). <https://doi.org/10.1057/s41599-023-01592-3>
- Li, L., Hwang, N. R., & Nartea, G. V. (2019). Department Of Economics and Finance School Of Business And Economics *Effects of Earnings Management Strategy on Earnings*. 9.
- Li, N., et al. (2019). Discretionary accruals and future profitability. *The Accounting Review*, 94(2), 211–236.
- Licern-Gutiérrez, A., & Cano-Rodríguez, M. (2017). Measuring Earnings Quality: A Proposal of a Theoretical Framework and an Empirical Method. *SSRN Electronic Journal*, November. <https://doi.org/10.2139/ssrn.3079680>
- Long, J. S., & Ervin, L. H. (2017). Using heteroscedasticity-consistent standard errors in the linear regression model. *The American Statistician*, 54(3), 217–224.

- Lu, H., & Homburg, C. (2013). Managerial) Overconfidence) and) Cost) Stickiness " Managerial) Overconfidence) and) Cost) Stickiness ".
- Luttman, S. M., & Silhan, P. A. (2011). Determinants Of Earnings Variability. *Journal of Applied Business Research (JABR)*, 11(1), 117. <https://doi.org/10.19030/jabr.v11i1.5898>
- Malmendier, U., & Tate, G. (2005). CEO overconfidence and corporate investment. *The Journal of Finance*, 60(6), 2661–2700.
- McDonough, R., Panaretou, A., & Shakespeare, C. (2020). Institutional background and challenges of fair value accounting under IFRS and GAAP. *Accounting Horizons*, 34(2), 89–113.
- McEwen, R. A., Mazza, C. R., & Hunton, J. E. (2008). Effects of Managerial Discretion in Fair Value Accounting Regulation and Motivational Incentives to “Go Along” with Management on Analysts’ Expectations and Judgments. *Journal of Behavioral Finance*, 9(4), 240–251. <https://doi.org/10.1080/15427560802551818>
- McVay, S. E. (2006). Earnings management using classification shifting: An examination of core earnings and special items. *The Accounting Review*, 81(3), 501–531.
- Miller BP. 2010. The Effects of Reporting Complexity on Small and Large Investor Trading. Working Paper Indiana University.
- Njoroge, J. G. (2018). Effect of voluntary disclosure on cost of equity capital of companies quoted at nairobi securities exchange in kenya.
- Mwangi, P., & Njoroge, C. (2022). Voluntary disclosures and earnings predictability: Evidence from the Nairobi Securities Exchange. *Journal of Asian Finance, Economics and Business*, 9(6), 233–245.

- Mwapula, J. (2016). Corporate governance and fair value accounting in Kenyan commercial banks. *African Journal of Accounting*, 12(1), 45–67.
- Nairobi Securities Exchange (2018). NSE Handbook. Nairobi, Kenya: NSE.
- Nairobi Securities Exchange. (2022). ESG Disclosure Guidance Manual. Nairobi: NSE.
- Nairobi Securities Exchange. (2022–2023). Integrated Reports. Nairobi: NSE.
- Nelson, M. W., Elliott, J. A., & Tarpley, R. L. (2002). Evidence from auditors about managers' and auditors' earnings management decisions. *The Accounting Review*, 77(s-1), 175–202.
- Noman, M., Pervin, S., & Chowdhury, M. (2015). Hausman specification test in econometrics. *International Journal of Economics, Commerce and Management*, 3(12), 234–242.
- Nor, K., & Ku, I. (2013). Governance Structure, Ownership Structure And Earnings Predictability. *Asian Academy of Management Journal of Accounting and Finance*, 9(1), 1–23.
- Ntim, C.G., Soobaroyen, T. and Broad, M.J. (2017), “Governance structures, voluntary disclosures and public accountability: the case of UK higher education institutions”, *Accounting, Auditing and Accountability Journal*, 30(1), 65-118,; <https://doi.org/10.1108/AAAJ-10-2014-1842>.
- Nuryaman. (2013). The Influence of Earnings Management on Stock Return and the Role of Audit Quality as a Moderating Variable. 4(2), 2–7. <https://doi.org/10.7763/IJTEF.2013.V4.263>
- Ogwe, C. (2014). Corporate governance and earnings quality of listed non-financial firms in Nigeria. *Journal of Accounting and Taxation*, 6(8), 120–130.

- Ogwe, J. A. (2014). Determinants of Voluntary Disclosure in the Annual Reports of Companies Listed at the Nairobi Securities Exchange. 1–66.
- Oluoch, O. (2015). Effect of Accruals' Quality on Cost of Capital of Public Companies in Kenya. 1115–1135. 3/Record/com.mandumah.search://http
- Omair, A. (2015). Sample size estimation and sampling techniques for selecting a representative sample. *Journal of Health Specialties*, 3(2), 142–147.
- Otieno, S., & Kimani, D. (2023). Audit quality as a moderator of the relationship between accounting discretion and earnings predictability. *African Journal of Business Management*, 17(4), 112–125.
- Park, H. M. (2015). Univariate analysis and normality test using SAS, Stata, and SPSS. The University Information Technology Services (UITs) Center for Statistical and Mathematical Computing, Indiana University.
- Peniel, D. (2016). Descriptive research design: Definition, examples and applications. *International Journal of Research*, 4(2), 45–55.
- Rabin, A. (2005). Creative accounting practices in South Africa. *Journal of Accounting in Emerging Economies*, 5(2), 179–194.
- Rahi, S. (2017). Research design and methods: A systematic review of research paradigms, sampling issues and instruments development. *International Journal of Economics & Management Sciences*, 6(2), 1–5.
- Rajasekar, S., Philominathan, P., & Chinnathambi, V. (2013). *Research methodology*. arXiv preprint arXiv:physics/0601009.
- Ralph, P. (2013). Sampling frames in research. *Research Design Review*, 9(2), 12–18.
- Reserve Bank of Zimbabwe. (2006). Annual Report. Harare: RBZ.

- Sagafi-nejad, T., Dunning, J. H., & Hagedoorn, J. (2010). The evolution of international business: An introduction. *Journal of International Business Studies*, 41(6), 995–1013.
- Salawu, R. O. (2019). Earnings Quality and Firms' Book Value: An Empirical Evidence from the Listed Firms In Nigeria. *Journal of Internet Banking and Commerce*, March.
- Salsiah, M. A., Norman, M. S., & Mohamat Sabri, H. (2008). Ownership Structure and Earnings Management in Malaysian Listed Companies: *The Size Effect*. *Asian Journal of Business and Accounting*, 1(2), 89–116.
- Samaha, K., & Dahawy, K. (2010). Factors influencing corporate disclosure transparency in emerging markets: The case of Egypt. *Corporate Ownership & Control*, 7(4), 69–79.
- Sánchez-Ballesta, J. P., & García-Meca, E. (2007). Ownership structure, discretionary accruals and the informativeness of earnings. *Corporate Governance: An International Review*, 15(4), 677–691. <https://doi.org/10.1111/j.1467-8683.2007.00596.x>
- Sankar, M. R., & Subramanyam, K. R. (2001). Reporting discretion and private information communication through earnings. *Journal of Accounting Research*, 39(2), 365–386. <https://doi.org/10.1111/1475-679X.00017>
- Sapkauskiene, A., & Orlovskij, S. (2017). The usefulness of fair value estimates for financial decision making: a literature review. *Zeszyty Teoretyczne Rachunkowości*, 93(0), 0–0. <https://doi.org/10.5604/01.3001.0010.3195>
- Saunders, M., Lewis, P., & Thornhill, A. (2009). Research Methods for Business Students. In *International Journal of the History of Sport*, 30(1). <https://doi.org/10.1080/09523367.2012.743996>

- Scaltrito, D. (2016). Voluntary disclosure in Italy: Firm-specific determinants an empirical analysis of Italian listed companies. *EuroMed Journal of Business*, 11(2), 272–303. <https://doi.org/10.1108/EMJB-07-2015-0032>
- Schipper, K., & Vincent, L. (2003). Earnings quality. *Accounting Horizons*, 17(2), 97–110.
- Serrano-Cinca, C., et al. (2019). Earnings prediction errors and market efficiency. *Journal of Business Research*, 101, 216–229.
- Serrano-Cinca, C., Gutiérrez-Nieto, B., & Bernate-Valbuena, M. (2019). The use of accounting anomalies indicators to predict business failure. *European Management Journal*, 37(3), 353–375. <https://doi.org/10.1016/j.emj.2018.10.006>
- Siekkinen, J. (2017). Board characteristics and the value relevance of fair values. *Journal of Management and Governance*, 21(2), 435–471. <https://doi.org/10.1007/s10997-016-9350-8>
- Silhan, P. (2014). Earnings variability and prediction models. *Journal of Applied Business Research*, 30(4), 1225–1236.
- Silhan, P. A. (2014). Interfirm differences in earnings variability: An analysis of fundamentals, cash flows and accruals. *Accounting and Finance*, 54(4), 1357–1379. <https://doi.org/10.1111/acfi.12038>
- Simamora, A. J. (2018). Effect of earnings management on earnings predictability in information signaling perspective. *Jurnal Akuntansi*, 22(2), 173. <https://doi.org/10.24912/ja.v22i2.346>
- Simunic, D. A., & Stein, M. T. (2012). Audit quality: Insights from the academic literature. *Accounting Horizons*, 26(2), 347–367.

- Simunic, D. A., & Stein, M. T. (2012). The impact of litigation risk on audit pricing: A review of the literature. *Auditing: A Journal of Practice & Theory*, 31(1), 321–339.
- Smith, J. (2012). The evolution of accounting standards. *The Accounting Review*, 87(3), 747–776.
- Šodan, S. (2019). Fair value accounting and earnings management: A literature review. *Economic Research-Ekonomska Istraživanja*, 32(1), 119–141.
- Šodan, S. (2019). Fair Value Hierarchy and Earnings Volatility. *Ekonomski Misao i Praksa*, 2, 567–577.
- Sun, L., Salama, A., Hussainey, K., & Habbash, M. (2019). Cost stickiness, corporate governance and firm performance. *Journal of Applied Accounting Research*, 20(2), 224–242.
- Sun, R., Ho, K. C., Gu, Y., & Chen, C. C. (2019). Asymmetric cost behavior and investment in R&D: Evidence from China's manufacturing listed companies. *Sustainability (Switzerland)*, 11(6), 1785. <https://doi.org/10.3390/su11061785>
- Tan, H. C., & Sidhu, B. (2012). Sources of earnings variability and their effect on earnings forecasts. *Accounting and Finance*, 52(SUPPL.1), 343–371. <https://doi.org/10.1111/j.1467-629X.2011.00444.x>
- Toluwa, A., & Power, J. (2019). Controversies in fair value accounting: Relevance versus reliability. *Accounting Perspectives*, 18(3), 309–335.
- Trading Economics. (2020). Kenya stock market (NSE20) historical data. Retrieved from
- Tucker, J. W., Tan, H., & Sidhu, B. K. (2012). Operating performance variability and earnings predictability. *The Accounting Review*, 87(1), 275–302.

- Tunyi, A. A., Ehalaiye, D., Gyapong, E., & Ntim, C. G. (2020). The value of discretion in Africa: Evidence from acquired intangible assets under IFRS 3. *International Journal of Accounting*. <https://doi.org/10.1142/S1094406020500080>
- Uyar, A., & Kiliç, M. (2012). Value relevance of voluntary disclosure: Evidence from Turkish firms. *Journal of Intellectual Capital*, 13(3), 363–376. <https://doi.org/10.1108/14691931211248918>
- van Zijl, T., & Hewlett, K. (2021). Fair value accounting: A review of the literature. *Accounting and Finance*, 61(3), 3485–3515.
- Van Zijl, W., & Hewlett, V. (2021). An analysis of the extent and use of fair value by JSE Top 40 companies. *South African Journal of Accounting Research*, 0(0), 1–24. <https://doi.org/10.1080/10291954.2020.1860484>
- Verrecchia, R. E. (2001). Essays on disclosure. *Journal of Accounting and Economics*, 32(1–3), 97–180.
- Walker, A., & Hay, D. C. (2013). Non-Audit Services and Knowledge Spillovers: An Investigation of the Audit Report Lag. <https://doi.org/10.1108/MEDAR-07-2012-0024>
- Walliman, N. (2011). *Research methods: The basics*. Routledge.
- Wambugu, J., & Gichuhi, M. (2023). Fair value accounting estimates and earnings predictability in non-financial firms listed at the NSE. *African Journal of Accounting and Finance*, 9(1), 77–95.
- Wang, M., Beal, D. J., Chan, D., Newman, D. A., Vancouver, J. B., & Vandenberg, R. J. (2017). Longitudinal Research: A Panel Discussion on Conceptual Issues, Research Design, and Statistical Techniques. *Work, Aging and Retirement*, 3(1), 1–24. <https://doi.org/10.1093/WORKAR/WAW033>

- Wang, X., Davidson, W. N., & Wang, J. (2017). Longitudinal research in accounting. *Journal of Accounting Literature*, 39, 76–96.
- Watts, R. L., & Zimmerman, J. L. (1986). *Positive accounting theory*. Prentice-Hall.
- Waweru, N. M., & Ntui, E. (2018). Audit quality and earnings management in East Africa. *Journal of Accounting in Emerging Economies*, 8(4), 584–602.
- Waweru, N. M., & Ntui, P. (2018). Corporate governance compliance and accrual earnings management in eastern Africa : *Evidence from Kenya and Tanzania* Article information : March. <https://doi.org/10.1108/MAJ-09-2016-1438>
- Weiss, D. (2010). Cost behavior and analysts' earnings forecasts. *Accounting Review*, 85(4), 1441–1471. <https://doi.org/10.2308/accr.2010.85.4.1441>
- Wooldridge, J. M. (2010). *Econometric Analysis of Cross Section and Panel Data* (2nd ed.). MIT Press.
- Wysocki, P. D. (2005). Assessing earnings and accruals quality: U.S. and international evidence. Working Paper, MIT Sloan School of Management.
- Zang, A. Y. (2012). Evidence on the trade-off between real activities manipulation and accrual-based earnings management. *The Accounting Review*, 87(2), 675–703.

APPENDICES

Appendix I: Secondary Data Collection Sheet

Variables (Measure)	Independent Variable 1 Cost stickiness		Independent Variable 2 Fair Value Estimates			Independent Variable 3 Voluntary Disclosures			
	Sales Revenues	SG&A	Level 1	Level 2	Level 3	3-5 Year business highlights	Key ratios	CSR	Fair value Disclosures
2010									
2011									
2012									
2013									
2014									
2015									
2016									
2017									
2018									
2019									
2020									
2021									
2022									

Variables (Measure)	Independent Variable 4 Discretionary Accruals		Moderator Variable Audit quality			Dependent Variable Price Earnings Ratio	
Year/Data	Total Accruals	NDA	Audit report date	Audit Opinion	Audit firm type	Share Price	EPS
2010							
2011							
2012							
2013							
2014							
2015							
2016							
2017							
2018							
2019							
2020							
2021							
2022							

Company Name

Company Type (Industry)

Appendix II: Listed Firms at Nairobi Securities Exchange

AGRICULTURAL

- 1 Eaagads Ltd.
- 2 Kapchorua Tea Kenya Plc.
- 3 Kakuzi Plc
- 4 Limuru Tea Co. Ltd.
- 5 Sasini Plc.
- 6 Williamson Tea Kenya Plc.

AUTOMOBILES & ACCESSORIES

- 7 Car & General (K) Ltd.

BANKING

- 8 ABSA Bank Kenya Plc.
- 9 Stanbic Holdings Ltd.
- 10 I & M Holdings Plc.
- 11 Diamond Trust Bank Kenya Ltd
- 12 HF Group Plc.
- 13 KCB Group Plc.
- 14 NCBA Group Plc.
- 15 Standard Chartered Bank Kenya Ltd.
- 16 Equity Group Holdings Plc.
- 17 The Co-operative Bank of Kenya Ltd

COMMERCIAL & SERVICES

- 18 Express Kenya Plc.
- 19 Kenya Airways Ltd.
- 20 Nation Media Group Plc.
- 21 Standard Group Plc.
- 22 TPS Eastern Africa (Serena) Ltd.
- 23 WPP Scan Group Plc.
- 24 Uchumi Supermarket Plc.
- 25 Eveready East Africa Ltd.
- 26 Longhorn Publishers Plc.
- 27 Deacons (East Africa) Plc.
- 28 Sameer Africa Plc.
- 29 Nairobi Business Ventures Ltd.
- 30 Homeboyz Entertainment Plc.

CONSTRUCTION & ALLIED

- 31 ARM Cement Plc.
- 32 Bamburi Cement Ltd.
- 33 Crown Paints Kenya Plc.
- 34 E.A Cables Ltd.
- 35 E.A Portland Cement Ltd.

ENERGY & PETROLEUM

- 36 Total Kenya Ltd.
- 37 KenGen Plc.
- 38 Kenya Power & Lighting Plc.
- 39 Umeme Ltd

INSURANCE

- 40 Jubilee Holdings Ltd
- 41 Sanlam Kenya Plc.
- 42 Kenya Re-Insurance Corporation Ltd.
- 43 Liberty Kenya Holdings
- 44 Britam Holdings Plc.
- 45 CIC Insurance Group Ltd.

INVESTMENT

- 46 Olympia Capital Holdings Ltd.
- 47 Centum Investment Plc.
- 48 Trans - Century Plc.
- 49 Home Afrika Ltd.
- 50 Kurwitu Ventures Ltd.

INVESTMENT SERVICES

- 51 Nairobi Securities Exchange Plc.

MANUFACTURING & ALLIED

- 52 B.O.C Kenya Plc.
- 53 British American Tobacco Kenya Plc.
- 54 Carbacid Investments Plc.
- 55 East African Breweries Ltd.
- 56 Mumias Sugar Co. Ltd
- 57 Unga Group Ltd.
- 58 Kenya Orchards Ltd.
- 59 Flame Tree Group Holdings Ltd.

TELECOMMUNICATION

- 60 Safaricom Plc.

REAL ESTATE INVESTMENT TRUST

- 61 ILAM Fahari I-REIT

EXCHANGE TRADED FUNDS

- 62 ABSA New Gold ETF

Source

