

## ABSTRACT

The most commonly used creative accounting practices are attributed to bad corporate governance. Bank managers and bank accountants use strategies that seek to erode profit mechanisms that amount to severe consequences for the entire banking and finance industry. Therefore the purpose of this study was to determine the effect of creative accounting practices on financial performance of Tier II commercial banks in Kenya. The study was guided by the following four objectives; establishing the effect of income smoothing on financial performance; determining the effect of loan loss provisions on financial performance; determining the effect of tax avoidance on financial performance; and establishing the effect of off-balance sheet items on financial performance of tier II Commercial Banks in Kenya. The study was based on Information theory, Agency theory and Positive accounting theory. This study adopted an explanatory survey research design in explaining the relationship between the independent and dependent variables. The target population for the study included 10 Central Bank of Kenya licensed tier II commercial banks where 40 respondents were included. Purposive sampling technique was used to select Finance managers, internal auditors and accountants as respondents to the study. The researcher obtained sample from all the 10 tier II commercial banks in their head offices in Nairobi, Kenya. Primary data was collected using structured Questionnaire while secondary data was collected from published financial statements from CBK Supervisory reports. The data was analyzed using the Statistical Package for Social Sciences (SPSS) version 24, by use of both descriptive and inferential statistics. Prior to the main study, a study was conducted and the research instrument was found to be reliable as all the Cronbach Alpha coefficients were more than 0.7 threshold. Construct validity was tested using Principle Component Analysis, where four factors were identified with all items having primary loadings with factors over 0.4. The study results revealed that Income Smoothing had an insignificant coefficient of 0.296 with the Financial Performance of tier II commercial banks in Kenya. The Tier II commercial banks in Kenya use Loan Reserve in avoiding fluctuations which occur in risk-weighted assets that in turn affect the bank's risk and profitability, hence generating an adverse effect on their financial performance. Findings further reveals that Tax saving enhances financial performance of Tier II commercial banks. The study shows that the absence of corporate transparency and monitoring of managerial actions necessitates the prevalence of capital reduction in Tier II commercial banks in Kenya. The study indicates that Off-Balance Sheet Items have a statistically significantly unique contribution in explaining the financial performance of Tier II commercial banks in Kenya. According to the findings, exclusion of liabilities activities are the source of funds for the banks. Based on these findings, the study recommends that watchdogs of the accounting practices need to exercise strict oversight on the extent to which Commercial bank adopt creative accounting practices. The study findings would form a timely and solid foundation that the banking industry pundits and policy makers would base most of their policy priorities in responding to the volatile accounting situation in Kenya today.