

**THE EFFECT OF CORPORATE GOVERNANCE PRACTICES ON EARNINGS
MANAGEMENT FOR THE LISTED COMMERCIAL BANKS IN KENYA**

BY

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DECLARATION

This research project is my original work and has not been submitted for examination to any other university.

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This research project has been submitted for examination with my approval as the University Supervisor.

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DEDICATION

This project is dedicated to my family for support and encouragement and to all the listed banks in NSE. To God Almighty, your unfailing love for me has kept me going. I am forever grateful to you LORD for you who began this good work in me; you have been faithful to carry it on to completion “Philippians 1:6”

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LIST OF ABBREVIATIONS

ANOVA:	Analysis of Variance
BOD	Board of Directors
CEO	Chief Executive Officer
EM:	Earning management
GP	Governance Practices
IFRS I	International Financial Reporting Standards
KCMA	Kenya Capital Market Authority
NSE	National Securities Exchange
SEC:	Securities and Exchange Commission
SPSS	Statistical Package for Social Sciences

ABSTRACT

The association between quality of corporate governance structures and firms' profitability is quite major focus in corporate governance practices. Banks are considered more sensitive as they hold depositors monies, and for their effect or role on Kenya's economy in regulating the amount of money supply. It is important to understand corporate governance in banks for several reasons. When banks efficiently allocate funds, it lowers the cost of capital to firms, enhances capital formation, and stimulates growth in the economy. The stability of financial system serves a broad role in the economic development and bank failure can reverberate with strong negative implications. Kenyan banks have in the recent past experienced a number of corporate failures related to corporate governance structures in place. This study sought to examine the effect of corporate governance practices on earnings management for the listed banks in Kenya. This study adopted a descriptive research design. The target population consisted of the 11 commercial banks listed at NSE as at 2013. The study adopted a census study approach due to the small population selected. Secondary data was obtained by abstraction method from corporate governance statements and financial statements for the 11 commercial banks covered as they had been published by NSE. Descriptive analysis was used (means scores and percentages) to analyze the extent of board independence. The regression results were interpreted based on the Pearson correlation, R-squared, adjusted R-squared, Test of significance using F statistic through the Analysis of Variance (ANOVA), coefficients of the independent variables and their p-values. From the findings, the coefficient of determination R^2 equals 0.815 implying that, Size, board size, board composition, board meetings, executive compensation explains 81.5 percent of the variance in earnings management amounts and the overall model is significant. In general, this study concluded that firms with effective corporate governance practices and undertake less earnings management. Although not all corporate governance variables support the stated hypotheses, the study achieved its objective by identifying the attributes that answer the research question. This implies that agency theory offers a generally good explanation of the associations between both corporate governance practices with earnings management practice. The study concluded that an increase in non executive directors / total directors as well as Executive compensation is positively associated with earnings management. On the other hand, an increase in total number of directors in the board, number of board meetings, ratio of total debt to total assets and size is negatively associated with earnings management. Based on the findings, this study recommends that the number of non executive directors / total directors as well as executive compensation be moderately reduced in order to reduce the risk of cases of earnings management. The study also recommends that the number of total of directors in the board, board meetings, ratio of total debt to total assets and size be increased and thereby reduce earnings management in the organizations.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Management decisions have powerful influence on a full range of business activities of a firm and its financial reported earnings. Corporate governance issues arise because of the existence of agency problems that cannot be resolved through contractual solutions due to high transaction costs (Petra, 2005). These agency costs manifest themselves in the form of conflict between investors and other claimants on cash flow on one hand, and the managers and the directors who have the discretion over the cash flow are used, on the other. The flexibility of current accounting principles provides managers with considerable ability to adjust accounting earnings. Claessens *et al* (2002) maintain that better corporate frameworks benefit firms through greater access to financing, lower cost of capital, better performance and more favorable treatment of all stakeholders.

Several studies document a significant relation between the characteristics of the board of directors and the integrity of accounting information (Rahman and Ali, 2006; Patelli and Prencipe, 2007; Hashim and Devi, 2008). Among the many claimants on firm's cash flows, equity shareholders have always claimed a special attention may be because of the residual nature of their claims. Parker (2007a) paradigm of the separation of share holder ownership and management's control explained that agency problem occurs when the principal (Shareholders) lacks the necessary power/information to monitor and control the agent (manager) and when the compensation of the principal and the agent is not aligned. It is assumed that for a company to prosper it will choose a corporate governance that is efficient

in minimizing agency costs. It has also been argued that in the end it is a country's political framework which determines the quality of its corporate governance practices (Roe, 2003).

Corporate governance is defined as a field in economics that investigates how to secure or motivates efficient management of corporations by the use of incentives mechanism, such as contracts, organization design and legislation (Mathiesen, 2002). Abor,. (2007) defines corporate governance as the system by which companies are directed and controlled. It also refers to as the way in which corporations are handled by corporate boards and officers. Hampel (1998) observes that good governance ensures that stakeholders with the relevant interest in the company business are fully taken into account. Brown and Caylor (2004) also share the foregoing views seeing corporate governance as the relationship among various participant in determining the direction and performance of the companies consistent with the public good. During the last decade, the study of original decline and turn around has been the subject of renewed interest. In their paper on corporate failures, Gemmill and Thomas (2004) reported that annual failure rate of large U S firms grew from 1% during 1967 to 1982 period to over 3% since 1985.

In Kenya, Wambua (2003) documented in general, the actions taken by companies facing rapid performance declines, he reported that employee lay-offs was popular and was taken by 60 % of the companies sampled. Mululu (2005) carried out research on corporate governance structures and performance on all listed firms in the securities exchange. He found that board activity is related to a number of corporate variables such as board size, the number of executive directors, the number of shares held by largest shareholders, number of shares by unaffiliated block holders, and the number of other directorships held by outside

directors. He reported that board increase the frequency of their meetings during financial crises.

Although corporate governance has long been considered as an important aspect of corporate control, it is only in recent years that researchers have become directly concerned in the study of alternative governance structures and their impact on performance. Several aspects of corporate governance including the form of executive pay and their composition of boards have been found to be associated with firm's strategic decisions and performance. An examination of firms in decline provides an ideal forum to analyze governance elements. Firms in decline face greater shareholders scrutiny and, it is speculated that they are more likely to respond to this scrutiny with changes to their governance structures.

1.1.1 Corporate Governance

Corporate governance structures can be defined as the systems or mechanisms designed to monitor managers and improve corporate transparency (Tsui and Gui, 2000). Typically corporate governance structures adopted by firms experiencing declining performance results in changes in; board meeting frequency (Klapper and Love, 2003); board composition (McCord, 2002) insider share ownership (Morck, Shleifer, and Vishny, 1998); and executive compensation (Monks and Minow, 2004). Board meeting frequency potentially carries important governance implication as it is less costly for a firm to adjust the frequency of its board meeting to attain better governance of the firm, than to change the composition of its board or ownership structures. Vafeas (1999) found that meeting frequency was influential in improving operating performance in a manner consistent with the agency theory.

Studies on firm performance as a function of board composition yield mixed results (Baysinger and Butler, 2005). MacAvoy and Millstein (2003), for example, found that the proportion of outside directors is significantly lower on boards of banks in state that restrict banking acquisitions, suggesting that outside directors play a role in evaluating takeover proposals. Weisbach reports that CEO turnover is more highly correlated with firm performance in corporations having a majority of outside directors than firms that have predominantly insider board. Further, Hermalin and Weisbach (1998) find that outsiders are more likely to join a board after a firm performs poorly or leaves an industry. Once inference may be the need for additional outside guidance in companies undergoing strategic shifts.

Abor (2007) commented that where managers hold little equity in the firm and the share holders are too dispersed to enforce value maximization, corporate assets may be deployed to benefit managers rather than shareholders. According to MacAvoy and Millstein, (2003) the costs of deviation from value maximization decline as management ownership rises because of converging interests. Consistent with the above, Mak and Yuanto (2003) found an inverted U- shaped relationship between Tobin's Q and managerial ownership. Numerous studies have identified a positive relationship between executive compensation and firm performance although debate continues as to the exact size of this function.

1.1.2 Earnings Management

The practice that the management uses judgment in financial reporting and in structuring transaction to alter financial earnings is called "earnings management" (Healy and Wahlen (1998). According to Dechow et.al. (1995) earnings management is a strategy used by the management of a company to deliberately manipulate the company's earnings so that the

figures match a pre-determined target. This practice is carried out for the purpose of income smoothing. Thus rather than having years of exceptionally good or bad earnings, companies will try to keep the figures relatively stable by adding and removing cash from reserves account.

According to Fischer and Rosenzweiz (1995) earnings management is the managers' action to increase / decrease current reported earnings of a company financials with no corresponding increase / decrease in the long-term economic gain in the company. Stolowy and Breton (2004), refers earning management as "manipulation of accounts". They describe it as the use of management's discretion to decide on accounting choices or to design transactions in a way that it will affect the chances of wealth transfer between the company and society, fund providers or managers. They further divide a manipulation of accounts into creative accounting, earning management and fraud. Earning management has been practiced in the last few decades. It occurs when managers use self or organization judgment in financial reporting and in designing transactions to alter financial reporting either to misguide some stakeholders about the underlying economic performance of the company or to have undue influence on contractual outcomes that depend on reporting accounting numbers (Healy and Wahlen, 1999).

Fischer and Rosenzweiz (1995) gave a more precise definition of earnings management where he stated that it's the managers' action which increase / decrease current reported earnings of a company financials with no corresponding increase / decrease in the long-term economic gain in the company; this is the definition that will be used throughout the study.

According to Dechow et.al. (1995) earnings management is a strategy used by the management of a company to deliberately manipulate the company's earnings so that the figures match a pre-determined target. This practice is carried out for the purpose of income smoothing. Thus rather than having years of exceptionally good or bad earnings, companies will try to keep the figures relatively stable by adding and removing cash from reserves account.

1.1.3 Effect of Corporate Governance on Earnings Management

Empirical studies have concluded various relationships exist between corporate governance and earnings management. The existence of concentration of power (CEO duality) increases earnings management while a country with higher levels of governability shows a lower level on earnings management practices (Bugshan, 2005).

Agency theory predicts that corporate governance and external audit enhance the convergence of interests between shareholders and managers. The theory proposes that Boards of directors are charged with ensuring that chief executive officer (CEO) carry out their duties in a way serving the best interests of shareholders (Vance, 1983). Therefore, boards can be seen as serving as a monitoring device that helps align CEO and shareholder interests and as a result increasing earnings management in an organization.

Liu and Lu (2007) documented systematic differences in earnings management across the China's listed companies during 1999–2005, and empirically demonstrated that firms with higher corporate governance levels have lower levels of earnings management. Their empirical findings, although not being able to completely exclude other explanations,

strongly suggested that agency conflicts between controlling shareholders and minority investors account for a significant portion of earnings management in China's listed firms.

Marion et.al. (2008) posited that earnings management is limited by certain corporate governance practices most critical being audit committee independence and board independence being associated with lower performance adjusted discretionary accruals. However the empirical study concluded that increasing executive shareholdings provides incentives to manage earnings.

Jesus and Emma (2013) observed that insider shareholding, ownership concentration, institutional investors, board independence, a greater number of board meetings negatively affects earnings management while family ownership, board size positively affects earnings management. Jesus and Emma (2013) empirically tested that when ownership concentration reaches a certain point, basically around 35.1 %, there is an increase in the use of discretionary accruals or earnings management. They also found that an increase in insider's ownership reduces earnings management by managers until such ownership reaches 14.1 % where the situation reverses with an increase in manipulative practices by insiders.

Previous studies by Bugshan (2005), Jesus and Emma (2013), Xie et al., (2003), Lopez and Saona, (2005) and Cespedes et al. (2008) among others identified various variables of corporate governance and their measures were applied as follows; Ownership Concentration is measured by proportion of ownership held by the main shareholder of institutional nature of the quoted company; Board Size is measured by the total number of directors in the board; board composition is measured by the proportion of non executive directors inside the board (non executive directors / total directors). In addition, board meeting frequency is measured

by number of board meetings held during the year. Board activity is measured by the number of meetings held during the year.

Dechow et.al. (1995) also assessed the ability of five accrual models to detect earnings management and found that the modified Jones Model is the most powerful in detecting earnings management in a sample of firms the SEC identified for overstating earnings. The evidence in Guay et al. (1996) suggests that only the Jones and modified Jones models produce abnormal accruals that are distinguishable from a random decomposition of earnings and thus consistent with abnormal accruals resulting from managerial decisions to increase and /or smooth income. Moreover, Bernard and skinner (1996) argue that Jones – type Model abnormal accruals systematically misclassify normal accruals as abnormal. Thus, current evidence suggests that accrual variables poorly measure the discretion managers’ exercise to manage earnings.

1.1.4 Listed Commercial Banks in Kenya

Commercial banks are financial intermediaries that serve as financial resource mobilization points in the global economy. They channel funds needed by business and household sectors from surplus spending to deficit spending units in the economy. A well developed efficient banking sector is an important prerequisite for saving and investment decisions needed for rapid economic growth. A well functioning banking sector provides a system by which a country’s most profitable and efficient projects are systematically and continuously funded. The role of banks in an economy is paramount because they execute monetary policy and provide means for facilitating payment for goods and services in the domestic and

international trade. At the Nairobi Securities Exchange the bank must have a minimum number of seven members according to the Companies Act chapter 486 of the laws of Kenya.

The listed commercial banks in Kenya are Barclays bank, CFC Stanbik Holdings Ltd, I&M Holdings Ltd, Diamond Trust Bank Kenya, Housing Finance Co Ltd, Kenya Commercial Bank Ltd, National Bank of Kenya Ltd, NIC Bank Ltd, Standard Chartered Bank Ltd, Equity Bank Ltd And The Cooperative Bank of Kenya Ltd. Kenya has adopted various guidelines in relation to earning management. First, Kenya adopted the use of the International Financial Reporting Standards (IFRs) effective January, 1999. Second, in 2002 KCMA issued corporate governance guidelines which were made mandatory for all companies listed on the NSE (KCMA, 2002). Third, over the last decade, the Kenyan economy has been experiencing major changes. For example, the capital market has expanded to reach a market capitalization of over one trillion shillings (about thirteen are principals and the managers are agents and there is an agency loss, which is the extent to which returns to the residual claimants, the owners, fall below what they would be if the principals, the owners, exercised direct control of the corporation.

1.2 Research Problem

The association between quality of corporate governance structures and firms' profitability is quite major focus in corporate governance practices. Jensen and Meckling (1976) have proven that firms with better governance structures might have more efficient operations, resulting in a higher expected future cash-flow stream. Recent scandals, such as the city group's \$8 billion scandal in generated charges, have focused attention on corporate governance issues in the financial sector. This has increased awareness of agency problems

in the banking industry leading to the question of whether corporate governance matters, in a regulated environment, like the banking industry (Capiro and Levine, 2002).

Banks are considered more sensitive as they hold depositors monies, and for their effect or role on Kenya's economy in regulating the amount of money supply. It is important to understand corporate governance in banks for several reasons. When banks efficiently allocate funds, it lowers the cost of capital to firms, enhances capital formation, and stimulates growth in the economy (Levine 2004). The stability of financial system serves a broad role in the economic development and bank failure can reverberate with strong negative implications. Kenyan banks have in the recent past experienced a number of corporate failures related to corporate governance structures in place.

According to Zoysa and Rudkin (2010) empirical studies on corporate governance and earnings management in Kenya shows that ownership structure and Board Composition are the main corporate governance characteristics influencing earnings management by Kenyan listed Companies. Highly leveraged firms were found to be more likely to engage in earnings management. According to (Ogoye, 2002) the increasing numbers of corporate failures and financial scandals have been caused by incompetence, fraud and abuse of office by the agents running the corporations. This further encourages the effective disclosure of information allowing investors to analyze financial markets and make informed decisions (Mwangi, 2009). Hendrikse (2004) states that the corporate failures witnessed recently confirmed that many directors put their own interests before those of the company and shareholders. In response the regulators have continuously spelt guidelines and regulations to ensure that there is prudential management in the organizations.

Most local studies have concentrated on profitability as a measure of financial performance and the effects of corporate governance to performance to various sectors of the economy. Other prior research on corporate governance in Kenya focused mainly on compliance with the principles of the best practices, and survey of the state of governance in various sector, Jebet (2001) documented the corporate governance structures in listed companies. A few studies among them Kaboyo (2013) and Irungu (2010) have looked at the factors motivating earnings management and the relationship between macro economic variables and earnings management for listed firms at the NSE. This study only concentrated on listed commercial banks in Kenya in the financial sector of the Nairobi Securities exchange. The study sought to answer the following research question: what is the effect of corporate governance practices on earnings management of commercial banks listed in Nairobi Securities Exchange?

1.3 Research Objective

To examine the effect of corporate governance practices on earnings management for the listed banks in Kenya

1.3.1 Specific Objectives

- i. To examine the effect board size on earnings management for the listed banks in Kenya
- ii. To find out the effect of board composition on earnings management for the listed banks in Kenya
- iii. To establish the effect of board meeting frequency on earnings management for the listed banks in Kenya

- iv. To establish the effect of executive compensation on earnings management for the listed banks in Kenya

1.4 Value of the Study

The study will have implications for regulators of financial markets. The study will help regulators of the banking industry to identify the crucial aspects of corporate governance structures that should be emphasized in the governance matrix. Given the many scams and financial fraud reported in many corporations and the vast sums of wealth of shareholders destroyed thereby, findings of the study should help regulators play their role effectively. The study will also be of benefit to management boards of listed and unlisted banks by giving guidelines on the key value aspects of corporate governance practices by helping them play their oversight role. The results of the study will further serve as a point of departure for further investigations in governance structures and systems for academics and researches in general. This study will be an eye opener in research in developing markets.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviews the theories of Corporate Governance and Earnings management. The empirical evidence on the relationship between corporate governance and earnings management of a firm is outlined. Empirical review focuses on the existing studies done by other scholars and researchers and provides some basic knowledge of the research topic.

2.2 Theoretical Review

This review will give an overview of theories of Corporate Governance and Earnings management. These theories are Agency Theory, Stewardship Theory, Stakeholder Theory and the Big Bath Theory which are reviewed as below;

2.2.1 Agency Theory

Intellectual foundation for agency theory development was in the work of Coase along with Alchian and Demsetz (1972). Incentive for agency theory development was relationship between ownership and control function within large corporations. Pioneers, Jensen and Meckling, tried to verify that corporations do not operate according to the maximization principle, mainly because of the conflicting interests of major governing parties (Jensen & Meckling, 1976). Agency theory (also known as contracting cost theory) is forecasted on the doctrine that individual agents choose actions that maximize their personal utility. In the modern corporation, there is a partition between the individuals making decisions that we

refer to as managers and people bearing the wealth consequences of those decisions who are regarded as shareholders (David. et al, 1999).

Agency Theory forecast about managerial functions and corporate diversification strategies. If managers obtain private benefits from broader horizons that exceed their private costs, agency theory forecast that managers will still maintain a diversification plan even if doing so decreases shareholders wealth (David. et al, 1999). Agency Theory which is the contract between the owners of financial resources (the principals) and managers (the agents) who are mandated with using and controlling that wealth is based on the reality that agents have more information than principals and that this information asymmetry adversely affects the principals' ability to monitor effectively whether their interests are being properly served by agents (Michael, 1994). Adverse selection may occur when the principal / owner(s) does not have access to all available information at the time a decision is made by a manager and is thus unable to determine whether managers' actions are in the best interest of the firm (Scapens, 1985).

Agency Theory is also based on hypothesis that principals and agents act rationally and that they will use the contracting route to maximize their wealth (Michael, 1994). This means that because agents have self-seeking motives, they are likely to take the opportunity to act against the interests of the owners of the firm for example partaking unwarranted high perquisite consumption. Scapens (1985) refers to this dilemma as the "moral hazard" problem. An inclusive theory about agency theory by Jensen and Meckling (1976) indicated that the principals who are the company owners can comfort themselves that the agent will make the most favorable decisions only if appropriate incentives and rewards are given and

only if the agent is watched. Incentives involves things like stock options, bonuses and many other benefits which are related with how fine the results of management's decisions serve the interests of shareholders.

Scapens (1985) argues that a state of efficiency, or "pareto-optimality" exists in the contracting relationship between principal / owners and agent / managers when neither party can enhance their wealth at the pareto-optimality in the contracting process, then both the principals and agents must incur contracting expenses such as monitoring expenditure incurred by the principal to subject financial statements to external audit scrutiny and also undertake regular checks of management perquisites and inserting limits on management decisions. Agents on the other hand incur bonding costs such as the cost of internal audit, in order to signal to principal / owners that they are acting responsibly and in a manner consistent with their contract of employment. Such action also helps managers to secure their positions in the firm and protect their salaries (Rutto, 2011).

The essential concern of corporate governance also arises from the separation of ownership and control in modern organizations. This is the essence of the agency problem, as articulated by early scholars like Berle and Means (1932) and Jensen and Meckling (1976). It's in this context that responsibility for control is vested in the board and management, the shareholders' agents. The board meet a few times each year but in turn appoints management (as their agents) headed by the chief executive officer to manage the organization.

2.2.2 Stewardship Theory

Stewardship theory is an alternative view of agency theory, whereby managers, left on their own, will indeed act as responsible stewards of the assets they control. It stresses the

beneficial consequences on shareholder returns if facilitative authority structures which unify command are put in place by having roles of CEO and chair held by the same person (Davis & Donaldson, 1997). Stewardship theory does not put the manager under control of owners, it empowers managers to take autonomous executive action. As the name suggests, a steward is one who protects and maximizes shareholders wealth through firm performance, because by so doing, the steward's utility functions are maximized (Davis & Donaldson, 1997).

Stewardship theory suggests the potential for what it calls the 'pro-organizational' motives of directors. What drives performance here is not the aligned greed of an executive but their personal identification with the aims and purposes of the organisation (Davis & Donaldson, 1997). Stewardship theory refutes the assumption that executive aims and motives are opposed to those of the shareholder; both, it insists, have an interest in maximising the long-term stewardship of a company and are therefore already well aligned. From this stewardship theory suggests the potentially negative impact of a division of responsibilities between a chairman and chief executive. The roles, it suggests, should remain combined in order to protect a key aspect of high performance; the strength and authority of executive leadership.

2.2.3 Stakeholder Theory

Stakeholder theory is a theory of organizational management and business ethics that addresses morals and values in managing an organization. It was originally detailed by Edward (1984); and identifies and models the groups which are stakeholders of a corporation, and both describes and recommends methods by which management can give due regard to the interests of those groups.

The stakeholder theory takes account of a wider group of constituents rather than focusing on shareholders. A consequence of focusing on shareholders is maintenance of shareholder wealth as paramount, whereas when a wider stakeholders group such as employees, providers of credit, customers, suppliers, government and local authority is taken into account the overriding focus on shareholder value becomes less evident. This means that the shareholders have vested interest in trying to ensure that the resources are used to maximum effort which in turn should be to benefit the society as a whole (Madiavale, 2011).

According to Jensen (2001), the proponents of the stakeholders' theory decline to specify how to make the necessary trade off among these competing interests, leaving managers with a theory that makes it impossible for them to make purposeful decisions. Jensen (2001) therefore advocates enlightened value maximization which he says is identical to enlightened stakeholder theory. He states that "enlightened value maximization utilizes much of the structure of stakeholder theory but accepts maximization of the long run value of the firm as the criterion for making prerequisite tradeoffs among its stakeholders and therefore solves the problems that arise from multiple objectives that accompany the traditional stakeholder theory".

2.2.4 The Big Bath Theory

The big bath theory of earnings Management suggests that firms experiencing low earnings in a given year may take discretionary write downs to reduce even further the current period's earnings. The notion is that companies and their management may not be punished proportionately more for the big hit, if it takes to its already depressed earnings. This "clearing of the decks" makes it easier to generate higher profit in the later years (Dye,

1986). Good corporate governance practices have the implication of monitoring management's desire to deliberately overstate a company's losses in a given year so as to absorb itself from foreseeable losses in subsequent years.

Dye (1986) notes that management has two primary reasons to manage or manipulate earnings. One is an external demand to meet earnings forecasts and increase share price; the other represents an internal demand relating to optimal contracting. Earnings allow managers to communicate with their principles (e.g. BODs) concerning the level of their performances. Regarding the external demand to meet their earnings forecast, Chenheiter and Melumad (2002) note that, *ceteris paribus*, investors presume a higher level of permanent cash flow from a higher level of reported earnings. Since increasing cash flow translates into higher share price and earnings are perceived to be a surrogate of cash flow, higher earnings increase the value of the firm.

Henry and Schmitt (2001) noted that a company will take a large non-recurring loss one year, typically when the profit are already depressed, so that future earnings are not burdened. The result is either increased future earning or reduced variability of future earnings. The notion is that, when things are already bad (i.e. depressed earnings), making them worse by clearing out rubbish does little harm to the company's or management's reputation. The market punishes a firm relatively the same whether it misses its earnings mark by a modest or by plenty.

Although the big bath theory has been espoused in the accounting literature for years, little empirical testing of its presence exist. A few studies examined big bath charges on the periphery or as an aside to their main topic of earnings management in general. For example

Cameron and Stephens (1991) while examining the impact of non-recurring items on the predictive ability or variability of earnings, found that these items are not used to smooth earnings but instead appear to be used more consistently with the big bath theory. Bauman et.al (2001) examined earnings management in relation to the discretionary adjustment associated with the valuation allowance for differed tax asset and found virtually no evidence in support of earnings management. Debt-holders have an incentive to monitor managerial performance to assess the risk of the firm (Legoria et al., 1999).

2.3 Determinants of Earnings Management for Listed Commercial Banks

Healy and Wahlen (1999) give four main determinants for earnings management for listed commercial Banks as: corporate governance structures, capital market expectation and valuation, contracts written in terms of accounting numbers and antitrust or other governmental regulation. Capital market expectation and valuation, is about the influence of earnings on the stock price. Managers can increase earnings, in order to increase the stock price, for example to meet analysts' expectations (Burgstahler and Eames, 1998). This can be important for the managers, since they will be held responsible for the results of a company. They therefore will think it is important to meet analysts' expectations, in order to avoid disappointed investors.

According to Healy and Wahlen (1999), the contracts written in terms of accounting numbers, has to do with all the contracting agreements a company has. In order to align the interests of managers and stakeholders, a lot of contracts are in place. According to Watts and Zimmerman (1978) these contracts give rise to an increase in possibilities for earnings management. An example is that companies that are close to lending contracts manage

earnings. Banks for example increase the interest rate when the risk of their client becomes higher. This can be a reason to manage earnings by presenting a better result in order to avoid an interest increase resulting in higher costs. Another, maybe more familiar example is management compensation contracts (Healy and Wahlen 1999). When the compensation of a manager depends on the results of the company, there will be an incentive to manage the earnings in a positive way. The reason for this is that the manager will receive a personal benefit as a result of the numbers presented.

The antitrust or other governmental regulation, has to do with eventual intervention of the government or another institution, for example when industrial regulations are violated. This is also known as the political cost theory (Deegan and Unerman 2006). In order to avoid such intervention, management tries to manage earnings in such a way that the intervention is not needed. An example of this situation can be that a bank which is close to a minimum capital requirement recognizes abnormal gains, which will lead to a better capital position (Healy and Wahlen 1999). But also the government or lobby groups can put pressure on a company. According to Deegan and Unerman (2006) especially large companies have to deal with such political costs, since they attract more attention as they are more visible than small companies.

2.3.1 Corporate Governance Structures

The following are the corporate governance structures; board size, board composition, board meeting frequency and executive compensation.

In regard to board size, Jensen (1993) argues that smaller boards perform their monitoring and controlling roles better than larger boards, which the CEO can more easily influence.

Beasley (1996), reports that board size is positively related to the incidence of financial statement fraud. Some studies find that smaller boards are better able to monitor managers' actions (Jensen, 1993; Ching *et al.*, 2006), whereas others find that larger boards are in a superior position to monitor managers' actions (Peasnell *et al.*, 2005).

Studies such as Davila and Watkins (2009) in Mexico and Ferraz et al. (2011) in Brazil, find that if the size of the Board is very small, the monitoring of the management team is smaller too, so they tend towards greater discretion in receiving higher remuneration, a greater chance of EM and are more prone to information asymmetry (Fernandez 1998; Azofra et al. 2005; Brick et al. 2006). Thus, a larger size of Board assumes a better supervision of the management team and a higher quality of corporate decisions (Pearce and Zahra, 1992).

In reference to board composition Fama (1980) argued that for the board to play its oversight role of effective monitoring, it should be composed of majority of outside directors. He argued that outside directors will exhibit considerable independence from top management. Mace (1971) reported that poor proposals or performance will be opposed by outside directors. Weishach (1998) found out that outside dominated boards are significantly likely to respond to poor performance by dismissing the chief executive officer. Weisbach and Hermalin (1998) found that outsiders are more likely to join the board after the firms performs poorly or leaves an industry, reflecting the need to inject new blood to procure expertise in the new industry. Both Coughlan and Schmidt (1995) and Warner , Watts, and Wruck (1998) examine the extent to which board discipline managers found out that poor firm performance increases the likelihood of change in top management team. However, the

relationship between firm performance and CEO turnover has been found to be fairly weak (Jensen and Murphy, 1990; Hermalin and Weisbach, 1998).

In the Jebet (2001), he carried out a research on how the corporate governance structures affect the firm performance (listed). Board composition was noted to be a quality/ fixation of firm performance. He sampled the various listed companies in the Nairobi securities Exchange and found that the firms with high number of outside directors performed well as compared to those with less representation from outside directors. This study seeks to verify if the bank's earning management factor is related to corporate governance practices.

Jensen (1993), while referring to board meeting frequency argues that boards of well run companies should be relatively inactive and exhibit few conflicts. Frequently scheduled meeting generate opportunity costs in the form of management time consumed, and cash costs in form of traveling allowances and sitting allowance fee for the board members. Mululu (2005) shows that board increase the frequency of their meeting following poor performance and consequence of such increase the performance of firm improves as captured by the increase in firm value giving support to Jensen (1993) and Vafeas (1999) that the role boards becomes increasingly important during crises, when share holders' interest are in visible danger. However, the association between meeting frequency and firm value remains unclear, and the linkage between the board activity and monitoring difficult to establish.

Some studies find the negative relationship between meeting frequency and the occurrence fraudulent financial reporting (Abbott et al (2000), Beasley et al (2000)). Some other studies, such as Abbott and Parker (2000), link the meeting numbers with higher audit quality. In

conclusion, a plenty of empirical results support the assertion that the meeting frequency of audit committee is positively associated with financial reporting quality.

Executive compensation involves directors receiving a fixed annual fee for their services or incentives. Incentive contracts can take a variety of forms, including share ownership, stock options, or a threat of dismissal if income is low (Fama, 1980). The optimal incentive contract is determined by manager's risk aversion, the importance of his decisions, and his ability to pay the cash flow ownership upfront (Stiglitz, 1975; Homstrom, 1982). However, they may also receive other forms of remuneration or reward from the company. One remuneration form which might hurt the independence of non-executive directors is stock option. When the directors are rewarded by large blocks of stock option, the temptation for them is to focus on ensuring that company price is as high as possible when the time comes for exercising the options.

Jensen and Murphy (1990) arrived at a striking number that executive pay rise by about \$3 per every \$1000 change in the wealth of shareholders. Kaplan (1994) showed that the sensitivity of pay (and dismissal) to performance is similar to all companies in the united state. Several studies have identified a positive relationship between executive pay and firm performance. Evans and Stormback (1994), and Izan, Sidhu, and Taylor (1998) both supported a positive pay –performance relationship. If the earning figure does not come out “right”, and managers have to adjust it, the directors may not have incentives to prevent this practice. Therefore, Cadbury report recommends non-executive directors should not participate in share option schemes since the independence of non-executive directors might be undesirably (Cadbury Committee, 1992).

2.3.2 Leverage

One can also obtain evidence from the literature that studies the effects of leverage on firms' behavior. Leverage has long been proposed as an efficient way to limit managerial discretion Jensen (2001). Empirically, one sees that more highly leveraged firms charge higher prices and respond more quickly and more strongly to shocks: Chevalier and Scharfstein (1996). Kovenock & Phillips (1997) confirm the results in Kaplan (1989) that firms decrease their investment and show that this effect is stronger in highly concentrated industries.

Prior research is consistent with the control hypothesis prediction that leverage increases reduce opportunistic behavior of managers. Beatty and Weber (2003) suggests that leveraged firms engage in Earnings Management to avoid debt covenant default. Nevertheless, Jelinek (2007) studies the effect of leverage increase on accrual earnings management and concludes that increased leverage is associated with reduced accrual Earnings Management.

Ujah and Brusa (2011) find that both financial leverage and cash flow volatility impact the degrees to which firms manage their earnings. That business cycle and not bond or debt ratings affect firm's earnings management. Furthermore, they find that depending of what economic group or industry a firm belongs to, their degree and extent of managed earnings varies, where consumer staples and cyclical is the most manipulated industry and transportation and utilities industries are the least manipulated.

Leverage increases constrain the opportunistic behavior of managers due to following reasons: Required debt repayments decrease the amount of cash available to managers for

investing in non-value increasing projects. When a firm is highly leveraged, it has to face the strict scrutiny of lenders and its spending are often restricted due to scrutiny of lenders.

2.3.3 Size

The firm size may have a positive impact on earnings management. First, the size of a firm is related to the internal control system. Larger companies may have more sophisticated internal control systems and have more competent internal auditors as compared to smaller companies. An efficient internal control system helps control inaccurate disclosure of financial information to the public. Another important factor in mitigating earnings management and improving the quality of financial reporting is corporate governance (Warfield, et al., 2005).

Beasley, et al (2000) report that deceitful companies in technology, health-care, and financial services have less internal audit support and are accompanied by weak corporate governance mechanisms. Therefore, larger firms are more likely to design and maintain more sophisticated and effective internal control systems in comparison to smaller firms, reducing the likelihood of manipulating earnings by management.

Second, large firms are usually audited by auditors from big 5 CPA firms. Large CPA firms tend to have more experienced auditors that in turn could help prevent earnings misrepresentation. Gore, et al. (2001) report that non-big 5 auditors allow more earnings management than big 5 auditors. Francis, et al. (1999) document quality differentiation in controlling aggressive and opportunistic earnings management among international big 6 accounting firms, national firms, and local firms. Specifically, the big 6 audited firms tend to

report lower levels of discretionary accruals even though they have high level of accruals, indicating that big 6 auditors mitigate earnings management.

In addition, firms audited by big 5 also report lower levels of discretionary accruals (Payne and Robb, 2000). Lennox (1999) also finds that the audit reports issued by large auditors are more accurate and more informative; exhibiting that auditor size is positively related to audit accuracy. Heninger (2001) documents a positive association between risk of audit litigation and abnormal accruals. These studies show that large firms are more advantageous than small firms in terms of receiving better audit services from established auditing firms due to larger operating budgets.

2.4 Empirical Review

Numerous studies have looked at the implications of corporate governance structures on firm earning management. These previous papers not only confirm that the board of directors does affect firm performance, but also find some characteristics of the board are related to the effectiveness of the board, especially in monitoring top managers. These characteristics are the size of the board, the composition, frequency of meeting and compensation. Firms which implement sound corporate governance systems provide more useful information to investors and its stakeholders to reduce information asymmetry as well as to help the company improve its operations (Hsiang-tsai Chiang et al., 2005).

Previous empirical studies mainly focused on the effect of insider ownership on the Earnings Management. Dhaliwal et al (2002) investigated whether firms use income tax accruals as an earnings management tool when free pretax earnings fall short of market earning expectations. They found that as the difference between analyst forecasts and pre-managed

earnings increases, fourths quarter effective tax rates decrease relative to third quarter effective tax rate. This finding is consistent with earnings management using total income tax expense. Chen, et al (2004) showed that the effect of good corporate governance on expected returns is more profound for firms with higher free cash flows but poor investment opportunities and for firms with lower insider ownership, consistent with agency costs of free cash flows as proposed by Jensen and Mecling (1976).

Leuz et al. (2003) examined using descriptive statistics systematic differences in earnings management across 31 countries. They proposed an explanation for these differences based on the notion that insiders, in an attempt to protect their private control benefits, use earnings management to conceal firm performance from outsiders. Therefore, earnings management was expected to decrease investor protection because strong protection limits insiders' ability to acquire private control benefits, which reduces their incentives to mask firm performance.

Abdullah and Norman (2010) sort to examine the effect of board structure, ownership structure, adviser structure and capital structure on discretionary current accruals – a proxy for earnings management for a sample of size-controlled rights issuers. Rights issues are basically chosen as a context in which firms have particular incentives to manage earnings. The results suggested that firms with higher debt to equity ratios, with lower proportions of non-executive directors, or with no large block owner are more likely to use discretionary current accruals to manipulate earnings around rights issue.

Aduda, Chogii & Magutu (2013) investigated the importance of the board composition variables of proportion of non executive directors, proportion of executive directors, size of the board, and the role of CEO duality on firm performance for actively trading companies at

the NSE between 2004 to 2007 in Kenya. Regression analysis and Tobin Q ratio were applied on the secondary data. The findings of the study were that overall regression models for the firm performance for both the Return on assets and Tobin Q ratio were significant.

Muchoki (2013) investigated the relationship between corporate governance practices and earnings management for companies quoted at the Nairobi securities exchange. The study found that a unit increase in ownership concentration will cause a decrease in earnings management, further a unit increase in board size will lead to a decrease in earnings management, a unit increase in board independence will lead to a decrease in earnings management, a unit increase in board activity will lead to an increase in earnings management and a unit increase in CEO duality will further lead to an increase in earnings management.

Otieno (2011) investigated the relationship between corporate governance practices and financial performance of local airlines in Kenya the study found that there is a significant relationship between corporate governance practices and financial performance of airlines. And airlines with strong corporate governance practices also have better financial performance, with a degree of variation on return on assets at 81.4%.

Kiambati (2009) investigated the influence of corporate governance practices on financial performance of commercial banks in Kenya. The finding of the study revealed that board complexity positively influences the financial performance of commercial banks. Also, 38.3379% of the corresponding change in financial performance of commercial banks can be explained by a unit change in board complexity.

Wasike (2012) investigated the corporate governance practices and performance at Elimu SACCO in Kenya. The finding of the study revealed that the size of the board had an impact on the quality of corporate governance and a large board could be dysfunctional and that smaller board sizes are better than larger ones because large boards since they may be plagued with free rider and monitoring problems. Further, it was indicated that larger boards are found to be slow in decision making because the monitoring expenses and poor communication in a larger board give a reason for the support of small board.

2.5 Summary of Literature Review

The above outcomes of various empirical studies signify that corporate governance may play a role other than enhancing firm performance. Agency theory suggests a direct relation between effective monitoring of management and reduced costs of dysfunctional behaviour, rather than a direct increase of performance (Jensen and Meckling, 1976). Hence, corporate governance may act as an assurance to shareholders on the reliability of information provided by managers. Most studies that have corporate governance attributes to be significant have focused on its role in reducing agency costs and aligning managers' interests with the shareholders'.

Corporate governance's primary objective is not to directly improve corporate performance, but to resolve agency problems by aligning management's interests with the interests of shareholders (Maher and Andersson, 2000). Gaps in literature include lack of clear empirical literature on earnings management on commercial banks listed at the N.S.E in Kenya. This study therefore seeks to provide literature on corporate governance practices affecting earnings management in Kenyan commercial banks.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the research design, the description of the study population, the sampling procedures, data collection procedures, data collection instrument, data analysis and the limitation of the study.

3.2 Research Design

This study adopted a descriptive research design. According to Mugenda and Mugenda (2003) Descriptive research or study is one in which information is collected without changing the environment sometimes referred to as “correlational” or “observational” studies. Descriptive study was preferred for this study because it demonstrated associations or relationships between corporate governance practices and earnings management.

3.3 Population

Target population in statistics is the specific population about which information is desired. According to Mugenda & Mugenda (2003), a population is a well-defined set of people, services, elements, and events, group of things or households that are being investigated. The target population consisted of the 11 commercial banks listed at NSE as at 2013. The study adopted a census study approach due to the small population selected (Appendix I).

3.4 Data Collection

Secondary data was obtained by abstraction method from corporate governance statements and financial statements for the 11 commercial banks covered as they had been published by

NSE. The data to be collected from the published results of the selected companies included the number of directors, number of meetings held in each study year, major shareholders' composition, proposition of executive and non executive directors in the board, CEO duality status and financial data including debt amounts, current assets and current liabilities, depreciation and cash equivalents. The data collected from the published results covered the results for the last five years (2009-2013).

3.5 Data Analysis

Descriptive analysis was used (means scores and percentages) to analyze the extent of board independence. The data collected was analyzed using linear regression and correlation analysis to test the relationship between the dependent variable Discretionary Accruals as an earnings management tool and specific corporate governance variables assumed to fit the NSE. The regression results were interpreted based on the Pearson correlation, R-squared, adjusted R-squared, Test of significance using F statistic through the Analysis of Variance (ANOVA), coefficients of the independent variables and their p-values.

3.5.1 Conceptual Model

The relationship among the variables was estimated using a function:

$$\mathbf{EM} = \mathbf{f}(\mathbf{GP})\dots\dots\dots (1)$$

EM = Earning management

GP= governance practices (structures)

3.5.2 Empirical Model

The Regression equation was modeled as follows;

$$E.M = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \varepsilon$$

Where-:

E.M is the discretionary accrual variable representing Earnings Management.

The measure of discretionary accrual (Earnings Management tool) used was based on Dechow et.al (1995), who computed accrual component of earning as follows-:

ACCRUAL = ($\Delta CA - \Delta Cash$) - ($\Delta CL - \Delta STD - \Delta TP$) - DEP. Where-; ΔCA = Change in Current Assets. $\Delta Cash$ = Change in Cash/ Cash equivalents. ΔCL = Change in Current Liabilities. ΔSTD = Change in Short-Term Debts included in Current Liabilities. ΔTP = Change in Income Taxes Payables DEP = Depreciation and Amortization Expense.

α represents the coefficient for each variable.

X_1 : Board Size is measured by the total number of directors in the board.

X_2 : Board composition is measured by the proportion of non executive directors inside the board (non executive directors / total directors).

X_3 : Board meeting frequency is measured by number of board meetings held during the year.

X_4 : Executive compensation over time (t in years) was determined from the financial statements of the banks

ε : Standard Error term.

X_5 and X_6 = Control variables were leverage (L) and (S) size

X_5 (L) = Ratio of total debt to total assets

X_6 (S) = Size, defined as the natural log (Ln) of Total assets

The Statistical Package for Social Sciences (SPSS) 17th version aided in the analysis.

3.5.3 Test of Significance

Results are said to be statistically significant within the 0.05 level, which means that the significance value must be smaller than 0.05. The significance was determined by the t-value, which indicates how many standard error means the sample diverges from the tested value.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents data analysis and interpretation. The objective of the study was to examine the effect of corporate governance practices on earnings management for the listed banks in Kenya. Data was collected from a sample of 11 commercial banks listed at NSE as at 2013. The data sources included corporate governance statements and financial statements for the 11 commercial banks covered as they had been published by NSE.

4.2 Descriptive Statistics

Table 4.1 Descriptive Statistics

Year	Earnings Management		Total number of directors in the board		Non executive directors ratio		number of board meetings		Executive compensation (000)		Ratio of total debt to total assets		Size	
	Mean	Std. Dev	Mean	Std. Dev	Mean	Std. Dev.	Mean	Std. Dev.	Mean	Std. Dev.	Mean	Std. Dev	Mean	Std. Dev
'09	0.238	0.264	8	2.442	2	1.440	5.273	5.273	2217.6	1689.7	0.53	0.05	11.88	0.19
010	0.115	0.025	10	2.914	3	1.421	5.000	5.000	2439.4	1858.7	0.55	0.04	11.97	0.19
011	0.143	0.030	9	2.714	3	1.362	4.818	4.818	2683.3	2044.6	0.55	0.08	12.04	0.19
012	0.226	0.029	9	2.063	4	1.635	5.091	5.091	3220.0	2453.5	0.56	0.06	12.14	0.19
013	0.151	0.036	10	3.228	3	1.578	6.182	6.182	2015.6	1536.5	0.60	0.03	12.07	0.19

Source: Research Findings

The findings in table 4.1 above illustrate that Earnings Management for the 11 commercial banks listed at NSE, as extracted from the corporate governance statements and financial statements reflects variations over the 5 year period; 0.238 in 2009, 0.115 in 2010, 0.143 in 2011, 0.226 in 2012 and finally 0.151 in 2013. It is also evident from the standard deviation that there exists a low variation in Earnings Management in the different commercial banks listed at NSE. As per the findings, Board Size, measured by the Total number of directors in the board for the 11 commercial banks listed at NSE, as extracted from the corporate governance statements and financial statements reflects an upward increase over the 5 year period except 2011, with the highest being 10 in 2010 and 2013. Moreover, the standard deviation shows a variation in Total number of directors in the different commercial banks listed at NSE.

According to the findings, Board composition, measured by the proportion of non executive directors inside the board for the 11 commercial banks listed at NSE, as extracted from the corporate governance statements and financial statements reflects an upward increase over the 5 year period except 2013, with the highest being 4 in 2012. In addition, the standard deviation depicts a variation in the proportion of non executive directors inside the board in the different commercial banks listed at NSE.

The findings further depict, Board meeting frequency, measured by number of board meetings held during the year for the 11 sampled commercial banks listed at NSE steadily declined from 5.273 to 4.818 between 2009 and 2011, this was followed by an increase to 5.091 and 6.182 in 2012 and 2013 respectively. It is also evident from the standard deviation

that there exists a low variation in Board meeting frequency in the different commercial banks listed at NSE.

Based the annual averages of the 11 companies, it is clear that Executive compensation over time (t in years) increased over the five year period except in 2013. The highest was in 2012 at 3220, In addition, the standard deviation depict a variation in Executive compensation amounts in different commercial banks listed at NSE. From the findings, Ratio of total debt to total assets for the 11 commercial banks listed at NSE, as extracted from the corporate governance statements and financial statements reflects an upward increase over the 5 year period except 2011, with the highest being 0.600 in 2013. In addition, the standard deviation depicts a low variation in the proportion of Ratio of total debt to total assets in the different commercial banks listed at NSE.

A review of the findings of Size for the 11 commercial banks listed at NSE, as extracted from the corporate governance statements and financial statements reflects an upward increase over the 5 year period except 2013, with the highest being 12.149 in 2012. In addition, the standard deviation depicts a low variation in Size in the different commercial banks listed at NSE.

4.3 Inferential Statistics

Inferential statistics is concerned with making predictions or inferences about a population from observations and analyses of a sample. The tests of significance involved provide the probability that the results of the analysis could have occurred by chance when there is no relationship at all between the variables studied in the population. The study applied correlation and regression analyses.

4.3.1 Correlation Analysis

To quantify the strength of the relationship between the variables, the study used Karl Pearson's coefficient of correlation. The Pearson product-moment correlation coefficient (or Pearson correlation coefficient for short) is a measure of the strength of a linear association between two variables and is denoted by r . The Pearson correlation coefficient, r , can take a range of values from +1 less than 0 indicates a negative association, that is, as the value of one variable increases the value of the other variable decreases.

The Pearson's coefficient was used to verify the existence or non-existence to -1. A value of 0 indicates that there is no association between the two variables. A value greater than 0 indicates a positive association, that is, as the value of one variable increases so does the value of the other variable. A value of linear correlation between and among the net assets value variables. The findings are presented as follows;

Table 4.2: Correlation Matrix Table Without the Control Variables

		Board size	Board composition	Board meeting frequency
Board size	Pearson Correlation	1	.937**	.039
	Sig. (2-tailed)		.000	.908
	N	11	11	11
Board composition	Pearson Correlation	.937**	1	.064
	Sig. (2-tailed)	.000		.852
	N	11	11	11
Board meeting frequency	Pearson Correlation	.039	.064	1
	Sig. (2-tailed)	.908	.852	
	N	11	11	11
Executive compensation	Pearson Correlation	.456	.730	1
	Sig. (2-tailed)	.011	.000	
	N	11	11	11
		.456	.730	
		.011	.000	

Source: Research Findings

From the findings, it was clear that there was positive correlation between the variables Total number of directors in the board and non executive directors / total directors (0.937); between non executive directors / total directors and number of board meetings (0.064); number of board meetings and Total number of directors in the board (0.039); between Executive compensation and number of board meetings (0.064); number of board meetings and Total number of directors in the board (0.456) as well as Executive compensation and non executive directors / total directors (0.730). However, there is little evidence of multicollinearity among the explanatory variables since the correlations among them are not

very strong hence all the variables can be incorporated into the subsequent regression analysis.

4.3.2 Regression Analysis

Regression analysis is the statistical technique that identifies the relationship between two or more quantitative variables: a dependent variable, whose value is to be predicted, and an independent or explanatory variable (or variables), about which knowledge is available. The technique is used to find the equation that represents the relationship between the variables. Multiple regressions provide an equation that predicts one variable from two or more independent variables.

Regression analysis is used to understand the statistical dependence of one variable on other variables. The technique can show what proportion of variance between variables is due to the dependent variable, and what proportion is due to the independent variables. The relation between the variables can be illustrated graphically, or more usually using an equation. The study adopted multiple regression guided by the following model:

$$E.M = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \varepsilon$$

Table 4.3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.903 ^a	.815	.629	.186

a. Predictors: (Constant), Size, Ratio of total debt to total assets, Executive compensation, non executive directors / total directors, number of board meetings, Total number of directors in the board

Source: Research Findings

In this case, the coefficient of determination (the percentage variation in the dependent variable being explained by the changes in the independent variables) R² equals 0.815, that is, Size, Ratio of total debt to total assets, non executive directors / total directors, number of board meetings, Total number of directors in the board explain 81.5 percent of the variance in earnings management amounts.

Table 4.4: ANOVA^b

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	.011	5	.002	4.395	.014 ^a
Residual	.002	5	.000		
Total	.013	10			

a. Dependent Variable: earnings management

b. Predictors: (Constant), Size, Ratio of total debt to total assets, executive compensation, non executive directors / total directors, number of board meetings, Total number of directors in the board

Source: Research Findings

In this case, the significance value of the F statistic is 0.014 indicating that all the predictor variables (Size, Ratio of total debt to total assets, non executive directors / total directors, number of board meetings, Total number of directors in the board) explain a variation in earnings management and that the overall model is significant.

Table 4.5 Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.676	.229		.670	.014
	Board Size	-.006	.008	-.531	-.787	.467
	Board composition	.012	.015	.521	.801	.460
	Board meeting frequency	-.002	.004	-.166	-.591	.580
	Executive compensation	.449	0.389	-.156	4.491	.000
	Leverage	-.499	.299	-.430	-1.671	.156
	Size	-.180	.054	-.983	-3.348	.020
a. Dependent Variable: earnings management						

Source: Research Findings

Table 4.5 presents results of the multivariate regression of corporate governance practices on earnings management. The coefficient table above was used in coming up with the model below:

$$Y = 0.676 - .006X_1 + .012 X_2 - .002 X_3 - .499X_4 - .499X_5 - .180X_6$$

where Y= Earning management

X₁ : Board Size

X₂ : Board composition

X₃ : Board meeting frequency

X₄: Executive compensation over time (t in years)

X₅= Ratio of total debt to total assets

X₆ = Size

From the finding in the above table the study found that holding size, Ratio of total debt to total assets, executive compensation, non executive directors / total directors, number of board meetings, Total number of directors in the board constant earnings management will be 0.676, the study also found that a unit increase in Total number of directors in the board will cause a .006 decrease in earnings management, further it was established by the study that a unit increase in non executive directors / total directors will lead to an increase in earnings management by 0.012, it was also found that a unit increase in number of board meetings will lead to an decrease in earnings management by a factor of 0.002, it was further found by the study that a unit increase in Executive compensation will lead to an increase in earnings management by a factor of 0.449, a unit increase in Ratio of total debt to total assets will further lead to a decrease in earnings management by a factor of 0.499 and a unit increase in Size will further lead to a decrease in earnings management by a factor of 0.180.

4.4 Interpretation of the Findings

The study found that holding Size, Ratio of total debt to total assets, executive compensation, non executive directors / total directors, number of board meetings, Total number of directors in the board constant Earnings Management would be 0.676.

The study also found that a unit increase in Total number of directors in the board will cause a 0.006 decrease in earnings management. These findings support the argument presented by Zahra and Pearce (1989) that larger boards are more capable than smaller boards of

monitoring the actions of management. Hence, smaller boards may be more likely to be “captured” by top managers or controlled by major institutional investors and block holders, with the result that monitoring by the independent directors is weakened.

Further it was established by the study that a unit increase in non executive directors / total directors will lead to an increase in earnings management by 0.012. This finding is in line with the previous findings of Klein (2002b), Xie et al. (2003), Peasnell et al. (2005), Davidson et al. (2005), Benkel et al. (2006), Dimitropoulos and Asteriou (2010) and Lo, et al. (2010) that boards with a high proportion of non executive directors are negatively related to earnings management.

It was also found that a unit increase in number of board meetings will lead to a decrease in earnings management by a factor of 0.002. This suggestion is supported by Lorsch and MacIver’s (1989) survey of US firms’ boards in the 1980s that presents evidence that the frequency of board meetings increases in times of crises and major challenges. Vafeas’ (1999) empirical study of US boards in the early 1990s also suggests that one way in which boards react to poor performance and challenging business circumstances is by increasing the number of board meetings; the study provides evidence that the frequency of board meetings increase following financial distress.

It was further found by the study that a unit increase in Executive compensation will lead to an increase in earnings management by a factor of 0.449. This result provides modest support for the findings of Adams and Ferreira (2004) who use a large panel data set on directors’ attendance at board meetings in publicly-listed firms for the period from 1996 to 2003. They provide robust evidence that directors are less likely to have attendance problems at board

meetings when board meeting fees are higher. They suggest that directors appear to perform their monitoring roles for even very small financial rewards.

A unit increase in Ratio of total debt to total assets will further lead to a decrease in earnings management by a factor of 0.499. This result is consistent with Becker et al. (1998) who find that leverage is negatively associated with the absolute value of discretionary accruals. The negative relationship between leverage and discretionary accruals is consistent with a conservative accounting attitude that responds to debt holders' concerns in assessing potential loans, or in monitoring borrowers' ability to pay back existing loans (Watts, 2003). Even though firms close to violating debt constraints have incentives to manage earnings upward to meet debt covenants, their opportunities to manage earnings may be more limited.

A unit increase in Size will further lead to a decrease in earnings management by a factor of 0.180. This supports the argument of John and Senbet (1998) that an increase in board size increases the board's monitoring capacity. Large boards are likely to increase financial expertise and diversity on the board.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents summary of findings, conclusion and recommendations. The aim of the study was to examine the effect of corporate governance practices on earnings management for the listed banks in Kenya

5.2 Summary

The established that Earnings Management for the 11 commercial banks listed at NSE, varied over the 5 year period; 0.238 in 2009, 0.115 in 2010, 0.143 in 2011, 0.226 in 2012 and finally 0.151 in 2013. The study found out that, Board Size, measured by the Total number of directors in the board for the 11 commercial banks listed at NSE, increased upwards over the 5 year period except 2011, with the highest being 10 in 2010 and 2013.

The study further determined that, Board composition, measured by the proportion of non executive directors inside the board for the 11 commercial banks listed at NSE, increased upwards over the 5 year period except in 2013, with the highest being 4 in 2012. The study also found out that, Board meeting frequency, measured by number of board meetings held during the year for the 11 sampled commercial banks listed at NSE steadily declined from 5.273 to 4.818 between 2009 to 2011, this was followed by an increase to 5.091 and 6.182 in 2012 and 2013 respectively.

Based the annual averages of the 11 companies, the study established that Executive compensation over time (t in years) increased over the five year period except in 2013. The

highest was in 2012 at 3220. The Ratio of total debt to total assets for the 11 commercial banks listed at NSE, was found to reflect an upward increase over the 5 year period except 2011, with the highest being 0.600 in 2013. In addition, the Size for the 11 commercial banks listed at NSE, also reflected an upward increase over the 5 year period except 2013, with the highest being 12.149 in 2012.

The study revealed that there was positive correlation between the variables ;Total number of directors in the board and non executive directors / total directors (0.937); non executive directors / total directors and number of board meetings (0.064); number of board meetings and Total number of directors in the board (0.039); Executive compensation and number of board meetings (0.064); number of board meetings and Total number of directors in the board (0.456) as well as Executive compensation and non executive directors / total directors (0.730).

The study found out that, Size, Ratio of total debt to total assets, executive compensation, non executive directors / total directors, number of board meetings, Total number of directors in the board explain 81.5 percent of the variance in earnings management amounts. The study also established that; Size, Ratio of total debt to total assets, non executive directors / total directors, number of board meetings, Total number of directors in the board explain a variation in earnings management.

The study found that holding Size, Ratio of total debt to total assets, executive compensation, non executive directors / total directors, number of board meetings, Total number of directors in the board constant Earnings Management would be 2.676, the study also found that a unit increase in Total number of directors in the board will cause a .006 decrease in earnings

management, further it was established by the study that a unit increase in non executive directors / total directors will lead to an increase in earnings management by 0.012, it was also found that a unit increase in number of board meetings will lead to an decrease in earnings management by a factor of 0.002, it was further found by the study that a unit increase in Executive compensation will lead to an increase in earnings management by a factor of 0.449, a unit increase in Ratio of total debt to total assets will further lead to a decrease in earnings management by a factor of 0.499 and a unit increase in Size will further lead to a decrease in earnings management by a factor of 0.180.

5.3 Conclusion

In general, this study concludes that firms with effective corporate governance practices and undertake less earnings management. Although not all corporate governance variables support the stated hypotheses, the study has achieved its objective by identifying the attributes that answer the research question. This study, therefore, finds that agency theory offers a generally good explanation of the associations between both corporate governance practices with earnings management practice.

The study concludes an increase in non executive directors / total directors as well as Executive compensation is positively associated with earnings management. On the other hand, an increase in Total number of directors in the board, number of board meetings, Ratio of total debt to total assets and Size is negatively associated with earnings management.

5.4 Recommendations for Policy

Based on the findings, this study recommends that the number of non executive directors / total directors as well as Executive compensation be reduced in order to reduce the risk of

cases of earnings management. The study also recommends that the number of Total of directors in the board, board meetings, Ratio of total debt to total assets and Size be increased to enhance reduction in earnings management in the organizations.

This study's results provide evidence that a number of corporate governance attributes are significantly related to the incidence of earnings management. However, there are several areas that are not covered by this study but that could be relevant to corporate governance and the occurrence of earnings management.

Thus, one possible avenue for future research is testing additional corporate governance attributes that may influence earnings management. Examples for such additional attributes are the size of remuneration and nomination committees and the number of their meetings, whether the CEO sits on these committees, and attendance rates at meetings of the board and its sub-committees.

Another avenue for further research is to take the corporate governance attributes and external audit factors and investigate their effects on other aspects of earnings management, such as auditor opinion, accounting conservatism, restatements and fraud. It would also be interesting to investigate the effect of these factors on a firm's performance and audit quality.

5.5 Limitations of the Study

This study has several limitations. First, it is possible that the nature of data from the financial statements is impacting the results in an unanticipated manner or limits the power of the tests to detect associations. This may be created by variation of statistical figures illustrating the key variables measurements.

It is possible that the statements do not indicate governance practices. A control variable is a variable that is held constant in a research analysis. The use of control variables is generally done to check observed relationship between two variables if a direct one or indirect with intervening. The correlations among the variables may be causing unanticipated results despite the efforts at identifying potential multicollinearity problems.

The study area was limited to the 11 commercial banks only and this could affect the generalizations of the findings to other unlisted banks. While the purpose of the study was to find out the effect of corporate governance practices on earnings management for the listed banks in Kenya, the study does not attempt to explain why such a change might have occurred.

Finally, the use of secondary data provided an opportunity to search for a more genuine and intrinsic relationship between the variables. This afforded the researcher the benefits of a greater focus on analyzing the available data more closely in a way that would enhance the achievement of the study objectives. However, selecting the right combination of variables to proxy for unobservable phenomena is always a problem in empirical quantitative research.

5.6 Areas for Further Research

This study examined the effect of corporate governance practices on earnings management for the listed banks in Kenya. There is a need for further studies to carry out similar tests for a longer time period.

A similar study should also be carried out on all the banks in Kenya. In addition, more variables depicting corporate governance practices should be adopted to uphold the study's

findings that indeed firms with effective corporate governance practices and undertake less earnings management.

Also, this study only covers a period of five years from 2009 to 2013 because of dearth of data. Future studies could increase the scope and consider the effect of corporate governance practices on earnings management for the listed banks in Kenya period before 2009.

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APPENDIX

Appendix I: Letter of Introduction



UNIVERSITY OF NAIROBI FACULTY OF COMMERCE MBA PROGRAM – LOWER KABETE CAMPUS

Telephone: 4184160 Ext. 208
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P.O. Box 30197
Nairobi, Kenya

DATE.....

TO WHOM IT MAY CONCERN

The bearer of this letter ELIZABETH MWIHAKI WANGARU

Registration No: DCI/791020/2012

Is a Master of Business Administration (MBA) student of the University of Nairobi.

He/she is required to submit as part of his/her coursework assessment a research project report on a management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would, therefore, appreciate if you assist him/her by allowing him/her to collect data in your organization for the research.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you.

PARTRICK NYABUTO
MBA ADMINISTRATOR



Appendix II: Listed Commercial Banks in Kenya as at 31 Dec 2013

1. Barclays Bank of Kenya Limited
2. CFC Stanbic of Kenya Holding Limited
3. I&M Holdings Ltd
4. Diamond Trust Bank
5. Kenya Commercial Bank Limited
6. National Bank of Kenya
7. NIC Bank Limited
8. Standard Chartered Bank Limited
9. Equity Bank Limited
10. Co-op Bank of Kenya Limited
11. Housing Finance

(Source: Nairobi Securities Exchange website, 2013)

Appendix III: Data Collection Sheet

Total number of directors in the board				
2009	2010	2011	2012	2013
9	10	9	10	11
8	16	12	14	19
6	11	13	8	10
11	12	10	7	10
7	12	10	9	10
7	9	7	11	10
5	7	7	7	9
7	7	8	8	9
5	8	6	9	8
13	6	4	9	6
8	11	11	11	11
non executive directors / total directors				
2009	2010	2011	2012	2013
4	3	3	3	4
3	5	2	5	7
2	4	5	2	3
4	4	4	1	3
1	4	3	4	2
2	3	1	6	3
1	1	2	3	2
1	4	3	3	2
1	2	1	4	3
5	1	1	2	1
3	5	4	6	4
number of board meetings				
2009	2010	2011	2012	2013
4	6	4	4	8
6	4	4	5	6
4	5	6	5	4
6	3	4	7	4
4	4	7	4	4
7	7	4	4	5
4	6	9	8	4
10	4	4	4	7
4	8	3	7	4
5	4	4	4	10

4	4	4	4	12
Ratio of total debt to total assets				
2009	2010	2011	2012	2013
0.55	0.56	0.58	0.56	0.62
0.59	0.62	0.68	0.62	0.62
0.43	0.6	0.59	0.69	0.6
0.48	0.48	0.66	0.55	0.63
0.5	0.51	0.49	0.58	0.59
0.52	0.5	0.39	0.57	0.55
0.56	0.55	0.44	0.61	0.61
0.59	0.58	0.56	0.49	0.6
0.61	0.61	0.54	0.47	0.65
0.55	0.55	0.55	0.55	0.58
0.54	0.54	0.57	0.52	0.55
Size				
2009	2010	2011	2012	2013
11.61	11.69	11.77	11.8	11.87
11.66	11.75	11.83	11.86	11.92
11.74	11.83	11.9	11.93	12.01
11.78	11.87	11.94	11.97	12.05
11.81	11.9	11.97	12	12.07
11.86	11.95	12.02	12.05	12.12
11.88	11.98	12.05	12.08	12.15
11.96	12.04	12.12	12.15	12.22
12.06	12.15	12.22	12.25	12.33
12.14	12.22	12.3	12.33	12.4
12.23	12.32	12.4	12.43	12.5
Earnings management				
2009	2010	2011	2012	2013
0.1	0.11	0.15	0.2	0.2
0.15	0.17	0.18	0.22	0.18
0.13	0.13	0.2	0.25	0.16
0.18	0.12	0.15	0.21	0.15
0.11	0.1	0.13	0.22	0.14
0.16	0.1	0.11	0.26	0.2
0.9	0.12	0.16	0.28	0.17
0.6	0.14	0.14	0.24	0.15
0.12	0.08	0.12	0.22	0.11
0.1	0.1	0.1	0.2	0.1
0.07	0.09	0.13	0.18	0.1

