THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE PRACTICES AND EARNINGS MANAGEMENT OF COMPANIES LISTED IN THE NAIROBI SECURITIES EXCHANGE

BY

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DECLARATION

I undersigned, declare that this is my original work and has not been presented for award of degree in any other university.

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This project report has been submitted for examination with my approval as the University supervisor.

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DEDICATION

I dedicate this research report to my family for their moral and financial support, I also dedicate it to the University of Nairobi

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I wish to acknowledge the unreserved contribution of several individual's and institution and all who played significant role towards success of this project.

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ABSTRACT

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. In Kenya, cases where managers and directors have been accused of poor corporate governance resulting in corporate scandals include, the collapse of the Euro Bank in 2004, the placement of Uchumi Supermarkets under receivership in 2004 due to mismanagement, the near collapse of Unga Group, National Bank of Kenya and the more recent Board room wrangles and the discovery of secret overseas bank accounts for siphoning company money by some directors at CMC Motors. The purpose of the study was to determine the relationship between corporate governance practices and earnings management among companies listed in the Nairobi Securities Exchange. The study adopted descriptive research design. The population under investigation was all the 63 companies listed in the N.S.E. The sample population consisted of 58 companies that had been actively trading at the NSE between January 2010 and December 2013. The study used secondary quantitative data. Descriptive statistics was used (mean scores, standard deviations and percentages) to profile the extent and distribution of various corporate governance practices. The data collected also employed linear regression and correlation analysis to test the relationship between the dependent variable. Based on the findings, the study found that board size positively and significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange. In addition the study also concluded that board independence negatively but significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange. The study further revealed that CEO Duality positively and significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange although the effect is moderate. The study also concludes that ownership structure negatively but significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange. The monitoring power derived from the ownership structure results in a kind of control exercised over the company and, particularly, over the top management team. Market regulators (or standard setters) and investors need to be aware of the different types of earnings management. While opportunistic earnings management tends to mislead and hurt investors, informative earnings management will, in fact, provide useful information through signaling out managers' private information about the firm's future cash flows and earnings potential. Rational investors should refer to different types of earnings management behaviors and adjust their decisions accordingly. The study recommended the need for effective corporate governance practices at senior managerial level of quoted companies in Kenya to contribute to reduced earnings management and hence improve on actual firm liquidity and avert possible collapse of public organizations in Kenya. Companies should consider adopting conduct of regular Corporate Governance Audits and Evaluations. The findings reiterate the importance of contextualizing the issue under consideration in view of the legal and institutional structures and processes in place rather than experimenting with some good corporate governance practices used in other contexts.

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ABBREVIATIONS

BODs : Board of Directors

CBK : Central Bank of Kenya

CEO : Chief Executive Officer

CMA : Capital Markets Authority

IPOs : Initial Public Offers

NSE : Nairobi Securities Exchange

OECD: Organization for Economic and Corporation Development

UK: United Kingdom

US: United States

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

In the light of corporate financial scandals, there is an ever increasing attention on corporate governance issues in firms. A weak corporate governance structure may provide an opportunity for managers to engage in behavior that would eventually result in lower quality of reported earnings, which is a strong indication of a serious decay in business ethics (Jesus and Emma, 2013). Following high profile corporate scandals and collapses of companies such as Enron, parmalat, WorldCom, Barings bank, among others wiping out the wealthy of shareholders has resulted in the need to reexamine corporate governance in companies. Kenya has not missed out on financial scams as demonstrated by failure of Trust bank, Euro bank and Uchumi supermarkets limited.

Since the studies published by Jensen and Meckling (1976) and Fama and Jensen (1983), it has been assumed that both, the role of BODS and ownership structure, are crucial in monitoring managerial activity, as they are capable of reducing costs resulting from the alignment of ownership and management interests. Thus several studies document a significant relation between the characteristics of the board of directors and the integrity of accounting information (Patelli and Prencipe, 2007; Hashim and Devi, 2008). All these studies relate mainly to Anglo-Saxon countries, where outside investors are well- protected by the legal system (e.g. United States, United Kingdom), the level of transparency is high and most companies present widely held ownership structures. The above scenarios cannot be readily applied on Kenya's companies listed in NSE, due to such characteristics as weak legal

protection of minority shareholder's interests and concentrated ownership structures by few individuals.

Unethical managers may be attracted to misstate financial statements when growth slows to maintain appearance of consistent growth of the company (Summers and Sweeney, 1998). It is on this background that this study seeks to establish whether CBK guidelines on Corporate governance practices are being enforced to prevent earnings management by companies listed in the NSE and to therefore identify regulatory areas needing more strengthening.

1.1.1 Corporate Governance Practices

Corporate governance refers to the process by which organizations are directed controlled and held accountable. It encompasses authority, accountability, stewardship, leadership, direction and control exercised in the organization. It has been assumed that both, the role of BODS and ownership structure, are crucial in monitoring managerial activity, as they are capable of reducing costs resulting from the alignment of ownership and management interests. The Cadbury report (1992), defines corporate governance as the system by which companies are directed and controlled. The report further states that, board of directors are responsible for the governance of their companies. The shareholders role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. According to Cadbury (1992), corporate governance entails four main aspects, first establishing a board of directors that has clear responsibilities and whose role of governing is different from that of firm managers. Secondly, establishing checks and balance in governing structures, with no one person having unfettered power. Third, having a well-balanced board team composed of executive and non-executive

directors, and lastly, ensuring transparency of a board in directing and controlling the organization.

Corporate governance is the organization of the relationship between the owner and the managers in the control of a corporation. Good corporate governance is able to tackle the conflicts of interest between managers and owners of the corporation and resolve them (Lanno, 1999). The center for corporate governance in Kenya, defines corporate governance as the manner in which the power of and over a corporation is exercised in the stewardship of its assets and resources so as to increase and sustain shareholders value as well as satisfying the needs and of interests all stakeholders.

According to the Economic Cooperation and Development (OECD) (1999), commonly accepted principles of corporate governance include: Shareholder Rights and equitable treatment of shareholders, organization should respect the rights of shareholders and help shareholders to exercise those rights by effectively communicating information that is understandable and accessible and encouraging shareholders to participate in general meetings. Interests of other stakeholders, organizations should recognize that they have legal and other obligations to all legitimate stakeholders. Role and responsibilities of the board, the board should have skills and understanding to be able to deal with various business issues, review and challenge management performance. It needs to be of sufficient size and have an appropriate level of commitment to fulfill its responsibilities and duties. The appropriate mix of executive and non-executive directors should be maintained. The issue of CEO duality should be addressed.

Integrity and ethical behavior, a code of conduct for directors and executives that promotes ethical and responsible decision making must be in place in all organizations. Disclosure and

transparency, roles and responsibilities of board of directors and management should be clear and publicly known to provide shareholders with a level of accountability. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information (Hashim and Devi, 2008).

Previous studies by Bugshan (2005), Jesus and Emma (2013), Lopez and Saona (2005) identified various variables of corporate governance and measures applied as follows; Board size is measured by the total number of directors in the board. Board independence is measured by the proportion of non-executive directors inside the board (non-executive director/total directors).

CEO duality is measured by a dummy value of 1 of the company CEO also pairs up as the board Chair and 0 if otherwise. Internal ownership is measured by the proportion of shares greater than 1% owned by members of the Board of Directors and managers of the firms (Jesus and Emma, 2013).

1.1.2 Earnings Management

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 reserve accounts (Rahman and Ali, 2006). Earnings Management is the use of accounting techniques to produce financial reports that may paint an overly positive picture of a company's business activities and financial position. It takes advantage of how accounting rules can be applied and are legitimately flexible when companies can incur expenses and recognize revenue. Investors, who prefer to see stability

and growth, tempt managers to take advantage of accounting manipulations. Aker et al (2007) defines earnings management as the attempts by management to influence or manipulate reported earnings by using specific accounting methods, recognizing one-time non-recurring items, deferring or accelerating expense or revenues transaction or using other methods designed to influence short-term earnings.

Common ways of earnings management may include; Revenue and Expense Recognition "Earnings" is just another word for profit, and profit is simply revenue minus expenses. Companies may manage earnings by changing the dates on which it enters certain revenues and expenses in its books (Price et al, 2006). To increase earnings in the current period, the company can recognize future revenue prematurely -- before that revenue has been fully earned -- or delay recognizing expenses. Similarly, if it wants to shift "extra" earnings from the current period to the next, it could delay the recognition of revenue that has been earned, or recognize expenses prematurely, before they're actually incurred. "Cookie Jar" Accounting, accounting rules require companies to recognize future expenses at the time they recognize the revenue associated with those expenses. For example, when a company sells an item with a warranty, it must estimate its future warranty costs and recognize that expense at the time it makes the sale. Similarly, when a company sells items to customers on credit, it must estimate the value of customer bills that will eventually go unpaid and immediately recognize that "bad debt expense." If a company overestimates these kinds of expense in the current period, it won't have to recognize as big an expense in future periods. Therefore, it shifts earnings from the current period to the future. This tactic goes by the name "cookie jar accounting (Lefort, 2005).

Changing Accounting Methods, accounting standards allow companies to choose the reporting method that works best for them. Examples include the system the company uses to

account for the value of its inventory and the schedule it uses to depreciate its capital assets. Over the long term, different methods for doing the same thing should produce the same end result -- the same total value will go into and out of inventory, for example, or the same amount of value will get depreciated (Teshma and Shuto, 2008). In the short term, however, a company's choice of methods can significantly affect its earnings from one period to the next. If a company switches from one accounting method to another primarily to affect earnings, it's engaging in earnings management.

One-Time Charges ,from time to time, companies may have to report a particularly large one-time expense - writing off the cost of a failed project, for example, or significantly reducing the value of an asset on the balance sheet. Companies that practice earnings management may try to "save" these charges for a time when earnings are high enough to absorb the hit -- or take the charges prematurely if current earnings are high. Similarly, a company that must take a big one-time charge in the current period might use the opportunity to accelerate all kinds of other expenses to that period, too. This is called the "big bath," after the idea that if the company is going to "take a bath" -- suffer bad results in a particular period -- it might as well take a big bath and get as many future expenses out of the way as possible (Patelli and Prencipe, 2007).

Financial reported earnings have powerful influence on a full range of business activities of a firm and its management decisions. The earnings could either affect investors' evaluation of the firm or impact contractual outcomes which are related to financial leverage or compensation of mangers. Therefore managers have strong intentions to adjust earnings numbers to the desirable level. The flexibility of current accounting principles also provides managers with considerable ability to adjust accounting earnings. 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).

Earnings management is undertaken by management for different purposes and techniques. Healy and Wahlen (1999) argue that managers manipulate earning for four kinds of incentives i.e. external contract incentives, management compensation contract incentives, regulatory and capital markets motivations. Earnings are equal to the sum of operating cash-flows and accruals, managing reported earnings can be achieved by undertaking accounting manipulations (i.e discretionary accruals) or real actions that affect operating cash-flows.(Barton ;2001).According to Matoussi and Kolsi; 2006, other techniques used in earnings management include manipulations of research and development and sale and lease back.

The measure of discretionary accrual (Earnings Management tool) is based on Dechow et.al (1995) who computed accrual component of earnings as follows:

ACCRUAL= (CA- Cash) – (CL- STD- TP) –DEP. Where; CA=change in Current Assets. Cash=Change in cash /Cash equivalents. CL=Change in Current Liabilities. STD =Change in Short-term Debts included in the Current Liabilities. TP= Change in Income Taxes Payables DEP= Depreciation and Amortization expense.

1.1.3 Corporate Governance Practices and Earnings Management

The regulatory response to financial scandals has been to take measures to protect information transparency, mitigate conflicts of interest and ensure the independence of auditors, all in order to protect the investors interests’ and increase the confidence of capital markets (Leuz, Nanda & Wysocki, 2003). Unethical managers may be attracted to misstate financial statements when growth slows to maintain the appearance of consistent growth of the company (Summers and Sweeney, 2007). 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. Empirical studies have also concluded various relationships exist between corporate governance and earnings management.

Firth, Fung & Rui (2007)in their study of United Kingdom and Chinese firms revealed that the independent board mitigates earnings management. That is the presence of independent directors improves the earnings quality as board independence allows disclosing information of good quality by the firms. Fraud is also more likely in firms that have fewer independent members of the board and audit committee (Beasley, 1996). Further, given the fact that the presence of independent directors improves the earnings quality as board independence allows disclosing information of good quality by the firms (Klein, 2002), and the likelihood that some non-independent non-executive directors are sometimes family members who may not be knowledgeable in corporate governance and financial reporting, the independence of the chairman of board becomes a grim reality.

Arguments are on-going on whether earnings smoothing is fraudulent or not. While Molenaar (2010) considered earnings management to be fraudulent, Tianran (2011) argued that it is a reasonable and legal management decision making and reporting, intended to achieve and disclose stable and predictable financial results. Therefore even when manipulation of financial numbers by managers are within the letter of the law and accounting standards, they are very much against the spirit of these rules, objectives of financial reporting and International Financial Reporting Board, the principles of corporate governance and certainly not providing the "true and fair" view of a company's results and financial position.

1.1.4 Firms Listed at Nairobi Securities Exchange

The Nairobi Securities Exchange (NSE) was c constituted as Nairobi Stock Exchange in 1954 as a voluntary association of stockbrokers in the European Community registered under the Societies Act (w.w.w.nse.co.ke).

Its vision is to be" a leading securities exchange in Africa, with a global reach" thus be able to provide world class securities trading facility. The NSE is licensed and regulated by the Capital Markets Authority (CMA). The NSE is important to the economy by facilitating good management of companies by asking them to give periodic reports of their performance and by providing daily market reports and price list to ensure that investors know the worth of their assets at all times.

The Capital Markets Act of Kenya (Cap 485A), Gazette Notice No. 3362, Guidelines on Corporate Governance practices by public listed companies in Kenya, corporate governance is defined as the process and structure used to direct and manage business affairs of the company towards enhancing prosperity and corporate accounting with ultimate objective of realizing shareholders long term value while taking into account the interest of stakeholders.

The CMA Gazette notice requires the following corporate governance practices in listed companies in Kenya; that every quoted company is headed by an effective Board of directors and board committees, directors remunerations are established through formal and transparent procedures and approved by the shareholders. Such remunerations should also be competitive, linked to performance and sufficient to attract and retain diligent directors. Other considerations include board size, board activities characterized by board meetings, appointment procedures, and board independence requiring that at least one-third of the directors should be independent and non- executive and of diverse background.

Sufficient supply and disclosure of information on aggregate directors loans, ownership concentration listing ten major shareholders of the company, share options and other forms of executive compensation. Other practices include accountability and audit of financial statements as a duty of the board in line with International Accounting Standards, appointment of independent auditors, maintaining independent and competent audit committees and designing a clear succession plan for the Board chair and the CEO.

The companies listed in the NSE ability to engender micro or global economic growth and development depends on their health, soundness and stability. In order to fulfil all those functions, the companies needs to be trustworthy and transparent (Sala-I-Martin et al., 2013). Thus, proper functioning, through adequate supervision and governance, the companies hinge on adequate transparency and accountability being built into reporting practices in the corresponding sub-sectors. In this regard, the companies vulnerabilities pose great challenges for the conduct of monetary policy (Draghi, 2012). Contrary, prior literatures have documented that business firms' managers manage their reported earnings for many different purposes (Liu & Ryan, 2006).

1.2 Research Problem

As a result of high profile cases of corporate collapses worldwide among them Enron and WorldCom in the US, Marconi in the UK, there has been exponential increase in the amount of laws, rules and guidelines setting in place heightened standards of corporate governance best practice (McConvil, 2005). 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 reserve accounts. Cases of corruption in Kenya have attracted lively debates in many legal and business sectors which have in result shaken both local and foreign investor confidence (Munyuru, 2005).

Though, arguments are mixed, prior studies evidence relationship between corporate governance and financial reporting quality, earnings manipulation, financial statement fraud, and weaker internal controls Qiao, & Zhou (2007) and Xiea, Davidson, & DaDaltb (2003) respectively using sample of firms from U.S.,China, New Zealand, Australia, argued that corporate governance may be important factor in constraining the propensity of managers to engage in earnings management, Hashim & Devi (2008), Agrawal & Chadha, (2005) and Klein (2002) respectively focusing on Malaysia, and U.S public companies find that several key governance characteristics are unrelated to the probability of a company restating earnings.

In Kenya, cases where managers and directors have been accused of poor corporate governance resulting in corporate scandals include, the collapse of the Euro Bank in 2004, the placement of Uchumi Supermarkets under receivership in 2004 due to mismanagement, the near collapse of Unga Group, National Bank of Kenya and the more recent Board room wrangles and the discovery of secret overseas bank accounts for siphoning company money by some directors at CMC Motors (Madiavale, 2011).The recently published huge losses and numerous unresolved disputes resulting in court cases by Kenya Airways and Kenol Kobil have also thrust corporate governance practices into the spotlight. Kenyan companies need to integrate ethics into their corporate culture and concentrate on putting appropriate corporate governance mechanisms in place.

Locally, there are many studies in corporate governance. Waweru and Riro (2013) conducted a study on corporate governance characteristics and earnings management in an emerging economy. Kaboyo (2013) and Irungu (2010) looked at the factors motivating earnings management and the relationship between macroeconomic variables and earnings management for listed firms at the NSE. Most of the other studies concentrate on profitability as a measure of financial performance and the effects of corporate governance on various sector of the economy. Unlike most corporate studies, this study will focus on the control aspect of corporate governance of companies listed in the NSE, rather than the performance aspect. The study focuses on a study period when managers had an incentive to manage earnings due to the effect of macroeconomic factors in the country e. g. general election in 2013, interest escalation in 2011/2012 and foreign exchange depreciation in 2011.

The research was guided by the question: Is there a relationship between corporate governance and earnings management for companies listed in the Nairobi Securities Exchange?

1.3 Objectives of the Study

1.3.1 General Objective

The main objective of the study was to determine the relationship between corporate governance practices and earnings management among companies listed in the Nairobi Securities Exchange.

1.3.2 Specific Objectives

The study was guided by the following specific objectives;

i. To establish the relationship between board independence and earnings management in companies listed in NSE.
ii. To find out the relationship between CEO duality and earnings management in companies listed in the NSE.
iii. To find out whether internal ownership has an effect on earnings management in companies listed in the NSE.
iv. To determine the relationship between board size and earnings management in companies listed in the NSE.

1.4 Value of the Study

The research will seek to establish the relationship between corporate governance variables; CEO duality, ownership structure, chair of audit committee, board size and activity, proportion of non-executive directors and earnings management in companies listed in NSE.

The study will be significant because it can aid the policy makers in the formulation of policies, which can be effectively implemented for better and easier regulation. The government can also use the study so as to come up with clear criteria of promoting companies in Kenya.

The study will be useful to Kenya Capital Markets Authority (KCMA) and accounting regulators in Kenya in the determination of whether to develop more corporate governance guidelines so as to improve the quality of information reported by companies.

To the shareholders, the study will sensitize them on the importance of ensuring that the board of directors' practices good corporate governance for the sake of maximizing their share value by appreciating board activities in relation to the quality of earnings reported.

The study is expected to contribute to the existing body of academic knowledge through publishing the results of its key findings, as well as opening up areas of further research.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

Literature review is the analysis of existing knowledge on a particular line of study. It focuses on the existing studies done by other scholars and researchers and provides basic knowledge of the research topic. 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.

2.2 Review of Theories

The study will be underpinned on various theoretical postulations on corporate governance. The study is hinged on the agency theory, stewardship theory, stakeholder theory and the big bath theory of earnings management.

2.2.1 Agency Theory

Jensen and Meckling (1976) define an agency relationship as "a contract under which one or more person(s) (principal(s) engage another person (agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. In a firm context, the owners are the principal and managers the agent. A major issue to the firm is the information asymmetry between managers and shareholders. In this agency relationship, insiders (managers) have information advantage. Thus, the agent takes advantage to engage in activities to enhance his personal goal. Adverse selection may occur when the principal 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 the 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 perquisites compensation. Scapeans (1985) refers to this dilemma the "Moral hazard" problem.

Earnings management is by and large practiced by senior management. Managers may sometimes no act in the interest of shareholders when the control of the company is different from its ownership (Livia et al, 2007). Livia further states that mangers can be 'satisfiers' rather than 'maximisers' that is, they play it safe and look for suitable level of growth because their main concern is to perpetuate their own existence rather maximizing the value of the firm .Jensen and Meckling (1976), indicate that the principals can comfort themselves that the agent will make the most favorable decisions only if appropriate incentives and rewards like stock options, bonuses, and other benefits are given and only if the agent is watched.

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 boards' 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

Directors are regarded as stewards of the company assets and are therefore expected to act in the best interest of the shareholders (Patelli and Prencipe, 2007). It is a requirement in Kenya Company Law (Cap 486) that directors show a fiduciary duty towards the shareholders of the company. This means that the directors having a fiduciary duty can be trusted and will act as stewards over the resources of the company.

Steward Theory is an alternative view of the agency theory, whereby managers, left on their own, will indeed act 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 (CEO duality) (Davis & Donaldson, 1997).

The stewardship theory suggests a potentially negative impact of division of responsibilities between chairman and the chief executive. The roles should be combined in order to protect a key aspect of high performance; the strength and authority of executive leadership. The implication for this study is to determine the effects of CEO duality to earnings management and discretionary accrual (Hashim and Devi, 2008).

In summary, the steward theory suggests that a firm's board of directors and its CEO, acting as stewards, are more motivated to act in the best interest of the firm rather than for their own selfish interests. This is because; over time senior executive tend to view the firm as an extension of themselves (Clarke, 2004). Therefore, the steward theory argues that compared to shareholders, top management cares more about the long term success of the firm (Mallin, 2004).

2.2.3 Stakeholder theory

The Stakeholder theory takes account of a wider group of constituents rather than focusing on shareholders. When a wider stakeholders group such as employees, providers of credit, customers, suppliers, government and local authority are taken into account they override the focus on shareholders' value. This means that shareholders have vested interest in trying to ensure that the resources are used to maximum effort which in turn benefits the society as whole (Madiavale, 2011).

Jensen (2001) argued that the proponents of stakeholders' theory decline to specify how to make the necessary tradeoff among these competing interests, leaving managers with a theory that make it impossible for them to make purposeful decisions. With no way to keep count, stakeholders' theory makes managers unaccountable for their actions. The theory would be attractive to the self-interest of managers and directors and encourages earnings management by managers.

Jensen (2001) therefore advocates enlightened value maximization which he says is identical to enlightened stakeholders theory. He states that" enlightened value maximization utilizes much of the structure of stakeholder theory accepts the maximization of the long run value of the firm as a criterion of making prerequisite tradeoffs among its stakeholders and therefore solve the problem that arise from multiple objectives that accompany traditional stakeholder theory".

2.2.4 The Big Bath Theory of Earnings Management

The big bath theory of earnings management suggests that firms experiencing low earnings in a given year may take the discretionary write downs to reduce even further the current periods' earnings. 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 principals about 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 a higher share price and earnings are perceived to be surrogate of cash flow, higher earnings increase the value of the firm.

Managing earnings through big bath charges follow a different, yet simple, line of reasoning because earnings are made to look bad, at least in the current period. Henry and Schmitt (2001) noted that a company will take large non-recurring loss once, typically when the profits are already depressed, so the future earnings are not burdened. The result is either increased future earnings or reduced variability of future earnings.

2.3 Determinants of Earnings Management

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., 1995). 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.

An important difference between public and private companies is that public companies are less likely to be managed by their key owners and in general have a much more dispersed ownership. This implies that there are greater demands to link pay to performance for managers of public companies. several studies suggest that bonus contracts can give managers the incentive to manage earnings (Fields et al., 2001). indeed, many privately held companies have external managers. However, the higher ownership concentrations in private companies give shareholders greater incentives to monitor the management. A possible consequence of this is that incentive contracts become less important.

A further factor that limits the incentive to manage earnings is that a firm and its managers can have the incentive to build up a track record for unbiased reporting (Palepu et al., 2004). such reputation capital is also likely to be valuable for private firms, for example, if they would go public in the future. finally, monitoring by financial analysts does also limit management's ability to manage earnings in public companies. financial analysts have in many cases firm specific and industry specific knowledge that enables them to assess the quality of reported financials.

several studies have found that companies with a high leverage use income increasing accounting methods (Holthausen and Seftwich, 2008). A reason for this is that companies approaching debt covenant violations respond with income increasing accounting methods. However, they point out that also other factors than debt covenants contribute to the

association between leverage and accounting choices. Bowen et al. (2007) suggest that considerations towards stakeholders, such as customers, suppliers and short term creditors, give companies the incentive to manage earnings although there are no explicit contracts related to accounting numbers. Banks lending on a relatively short term basis are likely to study financial statements carefully when loans are about to be granted or renewed. However, if creditors do not completely adjust accounting numbers for differences in accounting methods, companies having used income increasing accounting methods will be perceived as being less risky. suppliers might for similar reasons sell on more favourable terms to firms having used income increasing accounting methods. Titman (2009) argues that customers care about the future of a company if they expect future services, such as new versions of a computer program or repairs of products, from the supplier. The use of income increasing accounting methods may improve the financial image of firms as perceived by customers.

2.4 Review of Empirical Studies

Previous studies done by different scholars have recognized certain aspects, such as board composition characteristics and their impact on firm performance. They revealed many factors to measure the corporate Governance practices of a firm, such as number of directors/non-executive directors, board diversity, board size, director ownership, board compensation, CEO/chairman duality, education qualifications of board members, performance assessment of board, number of board meetings, debt and dividends (Bhagat & Black, 1999; Daily & Dalton, 1997; Lorsch & MacIver, 1989).

Numerous studies have looked at the implications of corporate governance structure on firm earnings management. Although the literature is not unanimous in its conclusions, there is clear evidence supporting the opinion that there is a significant relationship between

governance structures and earnings management. 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 firm improve its operations (Hsiang-tsai et al, 2005).

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). Some other studies analyze the effect of the internal ownership and shareholding concentration held by major shareholders on quality of financial results (Lefort, 2005; Kim and Yi, 2006; Price et al, 2006). All these studies relate to Anglo-Saxon countries, where outside investors are well-protected by the legal system (e.g. United States, United Kingdom), the level of transparency is high and most firms present widely held ownership structures.

Empirical studies have been conducted on the effect of ownership structure on earnings management as an internal control mechanism that focuses on the aspects that define the ownership of a company and refers to the manner in which rights of representation redistribute the capital of the company in one or more individual or legal entities. The monitoring power derived from the ownership structures results in a kind of control exercised over the company and particularly over the top management. Previous studies focused mainly on the effect of insider ownership on earnings management (Sanchez-Ballesta and Garcia-Meca, 2007; Teshma and Shuto, 2008), along with ownership concentration, measured by the fraction of ownership held by major shareholders or by the proportion of ownership held by the main shareholder of the firm (De Miguel et al, 2004; Boubraki et al, 2005). However, Demsetz and Villalonga (2001) affirm that in order to treat ownership structure appropriately, different dimension of ownership structure must be considered.

Dhaliwal et al (2002) investigated whether firms use income tax accruals as an earnings management tool when free pretax earnings fall short of market earnings expectation. They found that as the difference between analyst forecast and pre-managed earnings increases, fourth quarter effective tax rates decrease relative to third quarter effective tax rate. This finding is consistent with earnings management using total income tax expense.

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 the true picture of 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 conceal firm performance. The study covered fiscal years 1990 to 1999 across 31 countries; the variables were computed from 70,955 financial firms and 8,616 non-financial firms. By applying rank regression and two stages least squares method, their findings were consistent with their prediction and suggested an endogenous link between corporate governance and the quality of reported earnings.

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 opposed to free cash flows proposed by Jensen and Meckling (1976).

Abdullah and Norman (2010) sought 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.

Mang'unyi (2011) studied ownership structure and corporate governance and its effect on performance on selected banks in Kenya. The study revealed that there is no significant difference between ownership structure and financial performance, and between banks ownership and corporate governance practices. The study also found out there was a significant difference between corporate governance and financial performance of banks. However foreign-owned banks had slightly better performance than locally-owned banks.

Jesus and Emma (2013) investigated the relationship between corporate governance and earnings management in Latin America countries of Argentina, Brazil, Chile and Mexico from 2006 to 2009. Information was obtained for 435 firms and a total of 1740 observations were made. Descriptive analysis was use combined with regression analysis, time series and cross sections. Earnings management was measured using modified version of Jones proposed by Dechow et al (1995). They tested the effect of various corporate governance variables on earnings management e.g. ownership, board of directors, CEO duality and government index. The findings were 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. The existence of concentration of power (CEO duality) increases earnings management while a country with levels of governability shows a lower level on earnings management practices (Jesus and Emma, 2013).

Locally, Aduda, Chogii and 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. Regression analysis and Tobin Q were applied on the secondary data. The findings of the study were that overall regression models for the firm performance for the Return on assets and Tobin Q ratio were significant. Therefore board composition variables cited above were important predictors of firm performance. The study also found that the significance of the individual variables in the overall specification models have differing significant variables on the basis of the measure of performance selected for the firm.

Waweru and Riro (2013) conducted a study on corporate governance characteristics and earnings management in an emerging economy. The objective of the study was to investigate the influence of corporate governance and firm specific characteristic on earnings management by Kenyan listed companies. The study found out that ownership structure and board composition was 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.

2.5 Summary of Literature Review

The results of various empirical studies indicate 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 behavior 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'. All stakeholders should be considered in firm decisions and information content released from firms should have integrity and be useful to intended users. Voluntary disclosure of information should be encouraged.

Gaps in literature include the lack of clear empirical literature on earnings management on companies listed at NSE and lack of literature on corporate governance practices affecting earnings management in Kenya by company managers. This study seeks to provide such literature.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

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

3.2 Research Design

The study adopted descriptive research design so as to be able to bring out the relationship between corporate governance and earnings management in companies listed at the NSE. Descriptive study is the one in which information is collected without interfering with the environment sometimes referred to as "correlational" or "observational" studies. The Descriptive study demonstrates relationships between corporate governance practices and earnings management. It was a longitudinal study on the selected companies over four years.

3.3 Population

Target population is the specific group about which information is desired. A population is well-defined set of people, services, elements, and events, group of things or households that are being investigated (Mugenda and Mugenda, 2003). The population under investigation was all the 63 companies listed in the N.S.E. The sample population consisted of 58 companies that had been actively trading at the NSE between January 2010 and December 2013. The study adopted a census study approach due to the small population selected (Appendix I).

3.4 Data Collection

According to Kombo (2006), data collection refers to gathering specific information aimed at providing or refuting some facts. This process is important as it allows for dissemination of accurate information and development of meaningful programs (Kombo, 2006).The study used secondary quantitative data to investigate the relationship between corporate governance and earnings management.

Secondary data was obtained by abstraction method from corporate governance statement and financial statements for the 58 companies as they have been published by NSE. The data covered the period 2011 to 2013. The data from the selected companies included, the number of directors, proposition of executive and non- executive directors, number of meetings held in each year, major shareholders ,CEO duality and financial data including debt amounts, current assets, current liabilities, depreciation and cash equivalents.

3.5 Data Analysis

Data analysis is the process of bringing order, structure and meaning to the mass of information collected (Mugenda & Mugenda, 2008). Descriptive statistics was used (mean scores, standard deviations and percentages) to profile the extent and distribution of various corporate governance practices. This gave a general picture of the data set and also present summaries that show the spread of the data.

The data collected also employed linear regression and correlation analysis to test the relationship between the dependent variable. Regression analysis is a statistical method utilized to determine the relationship between one dependent variable and one or more independent variables (Hair et al., 2010). This study employed a multiple linear regression

analysis using earnings management as dependent variable and independent variables comprising of Board Size, Board Composition, CEO Duality and Internal ownership.

This study employed the following model;

$$Y_{it} = \beta_o + \beta_1 BOS + \beta_2 BODIND + \beta_3 CEODUAL + \beta_4 INTOWNSP + e_t$$

Where:

Y represents Discretionary Accruals as an earnings management tool will be used based on Dechow et.al (1995), who computed accrual component of earnings as follows; ACCRUAL= (CA- Cash) – (CL- STD- TP) –DEP. Where; CA=change in Current Assets. Cash=Change in cash /Cash equivalents. CL=Change in Current Liabilities. STD =Change in Short-term Debts included in the Current Liabilities. TP= Change in Income Taxes Payables DEP= Depreciation and Amortization expense.

BOS represents Board Size, measured by the total number of directors in the board.

BODIND represents Board independence, measured by the proportion on non-executive directors in the board of directors (non-executive directors/total directors).

CEODUAL represents CEO Duality, measured by a dummy value of 1 where the company CEO doubles up as the board Chair and 0 if otherwise.

INOWNSP represents ownership structure measured by the proportion of shares greater than 1% owned by the Board of Directors and managers of the company, and

e_t, the error term which account for other possible factors that could influence Y_{it} that are not captured in the model.

Test of Significance

The coefficient of determination (R^2) was used to measure the extent to which the variation in earnings management is explained by the variations in corporate governance practices. F-statistic was also computed at 95% confidence level to test whether there is any significant relationship between corporate governance practices and earnings management. This analysis was done using SPSS (V 21) software and the findings presented in form of a tables and graphs to aid in the analysis and ease with which the inferential statistics were drawn.

The model's test of significance was measured on how well the regression model fits the data by comparing explanatory variables that were proposed actually explain variations in the dependent variable. Quantities known as goodness of fit statistics are available to test how well the sample regression function (SRF) fits the data how or how close' the fitted regression line is to all of the data points taken together. The most common goodness of fit statistic is known as R2 (Brooks, 2008). A correlation coefficient must lie between −1 and +1 by definition. Since R2 defined in this way is the square of a correlation coefficient, it must lie between 0 and 1. If this correlation is high, the model fits the data well, while if the correlation is low (close to zero), the model is not providing a good fit to the data. R2 is the square of the correlation coefficient between the values of the dependent variable and the corresponding fitted values from the model..

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the information processed from the data collected during the study on the relationship between corporate governance practices and earnings management among companies listed in the Nairobi Securities Exchange. The sample composed of 58 companies listed in the Nairobi Securities Exchange which had audited reports for the period year ended 31st December 2010 to 31st December 2013.

4.2 Descriptive statistics

Table 4.1: Summary of the study variables for the study period

		2010	**2011**	**2012**	**2013**	**Average**
Discretionary accruals estimations by year	Mean	0.1814	0.189	0.199	0.207	0.194
	SD	0.704	0.293	0.42	0.489	0.477
Board Size	Mean	6.1721	6.3108	6.5435	6.8.47	6.342
	Std. Dev.	1.902	1.0827	1. 973	3.67	2.218
Board independence	Mean	0.394	0.366	0.375	0.385	0.380
	Std. Dev.	0.891	0.077	0.862	0.083	0.478
CEO Duality	Mean	0.196	0.180	0.127	0.150	0.163

	Std. Dev.	0.691	0.924	0.158	0.862	0.659
Ownership structure	Mean	0.060	0.045	0.061	0.073	0.060
	Std. Dev.	0.047	0.038	0.046	0.048	0.045

Table 4.1 shows the trend of the various variable of the study for the study period. The findings depict that earnings management as measured with discretionary accruals estimations improved over the years with a mean score of 0.194. it was also clear that the board size was almost constant over the study period although the highest value was recorded in 2013 (6.8.47). This is not the case for board independence and CEO duality which recorded the highest values in 2010 although the same trend is depicted for the ownership structure having the highest value in 2013 with a mean score of 0.073.

4.3 Regression Results

The study conducted a cross-sectional multiple regression on several corporate governance variables over the period 2011 - 2013 and of earnings management. Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (earnings management) that is explained by all the four independent variables (Board Size, Ownership structure, Board independence and CEO Duality).

Table 4.2: Results of multiple regression between earnings management and the combined effect of the selected predictors

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.876	0.767	0.734	0.529

Source: Author (2014)

The four independent variables that were studied, explain 73.4% of the earnings management as represented by the adjusted R^2. This therefore means the four variables contribute to 73.4% of earnings management, while other factors not studied in this research contributes 26.6% of earnings management among companies listed in the Nairobi Securities Exchange. Therefore, further research should be conducted to investigate the other (26.6%) factors influencing earnings management among companies listed in the Nairobi Securities Exchange.

Table 4.3: Summary of One-Way ANOVA results of the regression analysis between earnings management and predictor variables

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	4.683	4	1.171	3.369	0.0157
1	Residual	18.42	53	0.348		
	Total	23.103	57			

Source: Author (2014)

From the ANOVA statistics in table 4.3, the processed data, which are the population parameters, had a significance level of 0. 0157 which shows that the data is ideal for making a conclusion on the population's parameter. The F calculated at 5% Level of significance was 3.369. Since F calculated is greater than the F critical (value = 2.55), this shows that the overall model was significant i.e. there is a significant relationship between earnings management and corporate governance.

Table 4.4: Regression coefficients of the relationship between earnings management and the four predictive variables

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	0.478	0.172		2.074	0.039
	Board Size	0.649	0.115	0.584	3.593	0.026
	Board independence	-0.431	0.145	0.304	-3.556	0.032
	CEO Duality	0.372	0.138	0.229	4.874	0.016
	Ownership structure	-0.448	0.109	0.393	3.825	0.031
Dependent variable: earnings management						

Source: Author (2014)

The coefficient of regression in table 4.4 above was used in coming up with the model below:

EM = 0.478+ 0.649 BS - 0.431 BI + 0.372 CD - 0.448 OS

Where EM is Earnings management, BS is board size, BI is Board independence, CD is CEO Duality and OS is Ownership structure. From the model, taking all factors (Board Size, Board independence, CEO Duality and Ownership structure) constant at zero, earnings management was 0.478. The data findings analyzed also shows that taking all other independent variables at zero, a unit increase in board size will lead to a 0.649 increase in earnings management; unit increase in board independence will lead to a 0.431 decrease in earnings management; a unit increase in CEO Duality will lead to a 0.372 increase in earnings management while a unit increase in ownership structure will lead to a 0.448 decrease in earnings management.

According to the model, all the variables were significant as their significance value was less than 0.05. However, board independence and ownership structure were negatively correlated with earnings management while board size and CEO duality were positively correlated with earnings management.

4.4 Multicollinearity test

The study conducted a multicollinearity tests to determine if two or more predictor independent variables in the multiple regression model are highly correlated.

Table 4. 5: Multicollinearity Statistics

	Tolerance	**VIF**
Board Size	0.863	1.887
Board independence	0.653	2.491

CEO Duality	0.387	4.908
Ownership structure	0.334	4.868

Source: Author (2014)

The study used tolerance and variance inflation factor (VIF) values for the predictors as a check for multicollinearity. Tolerance indicates the percent of variance in the independent variable that cannot be accounted for by the other independent variable while VIF is the inverse of tolerance. Table 4.5 shows that tolerance values ranged between 0.334 and 0.863 while variance inflation factor ranged between 1.887 and 4.908. Since tolerance values were above 0.1 and VIF below 10, then were was no multicollinearity in the model.

The study also used Durbin Watson (DW) test to check that the residuals of the models were not autocorrelated since independence of the residuals is one of the basic hypotheses of regression analysis. Being that the DW statistic were close to the prescribed value of 2.0 (2.112) for residual independence, it can be concluded that there was no autocorrelation.

4.5 Summary and Interpretation of Findings

From the above regression model, the study found out that there were corporate governance variables influencing the earnings management among companies listed in the Nairobi Securities Exchange, which are board size, board independence, CEO duality and ownership structure. They either influenced it positively or negatively. The study found out that the intercept was 0.478 for all years.

The four independent variables that were studied (board size, board independence, CEO duality and ownership structure) explain a substantial 73.4% of earnings management among companies listed in the Nairobi Securities Exchange as represented by adjusted R^2 (0.734).

This therefore means that the four independent variables contributes 73.4% of the earnings management among companies listed in the Nairobi Securities Exchange while other factors and random variations not studied in this research contributes a measly 26.6% of the earnings management among companies listed in the Nairobi Securities Exchange.

The study established that the coefficient for board size was 0.649, meaning that board size positively and significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange. This correlates with Santiago and Brown (2009) who took a sample of 97 companies in Brazil, Chile, and Mexico and find a positive relation between the size of the Board and EM. This indicates that the low separation between ownership and control that exists in Latin American companies assumes that with a larger size of Board the levels of monitoring of the management team decrease, so increasing the risk of expropriation by controlling shareholders and the propensity to the discretion of the board members to establish a higher level of remuneration and manipulate the results of companies for their own benefit (Thomsen 2008). Simmilary, Ahmed, Hossain & Adams (2006); Bradbury, Mak & Tan (2006) and Jensen (1993) found that large board size reduces the information content of incomes and intensifies the earnings management respectively for American, Singapore and New Zealand firms. Abdul & Mohamed (2006) argue that coordinating and processing problems becomes more difficult when the boards are too large. This makes larger boards more ineffective in performing monitoring functions (Hashim & Devi, 2008).

The study established that the coefficient for board independence was -0.431, meaning that board independence negatively but significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange. This is in line with several studies provide empirical evidence relating to the role of external directors on the constriction of EM, documenting that a higher proportion of external directors, will mean greater and better

quality of financial information issued by firms, so reducing the chances of EM (Xie et al. 2003; Davidson et al. 2005; Garcı´a Osma and Gill de Albornoz 2007; Bradbury et al. 2006; Jaggi et al. 2009). Most recent studies such as Price et al. (2006, 2007), Teitel and Machuga (2008), Chong et al. (2009), Davila and Watkins (2009), and Ferraz et al. (2011) show that a legal framework in capital markets (such a Code of Best Corporate Practices) has forced Latin American firms to include more external directors, so making it possible to improve the way that firms disclose their financial information, and they therefore show a greater transparency in their reports and decrease the chances of EM.

The result however contrasts with the prominent role that both the theoretical and empirical literature has assigned to this attribute of the Board to safeguard the quality and transparency of results but, for the case of Latin American countries analyzed, it does not seem to be so effective. In this regard, Price et al. (2006, 2007), Teitel and Machuga (2008), Chong et al. (2009), and Davila and Watkins (2009) in Mexico; Silveira et al. (2003), Schiehll and Santos (2004), and Ferraz et al. (2011) in Brazil; Iglesias (1999) in Chile; suggest that this is due to Boards' being mainly composed of major shareholders and managers of the companies, with external directors having a very limited participation, which facilitates the EM and the managerial discretion. It is probable that this evidence is derived, as stated by Yermack (2004), from the presence of grey directors, lack of rotation of the directors or both.

The study further revealed that the coefficient for CEO Duality was 0.372, meaning that CEO Duality positively and significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange although the effect is moderate. This concur with Leal and Carvalhal da Silva (2005) in Brazil, through the application of surveys on a sample of 400 listed companies, documented that 36 % of companies have power concentrated in the same person. In Argentina, Chisari and Ferro (2009) for a sample of 100 listed firms, find

that in 75 % of the corporations the chairman and CEO are the same person. This situation is not very different in Chile; Lefort and Walker (2005) obtain similar results in a sample of 120 listed companies, pointing out that only in 21 % of corporations is the Chairman of the Board independent, that is, there is no duplication of functions between President-CEO, a situation that is widespread throughout Latin America. We can conclude that separation of the CEO from obtaining a chairman position simultaneously in the board is not effective in restraining earnings management among publicly-traded Palestinian firms. The findings are consistent with the evidence provided by Abduallah and Mohd Nasir (2004) that found that CEO duality did not effectively constrain earnings management. According to Chashmi and Roodposhti (2010), in the United States CEO Duality is the norm, while in Australia and the United Kingdom it is not widespread; therefore, there might be a cultural difference.

The study also deduced that the coefficient for ownership structure was -0.448, meaning that ownership structure negatively but significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange. Yeo et al. (2002) deal with the monitoring role played by external unrelated block holders, which reduces the opportunities of earnings management, and de Bos and Donker (2004) also show that increased ownership concentration is an effective corporate governance mechanism in monitoring accounting decisions of incumbent management, such as voluntary accounting changes. However, when the level of ownership concentration is too high it can lead to agency problems due to the expropriation of the minority shareholders' interests (Boubraki et al. 2005; Lefort 2007). In this paper we support the efficient monitoring hypothesis and suggest a negative association between ownership concentration and earnings management.

The current study supports the view that the significance of corporate governance is not appreciated unless shareholders react to it. If shareholders respond to corporate governance's

improvement to the reliability of earnings, then corporate governance should improve the earnings response coefficients.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

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. In Kenya, cases where managers and directors have been accused of poor corporate governance resulting in corporate scandals include, the collapse of the Euro Bank in 2004, the placement of Uchumi Supermarkets under receivership in 2004 due to mismanagement and the more recent Board room wrangles and the discovery of secret overseas bank accounts for siphoning company money by some directors at CMC Motors. The purpose of the study was to determine the relationship between corporate governance practices and earnings management among companies listed in the Nairobi Securities Exchange.

The study adopted descriptive research design. The population under investigation was all the 63 companies listed in the N.S.E. The sample population consisted of 58 companies that had been actively trading at the NSE between January 2010 and December 2013. The study used secondary quantitative data. Descriptive statistics was used (mean scores, standard deviations and percentages) to profile the extent and distribution of various corporate governance practices. The data collected also employed linear regression and correlation analysis to test the relationship between the dependent variable.

Based on the findings, the study concludes that board size positively and significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange. In addition the study also concluded that board independence negatively but

significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange. The study further revealed that CEO Duality positively and significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange although the effect is moderate. The study also concludes that ownership structure negatively but significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange. The monitoring power derived from the ownership structure results in a kind of control exercised over the company and, particularly, over the top management team.

5.2 Conclusions

Based on the findings, the study concludes that board size positively and significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange. 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 (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 addition the study also concluded that board independence negatively but significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange. Because previous CG literature shows that independence is often considered as a substitute for transparency and disclosure of annual reports, it has often recommended that the number of external members in board of directors be greater than the owners, for there to be more oversight of management and to maximize the value of the organization (Zattoni and

Cuomo 2010; Ferraz et al. 2011). This suggests that the degree of Board independence is directly related to the quality of information that firms issues (Cheng and Courtenay 2006).

The study further concludes that CEO Duality positively and significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange although the effect is moderate. It is understood that there is concentration of power in a company when the same person takes the role of chief executive and president of the Board. There is a high concentration of ownership and control held by families that produces an effect of entrenchment by the chairman of Board of Directors when he maintains family ties with the major shareholders. In this sense, in Mexico, Castan˜eda (2000b) found that in 85 % of Mexican companies listed on the Stock Exchange in New York the majority owners preside the Board of Directors and also exert the role of CEO.

The study also concludes that ownership structure negatively but significantly influenced the earnings management among companies listed in the Nairobi Securities Exchange. The monitoring power derived from the ownership structure results in a kind of control exercised over the company and, particularly, over the top management team. de Bos and Donker (2004) also show that increased ownership concentration is an effective corporate governance mechanism in monitoring accounting decisions of incumbent management, such as voluntary accounting changes.

5.3 Recommendations for Policy and Practice

This study has important policy implications. Market regulators (or standard setters) and investors need to be aware of the different types of earnings management. While opportunistic earnings management tends to mislead and hurt investors, informative earnings management will, in fact, provide useful information through signaling out managers' private

information about the firm's future cash flows and earnings potential. Rational investors should refer to different types of earnings management behaviors and adjust their decisions accordingly. From policy making point of view the results suggest concerted efforts to be made towards training these institutional investors towards their active role in board activities

To bolster the confidence of market participants, regulatory bodies should promote informative earnings management and constrain opportunistic earnings management. A practicable and useful approach to increasing informative earnings management is to improve corporate governance, which will have a positive impact on managerial motivations for informative earnings management.

Outside directors to the board may improve in governance practices and may be helpful to the board in monitoring the firm's management of earnings which implies that investors will rely on the information revealed in the financial statements when there are more outside directors in the board. The study recommended the need for effective corporate governance practices at senior managerial level of quoted companies in Kenya to contribute to reduced earnings management and hence improve on actual firm liquidity and avert possible collapse of public organizations in Kenya.

Ownership concentration needs to be reduced to avoid few people controlling the financial performance of the organization. Finally, the study recommends that financial monitoring should be done thoroughly by the board. A constitution which clearly indicates how to select and replace the CEO and directors need to be adopted. Companies should consider adopting conduct of regular Corporate Governance Audits and Evaluations. Good Corporate Governance has a positive economic impact on the institution in question as it saves the organization from various losses e.g. those occasioned by frauds, corruption and similar irregularities.

The findings reiterate the importance of contextualizing the issue under consideration in view of the legal and institutional structures and processes in place rather than experimenting with some good corporate governance practices used in other contexts. This would go a long way in strengthening firms' reputation and reposing investor confidence. Therefore, policy maker should motivate companies to applying corporate governance principles, otherwise they companies should be panelized.

5.4 Limitations of the Study

The researcher encountered various limitations that were likely to hinder access to information sought by the study. The researcher encountered problems of time as the research was being undertaken in a short period with limited time for doing a wider research. However, the researcher countered the limitation by carrying out the research across the companies that were active for the last five years which enabled generalization of the study findings on the effects of corporate governance.

The other concern was the measurement problems of earnings management. One of the limitations is that earnings management is assumed to be opportunistic rather than informative. Nevertheless, the different models used in the paper (Jones original, Jones modified, Jones cash flow, and KS model) indicate that the results are robust after controlling for alternative measures of discretionary accounting accruals. Because our results focus on all listed companies and on one period, 2010–2013, both data and time period are other limitations of the study.

Further, some corporate governance related issues are unaddressed, such as the actual composition and expertise of the BoD, the involvement of the government in the BoD, the interaction of the BoD, the protection of minority interests, the quality of internal and

external audits, and potential market reaction toward managerial informative earnings management.

5.5 Recommendation for further studies

The present study suggests a number of other avenues for future researches. First, the current study examines how corporate governance characteristics affect earnings management. Although field studies and qualitative research methods may raise issues of generalizability, future studies adopting this approach may complement this study by interviewing standard setters and managers to examine the regulation setting process by the former and the motivations for the latter to follow regulations. Findings from the interviews could provide fruitful suggestions on how best to design a corporate governance regime for each/different business setting(s) to ensure realization of long-term stakeholders' value.

Second, this study relies on the view that earnings management activities are undesirable. However, Peasnell et al (2005) argued that earnings management activities can be viewed as beneficial to shareholder, in particular when earnings management is used in order to improve informativness of reported earnings. Therefore, future research can be conducted to investigate how much earnings management activities are harmful to shareholders.

Third, future research could be conducted for financial companies such as commercial banks and insurance companies, where legal and regulatory authorities may play an important role in monitoring managers' activities.

Future research could also follow up on issues regarding the substance and quality of the subcommittees of the board of directors. Such research could investigate too whether it is the voluntary or mandatory adoption of certain corporate governance requirements, e.g. the

formation of a remuneration committee, that is effective in improving the quality of financial reporting.

Further research in the area of ownership identity (ownership by different types of large shareholders – other corporations, families, and government) would be fruitful, and may provide more insight into block-holders and earnings management relationships. Moreover, as many of the critical decisions of boards are driven by committees, further research on their roles and status would be rewarding to provide evidence on the effect of board committees on firms' earnings management; examples might relate to their nomination and compensation, and to strategy, audit, and ethics committees.

Finally, although much of the attention in earnings management has been directed towards large corporations, they represent only a small part of the total business world. Consideration of small and medium sized enterprises in the corporate governance-earnings management area may also be fruitful.

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Appendix 1: List of Quoted companies actively trading at NSE Between 2010 to 2013

1. Eaagads Limited
2. Kakuzi Limited
3. Kapchorua Tea Limited
4. Limuru Tea Limited Company
5. Rea vipingo plantations Limited
6. Sasini Limited
7. Williamson Tea Kenya
8. Car and General Kenya Limited
9. CMC Holding Limited
10. Masharls E.A Limited
11. Sameer Africa Limited
12. Barclays Bank of Kenya Limited
13. CFC Stanbic Bank
14. Diamond Trust Bank
15. Equity Bank Limited
16. Housing Finance Company Limited
17. I&MHoldings
18. Kenya Commercial Bank Limited
19. National Bank of Kenya
20. NIC Bank Limited
21. Standard Chartered Bank Limited
22. Co-operative Bank of Kenya Limited
23. Express Kenya
24. Hutchings Biemer Limited
25. Kenya Airways limited
26. Longhorn Kenya Ltd
27. Nation Media Group Limited
28. ScanGroup Limited
29. Standard Group Limited
30. TPS EA (Serena)Limited

31. Uchumi Supermarkets Limited
32. Athi River Mining Limited
33. Bamburi Cement Limited
34. Crown Paints Kenya Limited
35. East Africa Cables Limited
36. East Africa Portland Cement
37. KenGen Limited
38. KenolKobil Limited
39. Kenya Power and Lighting Company
40. Total Kenya Limited
41. CIC Insurance Group Ltd
42. Jubilee Holdings Limited
43. Kenya Re Corporation Limited
44. Pan Africa Insurance
45. Centum Investment Company
46. City Trust Limited
47. Olympia Capital Holdings Limited
48. Trans-Century Ltd
49. B.O.C Kenya
50. BAT Kenya Limited
51. Carbacid Investments Limited
52. East African Breweries Limited
53. Eveready East Africa Limited
54. Kenya Orchards Limited
55. Mumias Sugar Limited
56. Unga Group Limited
57. Access Kenya Group Limited
58. Safaricom Limited

(source: Nairobi Securities Exchange Website, 2014)

Appendix II: Raw Data

EARNINGS MANAGEMENT LISTED COMPANIES

	EM 2010	EM 2011	EM 2012	EM2013
1	0.340063	0.656364	0.08083	0.32646
2	0.13649	0.1656	0.17436	0.13103
3	6.40139	1.46252	3.29136	6.145334
4	2.43214	0.54703	0.026294	2.334854
5	0.35114	0.40146	0.000942	0.337094
6	0.17904	0.27014	0.136	0.171878
7	1.592117	0.136	0.136	1.528432
8	0.124951	0.41262	0.00777	0.119953
9	0.43009	0.0905	0.000632	0.412886
10	0.33251	0.19863	0.00181	0.31921
11	0.12212	0.225393	0.0085	0.117235
12	1.741907	0.245419	0.04924	1.672231
13	2.48229	0.86135	0.1214	2.30853
14	0.37271	0.07808	0.00746	0.34662
15	1.15669	0.40735	0.02366	1.075722
16	0.04527	0.37768	0.000552	0.042101
17	0.720135	0.02345	0.052688	0.669726
18	0.238424	0.51664	0.00695	0.221734
19	0.991409	1.020642	0.023623	0.92201
20	0.136	0.136	0.136	0.12648
21	0.461457	0.568892	0.01704	0.429155
22	1.093327	0.27511	0.10161	1.016794
23	0.690919	0.63925	0.100022	0.642555
24	0.568995	0.48195	0.04296	0.529165
25	0.824306	0.22994	0.04888	0.766605
26	0.61085	0.33278	0.00662	0.568091
27	0.007522	0.393675	0.000325	0.006995
28	0.844184	0.03946	0.06949	0.785091
29	0.73075	0.02419	0.05294	0.679598
30	0.384256	0.02407	0.00487	0.357358
31	0.477785	0.025848	0.02312	0.44434
32	0.02881	0.13062	4.36E+05	0.026793
33	2.89358	1.10438	0.344652	2.691029
34	0.897947	0.953298	0.06781	0.835091
35	0.127492	0.4676	0.02674	0.118568
36	0.15669	0.151633	0.000601	0.145722
37	0.103613	0.31747	0.011386	0.09636
38	0.331811	0.324551	37315.22	0.318539
39	0.304852	0.321159	38658.97	0.292658
40	0.277893	0.317767	40002.72	0.266777

41	0.250934	0.314375	41346.47	0.240896
42	0.223974	0.310983	42690.23	0.215015
43	0.197015	0.307591	44033.98	0.189134
44	0.170056	0.304199	45377.73	0.163254
45	0.143097	0.300807	46721.48	0.137373
46	0.116137	0.297415	48065.24	0.111492
47	0.089178	0.294023	49408.99	0.085611
48	0.204555	0.339307	55263.03	0.196373
49	0.186864	0.339049	56911.28	0.179389
50	0.169173	0.338792	58559.53	0.162406
51	0.151481	0.338534	60207.78	0.145422
52	0.13379	0.338276	61856.04	0.124424
53	0.116098	0.338018	63504.29	0.107971
54	0.098407	0.33776	65152.54	0.091518
55	0.080715	0.337502	66800.79	0.075065
56	0.063024	0.337244	68449.04	0.058612
57	0.045332	0.336986	70097.29	0.042159
58	0.027641	0.336728	71745.54	0.025706

Source: Annual Reports and Financial Statements, 2010-2013

CEO Duality 1 =Chair / CEO, 0=CEO only

1	2010	2011	2012	2013
2	-	-	-	-
3	1	1	1	1
4	-	-	-	-
5	-	-	-	-
6	-	-	-	-
7	-	-	-	-
8	-	-	-	-
9	-	-	-	-
10	-	-	-	-
11	-	-	-	-
12	-	-	-	-
13	-	-	-	-
14	-	-	-	-
15	-	-	-	-
16	-	-	-	-
17	-	-	-	-
18	1	1	1	1
19	-	-	-	-
20	-	-		
21	-	-	-	-
22	-	-	-	-
23	-	-	-	-
24	-	-	-	-
25	-	-	-	-
26	-	-	-	-

27	-	-	-	-
28	-	-	-	-
29	-	-	-	-
30	-	-	-	-
31	-	-	-	-
32	-	-	-	-
33	1	1	1	1
34	-	-	-	-
35	-	-	-	-
36	-	-	-	-
37	-	-	-	-
38	-	-	-	-
39	-	-	-	-
40	-	-	-	-
41	-	-	-	-
42	-	-	-	-
43	-	-	-	-
44	1	1	1	1
45	-	-	-	-
46	-	-	-	-
47	-	-	-	-
48	1	1	1	1
49	-	-	-	-
50	-	-	-	-
51	-	-	-	-
52	-	-	-	-
53	-	-	-	-
54	-	-	-	-

55	-	-	-	-
56	-	-	-	-
57	-	-	-	-
58	-	-	-	-

Source: Annual Reports and Financial Statements, 2010-2013

Ownership structure

	2010	**2011**	**2012**	**2013**
1	26.06	26.06	20.06	18.06
2	52.00	52.00	52.00	52.00
3	41.84	41.84	41.84	41.84
4	51.46	51.46	51.46	51.46
5	32.50	32.50	32.50	32.50
6	68.25	68.25	68.25	68.25
7	65.57	65.57	65.57	65.57
8	57.24	57.24	57.24	57.24
9	68.50	68.50	68.50	68.50
10	41.41	41.41	41.41	41.41
11	17.32	17.32	17.32	17.32
12	24.45	24.45	24.45	24.45
13	24.85	24.85	24.85	24.85
14	17.75	17.64	17.63	17.55
15	48.05	48.05	48.05	48.05
16	15.84	15.84	15.84	15.84
17	73.87	73.87	73.87	73.87
18	64.56	64.56	64.56	64.56
19	24.90	60.43	60.43	84.12
20	26.00	26.00	26.00	26.00
21	44.66	44.66	44.66	44.66
22	25.87	29.08	29.08	31.22
23	69.22	69.03	69.03	68.90
24	39.56	44.53	45.05	48.54
25	39.29	44.54	45.13	48.82
26	39.03	44.56	45.21	49.11
27	38.77	44.57	45.28	49.39
28	38.51	44.58	45.36	49.67
29	38.24	44.59	45.44	49.96
30	37.98	44.61	45.52	50.24
31	37.72	44.62	45.60	50.52
32	37.46	44.63	45.68	50.81

33	37.20	44.65	45.75	51.09
34	36.93	44.66	45.83	51.37
35	36.67	44.67	45.91	51.66
36	36.41	44.68	45.99	51.94
37	36.15	44.70	46.07	52.22
38	35.88	44.71	46.14	52.51
39	35.62	44.72	46.22	52.79
40	35.36	44.74	46.30	53.07
41	35.10	44.75	46.38	53.36
42	34.83	44.76	46.46	53.64
43	34.57	44.78	46.53	53.92
44	34.31	44.79	46.61	54.21
45	34.05	44.80	46.69	54.49
46	33.79	44.81	46.77	54.77
47	33.52	44.83	46.85	55.06
48	33.26	44.84	46.93	55.34
49	33.00	44.85	47.00	55.62
50	32.74	44.87	47.08	55.91
51	32.47	44.88	47.16	56.19
52	32.21	44.89	47.24	56.47
53	31.95	44.90	47.32	56.76
54	31.69	44.92	47.39	57.04
55	31.43	44.93	47.47	57.32
56	31.16	44.94	47.55	57.61
57	30.90	44.96	47.63	57.89
58	30.64	44.97	47.71	58.17

Source: Annual Reports and Financial Statements, 2010-2013

Board size				
	2010	**2011**	**2012**	**2013**
1	6	6	6	6
2	3	3	3	3
3	9	9	9	9
4	7	7	7	7
5	7	7	7	7
6	8	8	8	8
7	8	8	8	8
8	7	7	7	7
9	8	10	10	11
10	7	10	10	12

11	10	10	9	9
12	12	14	14	15
13	7	7	7	7
14	11	11	11	11
15	10	10	10	10
16	10	10	10	10
17	10	10	10	10
18	12	12	12	12
19	9	9	9	9
20	11	12	11	11
21	16	16	16	16
22	7	7	7	7
23	8	8	6	5
24	12	12	11	11
25	8	8	8	8
26	8	8	8	8
27	7	7	7	7
28	8	10	10	11
29	7	10	10	12
30	10	10	9	9
31	12	14	14	15
32	7	7	7	7
33	11	11	11	11
34	10	10	10	10
35	10	10	10	10
36	10	10	10	10
37	12	12	12	12
38	9	9	9	9
39	11	12	11	11
40	16	16	16	16
41	7	7	7	7
42	8	8	6	5
43	12	12	11	11
44	8	8	8	8
45	8	8	8	8
46	7	7	7	7
47	8	10	10	11
48	7	10	10	12
49	10	10	9	9
50	12	14	14	15
51	7	7	7	7

52	11	11	11	11
53	10	10	10	10
54	10	10	10	10
55	10	10	10	10
56	12	12	12	12
57	9	9	9	9
58	11	12	11	11

Source: Annual Reports and Financial Statements, 2010-2013

Proportion of non executive to total directors

	2010	2011	2012	2013
1	0.67	0.67	0.67	0.67
2	0.67	0.67	0.67	0.67
3	0.89	0.89	0.89	0.89
4	0.43	0.43	0.43	0.43
5	0.71	0.71	0.71	0.71
6	0.88	0.88	0.88	0.88
7	0.88	0.88	0.88	0.88
8	0.86	0.86	0.86	0.86
9	0.63	0.70	0.60	0.61
10	0.86	0.80	0.40	0.23
11	0.90	0.90	0.89	0.89
12	0.83	0.79	0.71	0.66
13	0.86	0.86	0.86	0.86
14	0.82	0.82	0.82	0.82
15	0.70	0.70	0.70	0.70
16	0.80	0.80	0.80	0.80
17	0.50	0.50	0.50	0.50
18	0.92	0.92	0.92	0.92
19	0.89	0.89	0.89	0.89
20	0.82	0.75	0.82	0.80
21	0.94	0.94	0.94	0.94
22	0.71	0.71	0.71	0.71
23	0.50	0.50	0.50	0.50
24	0.67	0.67	0.67	0.67
25	0.67	0.67	0.67	0.67
26	0.89	0.89	0.89	0.89
27	0.43	0.43	0.43	0.43
28	0.71	0.71	0.71	0.71
29	0.88	0.88	0.88	0.88
30	0.88	0.88	0.88	0.88

31	0.86	0.86	0.86	0.86
32	0.63	0.70	0.60	0.61
33	0.86	0.80	0.40	0.23
34	0.90	0.90	0.89	0.89
35	0.83	0.79	0.71	0.66
36	0.86	0.86	0.86	0.86
37	0.82	0.82	0.82	0.82
38	0.70	0.70	0.70	0.70
39	0.80	0.80	0.80	0.80
40	0.50	0.50	0.50	0.50
41	0.92	0.92	0.92	0.92
42	0.89	0.89	0.89	0.89
43	0.82	0.75	0.82	0.80
44	0.94	0.94	0.94	0.94
45	0.71	0.71	0.71	0.71
46	0.50	0.50	0.50	0.50
47	0.73	0.72	0.73	0.72
48	0.72	0.71	0.72	0.72
49	0.72	0.70	0.72	0.71
50	0.89	0.89	0.89	0.89
51	0.82	0.75	0.82	0.80
52	0.94	0.94	0.94	0.94
53	0.71	0.71	0.71	0.71
54	0.50	0.50	0.50	0.50
55	0.67	0.67	0.67	0.67
56	0.67	0.67	0.67	0.67
57	0.89	0.89	0.89	0.89
58	0.43	0.43	0.43	0.43

Source: Annual Reports and Financial Statements, 2010-2013