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EFFECT OF CORPORATE GOVERNANCE ON EARNINGS MANAGEMENT OF FIRMS LISTED IN NAIROBI SECURITIES EXCHANGE

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Abstract

The main aim the study was to analyze the effect of corporate governance on earnings management in Kenya. Agency theory and catering theory of earnings management were used to inform the study. This study adopted an explanatory design. The target population for the study comprised of the 60 listed firms at Nairobi securities exchange. Census technique was used in the study since it only captured all the 45 firms that have consistently operated at the Nairobi Security Exchange for the past 8 years from 2005-2012. The study utilized secondary data, and data was collected by use of content analysis. Data was analyzed using descriptive and inferential statistics. The hypotheses were tested using multiple regression model. The study found that board independence had no significant effect on earning management. CEO Duality had significant negative effect on earning management. The study also found that in firm where there is board independence and audit committee reduces earning management.

Keywords: Earning Management, corporate governance, board of directors, Audit Committee, Board Independence

INTRODUCTION

Earnings management is the deliberate altering of financial information to either mislead investors on the underlying economic status of a firm or to gain some contractual benefits that depend largely on accounting numbers (Ronen and Varda Yaari, 2008). Accruals are the most important earnings management instruments that are used by managers to either increases or decrease reported income. This is because they are components of earnings that are not

reflected in current cash flows, and a great deal of managerial discretion goes into their construction (Bergstresser and Phillippon, 2003). Corporate governance is a mechanism that is employed to reduce the agency cost that arises as a result of the conflict of interest that exists between managers and shareholders (Hassan and Ahmed, 2012). The conflict arises because of the separation of ownership from control of the modern day business places. This separation leverages management to take decisions that promote their personal interest (Kang and Kim, 2011). In other words, managers can use their decision making power over the firm to achieve personal objectives at the expense of other stakeholders. Indeed, opportunistic managers may produce less reliable accounting earnings that may not reflect a firm's financial performance (Habbash, 2010). Earnings management reduces the quality of reported earnings and its usefulness for decisions making, thus reducing investor confidence. The accounting earnings are more reliable and of higher quality when managers' opportunistic behavior is reduced using monitoring systems by enhancing corporate governance and the independence of external auditors (Habbash, 2010).

In this regard, Gul and Tsui (2001) support the effectiveness of corporate governance as a monitoring system. Xie *et al.* (2001) and Klein (2002b), among others, show that corporate governance reduces management's ability to manage earnings. Corporate governance and external audit therefore assist investors by aligning the objectives of management with the objectives of shareholders, thereby enhancing the reliability of financial information and the integrity of the financial reporting process (Habbash, 2010).

Jiraporn *et al.*, (2008) argued that firms with inaccurate information may engage in earnings management because a higher degree of asymmetric information makes it more difficult for the board to monitor managers. Managers might abuse their discretion over earnings, such as engaging in earnings management, thereby increasing agency costs. Kang and Kim (2011) observed that management could influence reported earnings by making accounting choices or by making operating decisions discretionally. One of such discretionary decisions to manipulate reported earnings is imbedded in the accrual-based accounting. Earnings management affects firm performance and can even temper with shareholders' wealth. The motivation for misrepresentation of firm performance arises because of the conflict of interest between managers and shareholders. Empirically, it is widely accepted that governance practices limit a manager's ability to manipulate earnings (Peasnell *et al.*, 2005; Kim and Yi, 2006; Chen *et al.*, 2007; Huang *et al.*, 2007 and Jaggi *et al.*, 2009). Accordingly, in order to constrain any divergence in interests and to ensure appropriate accountability of resources, an organization needs a comprehensive structure of controls that encourages efficient

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performance and responsible behavior. Epps and Ismail (2008) confirmed that board characteristics are important determinants of earnings management.

Cornett *et al.*, (2008) found that adjusting for impact of earnings management substantially improves the relevance of governance variables and significantly declines the importance of incentive-based compensation for firm performance. Zhu and Tian (2009) findings reveal that board composition is more effective towards improving firm performance when actual performance is considered. In today's corporate environment, good governance structures include an adequately functioning audit committee, a thoughtfully composed board of directors, a balanced ownership structure, and an independent and vigilant external auditor (Habbash, 2010). Cohen *et al.,* (2002) recognizes that one of the most important functions of corporate governance is to ensure the quality of the financial reports. Thus, effective oversight of the financial reporting process by the aforementioned corporate mechanisms is thought to improve the accuracy of reports to shareholders and act as a deterrent against possible opportunistic behavior by managers.

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). However, most of the studies concentrated only in direct effect of corporate governance of earning management.

In Kenya, there are cases where managers and directors have been accused of poor corporate governance resulting to corporate scandals which include the collapse of Euro Bank in 2004, the placement of Uchumi Supermarkets under receivership in 2004 due to mismanagement, the near collapses of Unga Group, National Bank of Kenya and more recently board room wrangles and the discovery of secret overseas bank accounts for siphoning company money by some directors at CMC Motors (Madiavale, 2011). Hendrikse (2004) argue 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. This is in recognition that prior to 2002; poor management was one of the factors pointed out to be contributing to serious liquidity problems and collapse of public

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organizations in Kenya. However, recent studies have shown that corporate governance is key determinant of earnings management (Lei, 2008; Iqbal and Strong, 2010; Cormier *et al*, 2012). Most of these studies have been conducted in developed world and very few have been conducted in developing countries leaving a dearth on the existing literature. Thus, the study was important in Kenya since it highlighted how ownership structure affects earnings management. In addition, most scholars argues that studies conducted in developed countries may become impossible to employee the same methodologies in developing countries due to their ongoing structural changes.

H_{o1}: *Board Independence has no significant effect on earnings management*

H_{o2}: *CEO duality has no significant effect on earnings management*

THEORETICAL FRAMEWORK

Stewardship theory developed by Donaldson & Davis (1990) is based on a psychological and sociological approach, which maintains that the interests of corporate executives (as stewards) are aligned with those owners (Albrecht *et al.*, 2004). The stewardship theorists focus on structures that empower and facilitate rather than monitor and control. Stewardship theory considers the board of directors as an instrument of assistance to a steward CEO rather than a controlling mechanism (Albrecht *et al.*, 2004). It also considers that management is less likely to practice earnings management.

It argues that the responsibility and authority of executive managers provides a better focus on company objectives, leadership and implementation of operational decisions, leading to more effective corporate governance and corporation. Donaldson & Davis (1994) contend that the stewardship theory remains the theoretical foundation for better regulation and legislation in corporate governance. Hence, best corporate governance practices leads to quality earnings reporting.

Stewardship theory view is that the board of directors has role of monitoring the manager to achieve the maximal interests of shareholders through the hiring and supervising the CEO to implement corporate strategies to maximize the realization of the interests of shareholders, and firing CEO when running a poor management. Board of directors is also responsibility to guide the development of major corporate strategic: firm’s mission, values and vision; make policy and strategic decisions that support mission, values and vision (Hendry and Kiel, 2004).

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EMPIRICAL REVIEW

Board Independence and Earnings Management

Board independence refers to the proportion of independent directors on the board (Sweeney, 1996). Recently, Garcia Osma (2008) shows that a more independent board contributes towards restricting managers from using research and development expenditure as a tool to manipulate earnings.

Chen *et al.,* (2006) also found out that characteristic of the board to independency is related to the earnings management level in a company. Bushman (2009) stated that having lower board independence and higher earnings management can be part of the general equilibrium and does not necessarily indicate that board independence reduces earnings management.

Studies demonstrates that the effectiveness of outside directors as monitors is greater when the cost of information acquisition is lower (Raheja 2005; Adams and Ferrira 2007; Harris and Raviv 2008; Duchin *et al*. 2010). It thus follows that the more informative the information environment is, the lower the information acquisition costs are, and the more effective the outside directors will be. Adams and Ferreira (2007) and Harris and Raviv (2008) show that knowing independent directors are tougher monitors, the management is reluctant to share important information with them or a board dominated by independent directors.

Larcker *et al*. (2007) find that board independence is not correlated with signed abnormal accruals, the absolute value of abnormal accruals, or the likelihood of accounting restatements. Beasley (2006) finds that board independence is negatively correlated with the likelihood of accounting frauds. In contrast, Agrawal and Chadha (2005) find that board and audit committee independence are not correlated with the likelihood of accounting restatements. Adams and Ferreira (2007) argue that “unless boards are given better access to information, simply increasing board independence is not sufficient to improve governance.”

A number of studies have linked board independence to financial performance and shareholder wealth (Brickley *et al*., 1994). Moreover, board independence is more effective in monitoring management. Klein (2002), Xie *et al*. (2003), Sonda *et al*. (2003) and Peasnell *et al*. (2005) provided evidence concerning board independence and earnings manipulation and found that companies with independent boards are less likely to report abnormal accruals. Conversely, Park and Shin (2003), Abdul Rahman and Ali (2006) and Osama and Noguer (2007) found no relationship between outsider directors and earnings management.

Klein (2002) finds that board independence is negatively correlated with earnings management, proxied by the absolute value of abnormal accruals. While this finding is confirmed by some later studies, such as Bedard *et al*. (2004), other studies find conflicting

results. For example, Vafeas (2005) finds that board independence is significantly related to the likelihood of avoiding earnings surprises, a proxy for earnings management. Independent non-executive directors have both, strong incentives to monitor the board, and the capabilities to identify earnings management (Peasnell et al.2000a).

The need to maintain director's reputation in the competitive market for directors provides incentive for independent non-executive directors to monitor the board, failing which would increase the likelihood of dismissal (Fama 1980). In addition, there is no tangible benefit that accrues to the independent non-executive directors from earnings management. Peasnell *et al.,* (2000a) report that independent non-executive directors have the capabilities to detect earnings management since most of them are familiar with financial reporting issues by holding senior management positions in other firms

The mixed prior evidence makes it difficult to predict whether the extent of earnings management will change when board independence increases following the recent regulatory requirements. In addition, prior studies, by examining the cross-sectional correlation between board independence and earnings management, are likely subject to the endogeneity issue. As pointed out by Guay (2008), Bushman (2009) and others, having lower board independence and higher earnings management can be part of the general equilibrium and does not necessarily indicate that board independence reduces earnings management.

CEO Duality and Earnings Management

CEO duality means one person acting as a CEO and also as the chairman of board. CEO duality existence will give chances to power concentration which can increase management discretion. Having a CEO and chairmanship of the board positions held by different individuals will have more effective monitoring (Cornett *et al.*, 2008). This is different if CEO Duality exists, which can make monitoring action less effective and could lead to high level of discretionary accrual.

Previous studies examined the relation between earnings management and role of CEO duality. For example, Klein (2002) found that discretionary accrual is positively related to the CEO duality. In contrast, Beasley (1996) documented no significant relation between the likelihood of financial statements fraud and CEO duality. In the same manner, Abdul Rahman and Ali (2006) found that separation between the role of CEO and chairman has no effect on earnings management. Finkelstein, Hambrick, and Cannella (2009) noted that CEO duality is a very contentious issue in public discussions of corporate governance. But underlying the contention surrounding joining or separating the CEO and chair positions is a question.

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Notwithstanding Dalton *et al.,* (2008) meta-analysis showing no empirical link between CEO duality and earnings management, the debate over this high-profile topic continues in academic and practitioner circles. Scholarship on the duality issue remains equally unsettled. As Dalton *et al.* (2007) observed, despite a lack of evidence supporting a CEO duality–firm performance link, the theoretical basis for a relationship remains quite strong.

There are two points of view on the issue of the separation of powers between the chairman and the CEO based on the agency theory and the stewardship theory (Abdul Rahman and Haniffa, 2005). Proponents of the agency theory believe that the separation of the two roles is crucial for the monitoring of the effectiveness of the board over management, by providing cross checking evidence against the possibility of over-ambitious plans by the CEO. Because, when the same person is holding two important positions, they are likely to pursue strategies which advance their own personal interests over those of the company. These views support the separation of power, with two separate individuals holding the position of chairman and CEO, thereby allowing efficient monitoring by the board (Zulkafli et al., 2005). In contrast, proponents of the stewardship theory believe that the combination of the two roles enhance the decision making process and allow a CEO with strategic vision to guide the board to implement a company's objectives with the minimum of interference from the board.

Jensen (1993) argues that the power of the CEO when that person is also a chairman of the board can provide the CEO more control over the information available. However, the study did not directly examine the effect of the separation of the role of CEO and the chairman on earnings management. Klein (2002a) suggests that the more independent the board of directors is from the influence of the CEO, the more effective the monitoring carried out by the board of directors.

RESEARCH METHOD

This study adopted an explanatory design because the research tries to establish causal relationship. Explanatory research focuses on why questions and it also established causal relationships (De Vaus, 2001). The target population for the study comprised of the listed firms at Nairobi Securities Exchange, by 2014 there where 60 listed firms trading at the NSE . Census technique; was used in the study since it only captured all the 45 firms that have consistently been operating at the NSE for the past 8 years from 2005-2012 irrespective of its industry or market segment. This study utilized secondary data which was collected using content analysis derived from the annual financial statements reports and annual investors' reports. Document analysis was used because data being collected was secondary in nature.

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Measurement of Variables

Dependent variable

Earnings management was measured as the difference between net income, which is the earnings before taxation and extraordinary item and cash flow from operating activities (Dechow et al. 1995).

Independent variable

CEO duality CEO duality means a situation where the CEO also is the chairman to the board (Rechner & Dalton, 1991). A company with the CEO as the Chairman to the board was assigned 1, while companies without CEO as the Chairman were assigned 0.
Board Independence was measured as the percentage of non-executive directors on the board (Beasley, 1996; Klein, 2002; Beekes *et al.*, 2004).

Model specification

Analysis and interpretation of data was done bearing in mind the objectives and the research hypopaper of the study. Data collected was analyzed by use of quantitative technique; quantitative data was analyzed using descriptive statistical method, the statistical tools such as frequency distribution, tables. Measures of central tendency such as mean, mode and median were used. Regression analysis was used to analyze the data collected and data was presented using tables.Hypopaper was tested at 0.05 level of significance (95% confidence level) from the multiple regression model which showed the relationship between the independent variable and dependent variable. The multiple regression model was used for testing hypopaper about the relationship between a dependent variable (Y) and two or more independent variables (X*s*). The regression model used in this study was given as;

$$y_{it} = \beta_0 + \beta_1 x_{1it} + \beta_2 x_{2it} + +å$$

y = earnings management

β_0 = Constant of the equation

x_1 = Board independence

x_2 = CEO Duality

ANALYSIS AND FINDINGS

Findings from table 1 indicated that average board size was 9 members with 74% of board members being independent directors. More findings revealed that 24% of the firms had CEO serving as a chairperson and CEO at the same time. Firms were reported to have an average of

53 years since the year of incorporation and 74% shareholder concentration. Firm size ratio was 6.6906 and gender was at a mean ratio of 0.4286.

Table 1. Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation	Skewness
Independent Directors	0.03	0.99	0.7464	0.16932	-1.625
C.E.O Duality	0	1	0.2331	0.42336	1.268
Firm size	4	8.46	6.6552	0.76845	-0.291
Shareholder concentration	0.3	0.95	0.7429	0.1517	-0.69

Correlation Results

Table 2 represents Pearson correlation results of the study. The findings indicate that firm size was negatively correlated with earning management ($r = 0.402$, $\rho<0.01$). Additionally, shareholder concentration was indicated to positively relate with earning management ($r = 0.169$, $\rho<0.01$). However, independent directors and CEO duality, had no significant relationship with earning management. This implies that only four variables are expected to influence earning management.

Table 2. Correlations

	Earning management	Independent Directors	C.E.O Duality	Firm size	Shareholder concentration
Earning management	1				
Independent Directors	0.049	.272**			
C.E.O Duality	-0.19*	-.119*	1		
Firm size	-.402**	0.02	0.016	1	
Shareholder concentration	.169**	0.013	-0.04	-.324**	1

* Correlation is significant at the 0.05 level (2-tailed).

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

Test of Hypopaper

The study findings in Table 3 showed that all the study test variables explained 47.29% variation of earning management. This showed that considering the independent variables, there is a probability of predicting earning management (R squared = 0.4729). Further, coefficient of

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determination was significant as evidence of F ratio of 23.52 with p value 0.000<0.05 (level of significance).

Hypopaper 1 stated that board independence has no significant effect on earning management. Study findings revealed that indeed board independence has no significant effect on board independence as evidenced by (β_1= 0.03, ρ>0.05).Consistent with the results, Agrawal and Chadha (2005), and Siregar and Utama (2008) found no relationship between board's independence and earnings management. Also, Mak, and Tan (2006) in Singapore failed to find any association between earnings management and board independence.

As much as the study has found no relationship between board independence and earning management, board independence from management is one of the important factors determining the board effectiveness and monitoring ability. For instance, Ching *et al.*, (2002) argues that a board comprising of non-executive and external directors increases board's independence and monitors top management effectively hence preventing earning management. Contrary to the results, Xie *et al.* (2003), Peasnell *et al.* (2005; 2006), and Liu and Lu (2007) indicate that external directors are negatively related to earnings management. In a similar vein, Mohd Saleh *et al.* (2005) in a study of sampled firms listed on Bursa Malaysia found a positive relationship between discretionary accruals and the ratio of non-executive and independent directors in firms with negative unmanaged earning as a result of big bath activities.

Conflicting with the results, Garcia Osma (2008) shows that a more independent board contributes towards restricting earning management. Further, Davidson, Goodwin-Stewart, and Kent (2005) find empirical support for the effective role of independent directors in constraining earnings management in Australian firms.

Hypopaper 2 stated that CEO duality has no significant effect on earning management. However study findings showed that CEO duality had significant and negative effect on earning management as shown by (β_2= -0.101, ρ>0.05).Cognate to the results, Daily and Dalton (1997),report that CEO duality is a sign of strong leadership structure whereas separate roles acts as an effective monitor. As a result, separate roles works as a monitoring mechanism hence preventing earning management. Conflicting with the results, Dechow, Sloan and Sweeney (1995) reported that firms that combined the CEO and chairman roles were more likely subjected to accounting enforcement actions by the SEC for infringement of GAAP. Similarly A. Klein (2002) found that CEO, who held a position in the nominating and compensation committees, manipulated the earnings by increasing the absolute value of discretionary accrual. Moreover, Muniandy (2007) reported that Malaysian firms that combined the CEO and chairman position were associated with higher audit fees. However, Cornett,

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Marcus and Tehranian (2008) reported that CEO duality had no influence on the earnings management of US listed firms. In the same way, Dahya, Garcia and Bommel (2009) showed that there was no difference in firm performance whether the firms split or combine the CEO-chairman. From the foregoing, it is evident that CEO duality has a mixed relationship with earning management.

Table 3. Regression Results for Testing the Hypopaper

	Coef.	**Std. Err.**	t-value	P value
Independent Directors	0.156809	4453186	0.35	0.725
C.E.O Duality	-0.62065	0.168565	-3.68	0.000
Firm size	-1.48738	0.103826	-14.33	0.000
Shareholder concentration	0.612918	0.502965	1.22	0.224
industry	-0.00979	0.02864	-0.34	0.733
constant	13.85867	0.989437	14.01	0.0000
R-sq: overall	0.4729			
R-sq: between	0.1165			
F(14, 352)	23.52			
Prob > F	0.0000			

CONCLUSION

The study results have shown no significant effect between board independence and earning management. However, the more the firms have external directors, the more effective they monitor managers. This is due to the fact that they are able to stand pressures from the firm's management to manage earnings because they do not have self interest in the firm. Further, external directors are independent of management and are more effective in protecting the interests of shareholders when there is an agency problem. A balanced board is therefore important for balanced board composition, prevention of earning management and enabling the board to function effectively.

Basing on the findings, CEO duality has a negative and significant effect on earning management. If both posts are served by one person, he/she will have better understanding and knowledge on the firm operation and environment. However, a clear separation between the roles of chairman and executive directors is effective in limiting earnings management. Specifically, when the chairman of the board and the CEO is the same person, the firm is highly likely to be controlled by one person and the board is not independent from the management. As a result, CEO duality affects board's effectiveness of monitoring management.

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RECOMMENDATIONS

As much as the study has found no significant effect between board independence. It is utmost necessary to have a balanced board composition. Therefore, there is need to add outside directors to the board so as to keep the independence of the board. This is because outside directors are independent of management and more effective in protecting the interests of shareholders whenever there is agency problem. Moreover, they are also effective in preventing earning management.

There is evidence from the study results of a negative effect between CEO duality and earning management. Therefore, if CEO and chairman roles are to be combined, there should be a strong independent element on the board and the decision to combine should be publicly explained. Moreover, CEO duality will also enhance better understanding and knowledge on the firm operation and also environment. However, if independence cannot be achieved at the board, there is needed to separate both roles so as to limit earning management.

This paper explores two important governance mechanisms namely, CEO duality and board independence. While this paper only examined internal governance mechanisms, it is possible that external governance factors not explored in this paper also determined the earning management. These points to the need of future researchers to explore the effect of external governance factors.

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