THE EFFECT OF CORPORATE GOVERNANCE PRACTICES ON EARNINGS MANAGEMENT OF COMPANIES LISTED AT THE NAIROBI SECURITIES EXCHANGE

Dr. Cyrus Iraya, PhD, MBA, BCOM, CPA(K)
Dr. Mirie Mwangi, PhD, MBA, BCOM, CPA(K)
Lecturer, Department of Finance and Accounting
University of Nairobi, Kenya
Gilbert W. Muchoki, MSc Finance, BBM, CPA(K)
National Council of Churches of Kenya
Nairobi, Kenya

Abstract

The objective of the study was to establish the effect of corporate governance practices on earnings management of companies listed at the Nairobi Security Exchange (NSE). The target population consisted of the 49 companies that had been continuously and actively trading at the NSE between January 2010 and December 2012. Secondary data was used covering the period 2010 to 2012 and analyzed using linear regression to test the effect of the independent variables on the dependent variable. The study found that earnings management is negatively related to ownership concentration, board size and board independence but positively related to board activity and CEO duality. The study recommended the need for effective corporate governance practices in listed companies in Kenya to contribute to reduced earnings management and avert possible collapse of listed companies in Kenya.

Keywords: Earnings Management, Corporate Governance Practices, Nairobi Securities Exchange

Introduction

In recent years large accounting frauds uncovered in the stock markets have once again confirmed the existence of ethical failures and the importance of transparency and reliability of the financial information provided to stock markets (Lang and Lundholm, 2000). 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) . A weak corporate governance structure may provide an opportunity for managers to engage in behavior that would eventually result in a lower quality of reported earnings, which is a strong indication of a serious decay in business ethics (Jesus and Emma, 2013).

Corporate governance is the system by which companies are directed and controlled. Boards 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 (Cadbury Committee, 1992). Capital Markets Act of Kenya (Cap. 485A), defines corporate governance as the process and structure used to direct and manage business affairs of the company towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders long-term value while taking into account the interest of other stakeholders (CMA, 2002).

Gazette Notice No. 3362 to the Capital Markets Act of Kenya (Cap. 485A) 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 remuneration should also be competitive, linked to performance and sufficient to attract and retain diligent directors (CMA, 2002). 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 is required on aggregate directors' loans, ownership concentration listing ten major shareholders of the company, share options and other forms of executive compensation.

Earnings management is a strategy used by the management of a company to deliberately manipulate the company's earnings so that the figures match a pre-determined target. This practice is carried out for the purpose of income smoothing. Thus rather than having years of exceptionally good or bad earnings, companies will try to keep the figures relatively stable by adding and removing cash from reserves account (Dechow et al., 1995). Stolowy and Breton (2004) define earning management as the use of management's discretion to decide on accounting choices or to design transactions in a way that it will affect the chances of wealth transfer between the company and society, fund providers or managers. Fischer and Rosenzweiz (1995) gave a more precise definition of earnings management where they stated that it's the managers' action which increase / decrease current reported earnings of a company financials with no corresponding increase / decrease in the longterm economic gain in the company.

The agency theory posits a negative relationship between corporate governance and earnings management. Jensen and Meckling (1976) indicated that the principals who are the company owners can comfort themselves that the agent will make the most favourable decisions only if appropriate incentives and rewards are given and only if the agent is watched. This in effect supports monitoring of management by the director who according to the stewardship theory hold the fiduciary duty of safeguarding shareholder's interest. Higher monitoring by directors in their duty results to lower manipulation of earnings hence supporing a negative relationship between corporate governance and earnings management. The big bath theory of earnings management, however, suggests that firms experiencing low earnings in a given year may take discretionary write downs to reduce even further the current period's earnings with the assumption that they can not be met with an extra punishment for the accelerated poor performance (Dye, 1986). Again this behaviour positively affects earnings management and can only be controlled by such firms practicing good corporate governance thus a negative relationship is further supported. The stakeholders theory leaves managers with immense uncontrolled power that positively affects earnings management to their advantage. Here again good corporate governance practices can help monitor management so as to safeguard accountability and transparency and the integrity of financial reports free of earnings management.

Empirical studies have also concluded that various relationships exist between corporate governance and earnings management. Jesus and Emma (2013) observed that insider shareholding, ownership concentration, institutional investors, board independence, a greater number of board meetings negatively affects earnings management while family ownership, board size positively affects earnings management. The existence of concentration of power (CEO duality) increases earnings management while a country with higher levels of governability shows a lower level on earnings management practices (Bugshan, 2005). Liu and Lu (2007) documented systematic differences in earnings management across the China's listed companies during 1999–2005, and empirically demonstrated that firms with higher corporate governance levels have lower levels of earnings management. Their empirical findings, although not being able to completely exclude other explanations, strongly suggested that agency conflicts between controlling shareholders and minority investors account for a significant portion of earnings management in China's listed firms.

The Nairobi Securities Exchange was constituted in 1954 as a voluntary association of stock brokers registered under the Societies Act. The firms listed at the NSE are classified into different sectors based on the nature of their activities and operations including agricultural, commercial and services, Banking, Insurance, Investment and the manufacturing, Construction and allied sector among others.

The research problem

As a result of a series of high- profile cases of corporate collapses worldwide among them Enron and WorldCom in the US, Marconi in the UK and Royal Ahold in the Netherlands, there has been an exponential increase in the amount of laws, rules and guidelines setting in place a heightened standard of corporate governance best practice (McConvill, 2005). 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 (Manyuru, 2005). According to Ogoye (2002), the increasing number of corporate failures and financial scandals has been caused by incompetence, fraud and abuse of office by the agents running the corporations.

In Kenya, cases where managers and directors have been accused of poor corporate governance resulting to corporate scandals 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 organizations in Kenya.

Several studies in corporate governance and earnings management have been undertaken internationally including Alghamdi (2012) who studied investigation into earnings management practices and the role of corporate governance and external audit in emerging markets from Saudi listed companies and, Jesus and Emma (2013) who studied whether corporate governance influenced earnings management in Latin American markets. Locally, there are many studies in corporate governance though none has focused on its relationship or effects to earnings management. Most studies have concentrated on profitability as a measure of financial performance and the effects of corporate governance on performance of various sectors of the economy. A few studies among them Kaboyo (2013) and Irungu (2010) have looked at the factors motivating earnings management and the relationship between macro economic variables and earnings management for listed firms at the NSE. Unlike most corporate governance studies, this study focused on the control aspect of corporate governance rather than the performance enhancing aspect. The study focused on a period when managers in Kenya had an incentive to manage earnings due to the effect of macroeconomic factors in the country e.g. general election in 2013, interest rate escalation in 2011/2012 and foreign exchange depreciation in 2011. The research was guided by the question: What is the effect of corporate governance on earnings management of listed companies at the Nairobi Securities Exchange?

Research objectives

The main objective of the study was to establish the effect of corporate governance practices on earnings management of companies listed at the Nairobi Securities Exchange (NSE). The specific objectives were to establish:

i. the effect of ownership concentration on earnings management
ii. the effect of board size on earnings management
iii. the effect of board activities on earnings management
iv. the effect of CEO duality on earnings management

Research methodology

General Background and Population of the Study

In order to look at the corporate governance practices and their associations or relationship with earning management by quoted companies at the NSE, this study adopted a descriptive research design. Descriptive research design is concerned with finding out “what is” and can either be quantitative or qualitative since it involves gathering data that describes events and then organizes, tabulates, depicts and describe the data collection. Although there are 61 currently quoted companies at the NSE, the target population consisted of the 49 companies that had been continuously and actively trading at the NSE between January 2010 and December 2012. The study adopted a census study approach due to the small population selected.

Data Collection Method and Instruments

The study used secondary quantitative data to analyze the relationship between corporate governance and earnings management. Secondary data was obtained by abstraction method from corporate governance statements and financial statements for the 49 companies covered as they were published by NSE. This data covered the period 2010 to 2012. The data was collected from the published results of the selected companies and included the number of directors, number of meetings held in each study year, major shareholders' composition, proposition of executive and non executive directors in the board and CEO duality status while financial data included total assets, net revenue, accounts receivables, cash flow from operations and property, plant and equipment.

Data Analysis Technique

The data collected was analyzed using linear regression analysis to test the relationship between the discretionary accruals as an earnings management tool and specific corporate governance variables assumed to fit the NSE. The regression results were interpreted based on the Pearson correlation, adjusted R-squared, Test of significance using F statistic, coefficients of the independent variables and their p-values.

The measure of discretionary accrual (Earnings Management tool) used in this study was as applied previously by Jesus and Emma (2013) based on the Dechow et al. (1995) discretionary accruals model as follows:-

$EM_j = TA_j/A_j – [\alpha_0 (1/A_j) + \alpha_1 ((\Delta REV_j - \Delta REC_j) /A_j) + \alpha_2 (PPE_j/A_j)]$

Where:

TA is the total accruals

A is the beginning of year total assets

ΔREV is the change in net revenue

ΔREC is the change in accounts receivables

PPE is property, plant, and equipment

j denote the firm

$\alpha_{0,}$ α_1 and α_2 are the parameters for each variable

EM_j = Discretionary Accrual (Earnings Management).

The Regression equation was modeled as follows;

$EM=\beta_0 +\beta_1(X_1) +\beta_2(X_2) +\beta_3(X_3) +\beta_4(X_4) +\beta_5(X_5) + \varepsilon$

Where-:

EM is the discretionary accrual variable representing Earnings Management.

β represents the parameters for each variable.

X_1: Ownership Concentration measured by proportion of ownership held by the main shareholder of institutional nature of the quoted company.

X_2: Board Size measured by the total number of directors in the board.

X_3: Board Independence measured by the proportion of non executive directors inside the board (non executive directors / total directors).

X_4: Board Activity measured by number of board meetings held during the year.

X_5: CEO Duality measured by a dummy value of 1 if the company CEO also pairs up as the Board Chair and 0 if otherwise.
ε : Standard error term.

Results of research and discussions

Regression Results

Table 1 below shows adjusted R^2 of 0.667 indicating that all the independent variables taken together explain about 66.7% of the variations in earning management. The overall model is significant as shown by F statistic of 15.911 with a $p<0.05$. This implies that all the independent variables taken together can help predict earning management.

Test of the slope using t test was also undertaken and indicate that the coefficients of aggregate Earnings Management is negative and significant, indicating that holding Ownership Concentration, Board Size, Board Independence, Board Activity and CEO Duality constant Earnings Management will be -5.08. The study also found that a unit increase in ownership concentration will cause a 5.53 decrease in earnings management, further a unit increase in board size will lead to a decrease in earnings management by 0.42, a unit increase in board independence will lead to an decrease in earnings management by a factor of 6.94, a unit increase in board activity will lead to an increase in earnings management by a factor of 0.020 and a unit increase in CEO Duality will further lead to an increase in earnings management by a factor of 2.98. All the predictor variables are significant with $p<0.05$. The predicting equation therefore can be given by:

$$\mathbf{Y= -5.08-5.53X_1-0.42\ X_2-6.94\ X_3+0.02X_4+2.98\ X_5}$$

where Y= Earnings Management

B_0= intercept, X_1= Ownership Concentration, X_2= Board Size, X_3= Board Independence, X_4= Board Activity and X_5= CEO Duality

Table 2: Regression Results of Corporate Governance Practices and Earning Management

	Model 1[a]
Constant	-5.08 (.028)
Ownership Concentration	-5.53(.020)
Board Size	-0.42(.048)
Board Independence	-6.94(.000)
Board Activity	0.02 (.026)
CEO Duality	2.98 (.001)
Adjusted R^2	**0.667**
F	**15.911(.000)**

p – values in parenthesis
Predictors: Ownership Concentration, Board Size, Board Independence, Board Activity and CEO Duality
Dependent Variable: Earnings Management

Discussion of Findings

The findings suggest that the presence of block holders could effectively monitor the management to avoid their opportunistic behaviour including earnings management, the study result are consistent with the findings of Demsetz and Lehn (1985). The findings also show that board independence is negatively related to earnings management. That is, adding outside directors to the board may improve in governance practices since they are helpful to the board in monitoring the firm's management of earnings consistent with the findings of Beasley (2006) and Chen (2004).

The positive and significant relationship between CEO duality and earnings management is consistent with the findings of Dechow et al. (2006) and Finkelstein and D'Aveni (2003). The negative association between board size and earnings management is similar to the findings of Xie et al. (2003) and Chtourou et al. (2001) who found that larger boards are strongly associated with lower levels of earnings management an increase in board size improves the board's monitoring capacity.

Conclusion of the Study

The study conclude that that a unit increase in ownership concentration will cause a decrease in earnings management, a unit increase in board size will lead to a decrease in earnings management, a unit increase in board independence will lead to a decrease in earnings management, a unit increase in board activity will lead to an increase in earnings management and a unit increase in CEO duality will further lead to an increase in earnings management.

Policy Recommendations

From the findings and conclusions, the study recommends the need for effective corporate governance practices at senior managerial level of listed 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.

Recommendation for Further Studies

Further studies should be undertaken to explore earnings management for non-listed companies in Kenya and large family run private companies in Kenya. The findings would be very useful to the tax authorities in their pursuit to net more taxes and widen the tax base.

An opportunity arises for further research in the development of an experiment that would identify how average investors measure earnings management. This is because it is unclear whether investors use abnormal accruals, as measured by aggregate accruals approach, as a representation of earnings management. The complexity of such models suggests that the average investor is unlikely to use this measure.

References:

Alghamdi, S. A. (2012). Investigation into earnings management practices and the role of corporate governance and external audit in emerging markets: empirical evidence from Saudi listed companies. *Doctoral Thesis*, Durham University

Beasley MS (2006). An empirical analysis of the relation between the board of director composition and financial statement fraud. Account. Rev., 71 (4): 443-465.

Bugshan, T. O. (2005). Corporate Governance, Earnings Management, and the Information Content of Accounting Earnings: Theoretical Model and Empirical Tests.

Cadbury Committee, (1992). *Report of the Committee on the Financial Aspects of Corporate Governance Report with Code of Best Practice*. London: Gee & Co. Publishing.

Capital Markets Authority (2002). *Guidelines on corporate governance practices by public listed Companies in Kenya*, Gazette Notice No. 3362

Chen, Z. & Wei, K. C. J. (2004). *Corporate Governance, Agency Costs, and Expected Stock Returns: Evidence from Analysts' Earnings Forecasts*. Kowloon Hong Kong University of Science & Technology.

Chtourou, S. Bedard, J. & Courteau L. (2001). Corporate governance and earnings management", *working paper*.

Dechow, P. M., Sloan, R. G. & Sweeney, A. P. (1995). Detecting Earnings Management. *The Accounting Review 70*: 193-225.

Dechow, P., Sloan, R. & Sweeney, A. (2006). Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC, *Contemporary Accounting Research*, *13*, 1-36.

Demsetz, H. & Villalonga, B. (2001). Ownership structure and corporate performance. *Journal of Corporate Finance*, *7*, 209–233.

Dye.R. (1986). Proprietary and Non-proprietary Disclosure. *Journal of business*, *50*(2), 331-336.

Finkelstein, S. & D'Aveni, R. (2003). CEO Duality as a Double-edged Sword: How Boards of Directors Balance Entrenchment Avoidance and Unity of Command, *Academy of Management Journal, 37,*5 1079–1108.

Fischer,M. & K. Rosenzweig (1995). Attitudes of Students and Accounting Practitioners Concerning the Ethical Acceptability of Earnings Management. *Journal of business ethics, 13,* 205-221.

Hendriske, J. W. & Hendriske, L. (2004). *Business Governance Handbook; Principles and Practice*. Cape Town: Juta & Co.

Irungu, A.M. (2010). The Relationship Between Selected Macro Economic Variables and Earnings Management for Companies Quoted at the NSE. *Unpublished MBA Project*, University of Nairobi.

Jensen, M.C. & Meckling, W.H. (1976). Theory of the Firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, *4*, 305-360.

Jesus, S.G. & Emma, G.M. (2013). Does Corporate Governance Influence Earnings Management in Latin American Markets? *Journal of Business Ethics*, *10*(6) 851-892.

Kaboyo, O.W. (2013). Motivation Factors for Earning Management Practice in Kenyan Firms: Case for Public Listed Corporations. *Unpublished MBA Project*, Strathmore University.

Lang, M. & Lundholm, R. (2000). Voluntary Disclosure and Equity Offerings: Reducing Information Asymmetry or Hyping the Stock. *Contemporary Accounting Research*, *17*(4), 623–669.

Leuz, C., Nanda, D. & Wysocki, P. D. (2003). Earnings Management and Investor Protection: An International Comparison. *Journal of financial economics*, *69*(3), 505-527.

Liu, Q. & Lu, Z. J. (2007). Corporate Governance and Earnings Management in the Chinese Listed Companies: A Tunneling Perspective. *Journal of Corporate Finance*, *13*(5), 881-906.

Madiavale, C. (2011). The Relationship Between Corporate Governance and Financial Performance of Previously Government Owned Companies Quoted on the Nairobi Stock Exchange. *Unpublished MBA Project*, University of Nairobi.

Manyuru, P.J. (2005). Corporate Governance and Organisational Performance: The case of companies quoted at the Nairobi Securities Exchange. *Unpublished MBA Project*, University of Nairobi.

McConvill, J. (2005). Positive Corporate Governance and its Implications for Executive Compensation. *German Law Journal*, *6*(12)

Ogoye, H. K. (2002). *Corporate Governance and Management Compensation*, an empirical investigation.

Xie, B., Davidson, W. N. & DaDalt, P. J. (2003). Earnings Management and Corporate Governance: The Role of the Board and the Audit Committee. *Journal of corporate finance*, *9*(3), 295-316.