

Corporate Governance, Firm Characteristics and Earnings Management in an Emerging Economy

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Abstract

The main objective of this paper is to investigate the influence of corporate governance and firm specific characteristics on earnings management by Kenyan listed companies. Using panel data of 148-firm years obtained from the annual reports of the 37 companies listed on the Nairobi Stock Exchange (NSE), the study found that ownership structure and Board Composition were 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. The results of this study are important to the Kenya Capital Markets Authority (KCMA) and other 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 Listed Companies. The study is also important to investors in developing countries, who must interpret financial statement numbers reported in the companies while making investment decisions. Furthermore, the study contributes to our understanding of how corporate governance influences financial reporting in developing economies, such as Kenya.

Key Words

**Corporate Governance,
Earnings Management,
Reporting quality,
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Introduction

The main motivation for this study is to examine the relationship between the quality of corporate governance and earnings management in a developing country, Kenya. Specifically this paper investigates the influence of corporate governance characteristic (Ownership structure, Independence of the Audit Committee and Board Composition) and firm specific characteristics (Firm size, Firm Performance and Leverage) on earnings management by Kenyan listed companies. We seek to contribute to the debate of whether good corporate governance may be viewed as a prerequisite to good business (Che Haat et al., 2008) by reducing earnings management.

Whereas many of corporate governance studies have been carried out in developed countries of Europe, United States of America (USA) and Japan (Joshi and Wakil, 2004), only a few studies have been completed in developing countries of Africa (for example Uddin and Choudhury, 2008). According to Zoysa and Rudkin, (2010) empirical studies on corporate governance and reporting quality reveal that the majority of them have been conducted in countries with developed capital markets, and studies conducted in countries with emerging capital markets are extremely sparse. The conclusions of the studies conducted in developed capital markets cannot be considered as applicable to emerging capital markets due to the large differences in political, cultural, technological, economic, and social factors between the two markets. It is therefore necessary to study the question of quality of information reported by Kenya listed companies (an emerging capital market) and examine whether corporate governance and firm specific variables have an impact on the quality of this information.

Motivation

Razae (2003) stated that good corporate governance promotes relationships of accountability among the primary corporate participants and this may enhance corporate performance. Good corporate governance holds management accountable to the board and the board accountable to shareholders. A number of prominent participants in the

debates surrounding financial reporting and auditing practices have increased attention given to the role of corporate governance procedures in the development of credible financial statements information (Levitt, 1998).

Prior studies (Karamanou and Vafeas, 2005; Beekes and Brown, 2006) suggest that corporate governance can be associated with higher financial reporting quality. Most of these studies have investigated the impact of governance mechanisms on the quality of financial information in developed contexts. For example in the USA context, empirical evidences find that the percentage of outside and independent directors reduces the fraud in financial statements and the earnings management and so it's associated with a higher financial disclosure quality (Beasley, 1996; Klein, 2002; Karamanou and Vafeas, 2005). In the Asian context, there is evidence suggesting that the board independence improves the earnings informativeness (Firth et al., 2006; Lai, 2011). Bradbury, et al., (2006) have also found that, a small board of directors reduces the level of discretionary accruals and increases the information content of accounting incomes in Malaysia. However, there is limited research on the whether quality corporate governance practices minimizes earnings management in developing countries of Africa. This study seeks to fill this research gap.

Accounting information is essential for all companies competing to acquire resources on capital markets. High quality financial reporting is well appreciated by market participants as it reduces information asymmetries (Jensen & Meckling, 1976), increases overall transparency, and provides a better device for contracting purposes (Watts & Zimmerman, 1978). International Chamber of Commerce (I.C.C) (2005) noted that high quality, consistent, comparable and understandable reporting by business enterprises enhances investor confidence and market efficiency. These contribute to the depth and liquidity of capital markets, which businesses depend upon for sustainability and growth. The importance of good corporate governance has been highlighted by the wave of corporate corruption scandals and it is becoming an increasingly important component of investor relations (Standard and Poor's, 2003). The ICC (2005) recognizes that

high-quality corporate governance norms are critical to high-quality financial reporting. ICC (2005) supported this view by pointing that a single worldwide framework for financial reporting requires more than a common set of accounting standards. It also requires an underlying infrastructure of strong corporate governance practices, effective regulatory oversight and enforcement, effective auditing, management committed to transparency, and support from users of financial information. The importance of corporate governance in the reporting process was captured by Lerach (2004) who noted that virtually every number in a corporate financial report is created by judgments and estimates made by corporate insiders whose cash bonuses depend upon meeting pre-set earnings targets.

Jianga, Leeb, and Anandarajan, (2008) concluded that firms in the highest category of corporate governance experience significantly improved quality of earnings. They also found that higher levels of corporate governance are associated with lower absolute discretionary accruals and higher quality of earnings. This implies that firms with weak corporate governance are more likely to manage earnings in order to meet or beat analyst forecasts. Empirical evidence exists to show that companies in both developing and developed countries manage their earnings. For example, Iqbal and Strong (2010) found that US firms manage earnings around seasoned equity offerings while Al-Fayoumi, Abuzayed, and Alexander (2010) concluded that Jordanian firms manage their earnings upwards. Matoussi and Kolsi (2006) noted that firms manipulate their discretionary accruals especially at the end of the year while Iqbal and Strong (2010) observed that there exists evidence of variations in the aggressiveness of earnings management among firms.

The choice of Kenya is motivated by a number of factors. First, Kenya adopted the use of the International Financial Reporting Standards (IFRS) effective January, 1999. Second, in 2002 KCMA issued corporate governance guidelines which were made mandatory for all companies listed on the NSE (KCMA, 2002). Third, over the last decade, the Kenyan economy has been experiencing major changes. For example, the capital market has expanded to reach a market capitalisation of over one trillion shillings (about thirteen

million dollars) (NSE, 2010). Share ownership has moved away from the government and is now dispersed over many small shareholders. Institutional investors, most of who are from other countries, have become major players at the N.S.E. Kenya has also been advancing very fast on the technological front with its vision to being the regions technology hub. Furthermore, KCMA 2002 guidelines and the N.S.E have recommended that public listed companies should establishment and encourage the use of corporate web site by shareholders to ease communication and interaction among shareholders and the company.

Using panel data of 148-firm years obtained from the annual reports of the 37 companies listed on the NSE, the study found that ownership structure and board composition were the main corporate governance characteristics influencing the quality of information reported by Kenyan listed Companies. The results of this study are important to investors in developing countries, who must interpret financial statement numbers reported by companies while making investment decisions. Furthermore, the study contributes to our understanding of how corporate governance influences financial reporting in developing economies, such as Kenya.

The remainder of this paper is organised as follows: Section two (2) reviews prior research and develops the hypotheses while section three (3) outlines the research design, how the sample was selected and highlights the variables. Section four (4) presents the results while section five (5) presents the conclusions.

Literature Review and Hypotheses Development

Corporate Governance

Various theories have been advanced on corporate governance which includes agency theory, stewardship theory and stakeholders' theory of which agency theory has had the greatest influence. It holds that managers will not act to maximise the returns to shareholders unless appropriate governance structures are implemented in the large corporation to safeguard the interests of shareholders (Jensen and Meckling, 1976). It holds that the owners

are principals and the managers are agents and there is an agency loss, which is the extent to which returns to the residual claimants, the owners, fall below what they would be if the principals, the owners, exercised direct control of the corporation (Jensen and Meckling, 1976). Until recently there was still a debate about the meaning of governance and consensus on what constitutes good governance is a recent phenomenon. Most national codes of corporate governance seek to protect stakeholder rights, support the concept of independence and a balance of power in the boardroom, and recognize the importance of transparency and disclosure. Most propose board structures to promote an efficient balance of power, such as independent committees, and in particular, audit committees (United Nations Conference on Trade and Development (UNCTD), 2006).

The I.C.C. (2005) recognizes that high-quality corporate governance norms are critical to high-quality financial reporting. Studies by Byard, Li, and Weintrop, (2006); Jianga et al., (2008) concluded that the quality reported information increases with the quality of corporate governance. They also found that higher levels of corporate governance are associated with lower absolute discretionary accruals and higher quality of earnings. This implies that firms with weak corporate governance are more likely to manage earnings in order to meet or beat analyst forecasts.

The wave of corporate corruption scandals has highlighted the importance of good corporate governance (Standard and Poor's, 2003). The failure of high profile companies in the USA, UK and other parts of the world has largely been attributed to failures in the corporate reporting process (IFAC, 2003). In the U.S.A an increasing number earnings restatements by publicly traded companies coupled with allegations of financial statements fraud and lack of responsible corporate governance of high profile companies (for example Enron, Global crossing, and World com) has sharpened the ever increasing attention on corporate governance in general and quality of corporate reporting. The fall of the above companies raised concerns regarding the lack of vigilant oversight functions of their boards of directors and audit committees in effectively overseeing financial reporting process and auditing functions (Razae, 2003).

In the UK various reports addressing the issue of corporate governance have been published (for example, Greenbury Report, 1995; Turnbull Report, 1999). The Cadbury committee (1992) was constituted in response to the continuing concern about standards of financial reporting and accountability, heightened by BCCI, Maxwell and the controversy over directors' pay, which had kept corporate governance in the public eye.

The Cadbury committee (1992) was set up, as its sponsors (Financial Reporting Council, the London Stock Exchange and the accountancy profession) were concerned at the perceived low level of confidence both in financial reporting and in the ability of auditors to provide the safeguards, which the users of company reports sought and expected. The underlying factors were seen as the looseness of accounting standards, the absence of a clear framework for ensuring that directors kept under review the controls in their business, and competitive pressures both on companies and on auditors which made it difficult for auditors to stand up to demanding boards (Cadbury, 1992; Tackett, 2004;).

Corporate governance codes and guideline have been issued by most countries both developed and developing for example, Canada, France, Germany, India etc with similar recommendations. Major organisations such as the Organisation for Economic Co-operation and Development (OECD) have also issued widely recognized recommendations on corporate governance. Their emphasis is on shareholders' rights, equal treatment of shareholders, the role of various persons, or parties, involved in the company (stakeholders), disclosure and transparency as well as duties of the supervisory board (OECD, 2004)

Kenya has also not been spared from the failures in corporate governance experienced in other countries. In the 1980's more than 33 banks collapsed (Barako et al., 2006). Many companies and state owned corporations, for example, Kenya Corporative Creameries (KCC), National Housing Corporation and the Kenya National Assurance Company among others followed suit in the 1990's (Eshiwani, 2006). Uchumi Supermarket was placed under receivership with millions of shareholders' funds in 2006, and the collapse of three stock brokerage firms in 2008, and boardrooms wars

at the Copper Motors Corporation in 2011 has refocused attention on corporate governance and corporate reporting. Corporate governance has been addressed from two fronts in Kenya.

The Kenyan Capital Market Authority (KCMA) issued guidelines on corporate governance practices by public listed companies in Kenya in 2002. The guidelines were prepared in recognition of the role of good corporate governance in corporate performance, capital formation and maximization of shareholders value as well as protection of investors rights (KCMA, 2002).

Through legal notice No 60, 2002, KCMA issued guidelines on the board and board committees, shareholders and their rights, and top management. To improve on the quality of the financial reporting process, KCMA (2002) proposed the establishment of audit committees. On the rights of the shareholders section 3.2(vii) recommends the board to maintain an effective communication policy that enables both the board and management to communicate effectively with its shareholders, stakeholders and general public. Section 3.2(xii) further recommends every public listed company to encourage the establishment and use of the company's website by shareholders to ease communication and interaction among shareholders and the company.

Quality of Reported Information

Verdi (2006) conceptually defined financial reporting quality as the precision with which financial reporting conveys information about the firm's operations, in particular its expected cash flows, in order to inform equity investors. Schiller and Vegt (2010) citing Francis, Olsson, and Schipper (2006) argued that accounting quality has multiple dimensions. They used a two-dimensional concept: they first asked whether there is faithful representation that is if the earnings report is unbiased. If an earnings report is faithful, it leads to a better reflection of the shareholder value in the stock price. Secondly, they asked if the report is timely. If a manager has early financial information, the introduction of interim reporting leads to an increased timeliness if the information is disclosed at the interim stage rather than at the end of the fiscal year. To summarize, they defined accounting quality as improved if, for a given degree of

timeliness, there is increased faithfulness or if, for a given degree of faithfulness, there is better timeliness.

Financial reporting should provide information to help investors, creditors, and other users assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise. Information about enterprise earnings and its components measured by accrual accounting generally provides a better indication of enterprise performance than information about current cash receipts and payments (IASB, 2010). The demand for financial reporting and disclosure arises from information asymmetry and agency conflicts between managers and outside investors (Healy and Palepu, 2001). Hence, the purpose of corporate reporting is to provide information that is useful to a wide range of users in making economic decisions. Standards & Poor's (2003) correctly observed that, investor confidence and market efficiency depend on the disclosure of accurate and timely information about corporate performance.

Cadbury (1992) stated that the lifeblood of markets is information and barriers to the flow of relevant information represent imperfections in the market. The need to sift and correct the information put out by companies adds cost and uncertainty to the market's pricing function. The more the activities of companies are transparent, the more accurately will their securities be valued (Cadbury, 1992). High quality financial information provide users with more reliable and decision useful information and better reflect the underlying economic fundamentals of companies.

Healy and Palepu (2000) noted that firms provide disclosure through regulated financial reports, including the financial statements, footnotes, management discussion and analysis, and other regulatory filings. In addition, some firms engage in voluntary communication, such as management forecasts, analysts' presentations and conference calls, press releases, internet sites, and other corporate reports. Finally, there are disclosures about firms by information intermediaries, such as financial analysts, industry experts, and the financial press. The quality of accounting information according to Cascino, et al., (2010) refers to the

informativeness of reported numbers, the level of disclosure, and the degree of compliance with generally accepted accounting standards.

The quality of financial reports, however, is not only a function of the International Financial Reporting Standards. Global standards are only likely to be optimal if the institutions that monitor and enforce adherence to standards work equally well across countries (Healy et al., 2001). A study by Paiva, and Lourenço (2010) showed that for countries like UK and France, different firms accounting incentives dominate accounting standards in determining accounting quality. Soderstrom and Sun, (2007); Burgstahler et al., (2006) also noted that firms and institutional incentives affect this feature of accounting numbers. Monterrey and Amparo (2004) properly concluded that the quality of financial reporting standards is a necessary, although not sufficient, condition for the quality of accounting disclosure.

International investors and lenders need reasonable assurance that accounting and reporting standards are more than written words, that they are applied effectively in practice. IFAC (2009) stated that it has been said, "A wise person builds his house on a rock." Similarly, corporate governance is the foundation of high-quality financial reporting. It is hard to envisage a good financial report coming out of an organization with a bad governance structure. Therefore, improvements in corporate governance contribute directly to bringing financial reporting to a higher level (IFAC, 2009).

A number of studies draw from the positive accounting theory and examine managerial incentives for accounting policy choice. Cotter (1999) and Gupta (1995) show that managerial incentives to choose accounting policies derive from the relationships among a corporation's stakeholders, including managers, stockholders and creditors. These studies have generally found that the presence of bonus plans, restrictive debt covenants, and political costs affect accounting procedure choices. Yet, their results afford only partial insights in our understanding of managers' motives since they focus on a single accounting choice at a time. Missioner (2004) identifies bank and private loans, ownership dilution, labour force and managers' own compensations as significant factors influencing the accounting method

choice of Swiss managers. The study found size of a firm and leverage as insignificant in the Swiss context. In contrast to Missonier's study, Inoue and Thomas (1996) found that the size of a firm and leverage are major factors shaping Japanese managers' accounting choice methods. The study identifies other factors as taxation, foreign political costs and a firm's ability to finance its operations internally as being significant in influencing Japanese managers' choices of accounting methods.

According to Beattie et al. (1994), firms tend to choose accounting methods to smooth income. In smoothing their income, managers choose accounting methods to increase or decrease income to meet their own interests. The study identified factors which cause managers to choose extraordinary items to smooth income in the UK context. These are accounting risk, market risk, agency costs, political costs, ownership structure, industry, dividend pay-out and managerial share options. Of these factors, accounting risk, agency costs, ownership structure and dividend pay-out are significant in explaining choice of extraordinary items by UK managers. Market risk, political costs, industry and managerial share options are not significant. This is in contrast with Inoue and Thomas (1996), where size as a measure of political cost is found to be significant. Furthermore, the results in the case of share options are in line with bonus plan in the Japanese context and contradict managerial compensation in the Swiss context. Basing their research on a single industry, Aitken and Loftus (2009), identify compensation plans, debt and political costs to explain managers' accounting policy choice in Australia. Only the compensation plan is found to be significant while debt and political costs are not. This study rejects the political and debt hypothesis which describes the positive accounting theory proved in the US since the studies by Watts and Zimmerman (1986 & 1990).

Earnings Management

Matoussi and Kolsi (2006) observes that recent corporate financial scandals highlighted that firms facing deep legal investigations have used extreme forms of earnings manipulations in order to alter their financial reporting. Akers, Giacomino and Bellovary (2007) defines earnings management as

attempts by management to influence or manipulate reported earnings by using specific accounting methods (or changing methods), recognizing one-time non-recurring items, deferring or accelerating expense or revenue transactions, or using other methods designed to influence short-term earnings. According to the signalling theory, earnings indicate to the capital market the extent to which a company has engaged in value adding activities during a given period. As a result, company's management are interested in the amount of earnings and how it is reported in the financial statements. Almilia and Surabaya (2009) argued that agency theory is regarded as an important construct for understanding financial reporting incentives. Agency theory argues that, in the presence of information asymmetries, managers will choose the set of decisions required to maximise their usefulness.

Earnings management is undertaken by management for different purposes and by different techniques. Healy and Wahlen (1999) argue that managers mainly manipulate earnings for four kinds of incentives i.e. external contract incentives, management compensation contract incentives, regulatory motivations and capital market motivations. Barton (2001) noted that as earnings are equal to the sum of operating cash-flows and accruals, all else equal, managing reported earnings can be achieved by undertaking accounting manipulations (i.e. discretionary accruals) or real actions that affect operating cash-flows.

Other techniques used in earnings management include manipulations of research and development and sale and lease back (Matoussi and Kolsi, 2006), use of revenue recognition methods, operating expense timing, unrealistic assumptions to estimate liabilities and real or operating actions (Ortega and Grant, 2003). Carlos, Yun and Gerald, (2008) presented a list of eleven techniques used in earnings management which include adjusting accounts receivables or bad debt allowance, gains or losses from disposals, changing the depreciation method and operating revenue among others.

Matoussi and Kolsi (2006) noted that although accounting figures management is tolerated by accounting rules, real earnings manipulations have regained new attention after recent

corporate financial scandals that occurred in US financial markets. These scandals have shown that neither firms' managers nor market participants are able to forecast the effects of these manipulations on firms' value. Carlos, Yun and Gerald, (2008) observed that practitioners and regulators often see earnings management as pervasive and problematic and in need of immediate remedial actions. Prior research has attempted to detect earnings management through various approaches including accounting policy choice (e.g. Skinner 1993), real transactions (Roychowdhury, 2006), income smoothing (Imhoff, 1977) and accrual methods (Jones, 1991., Dechow et al., 1995).

The choice of accounting methods approach is based on the premise that managers have the discretion to choose different accounting methods or policies and their action can either increase or decrease accounting income. Sun and Rath (2010) argue that research will tend to use accounting choices as a measure of earnings management since accounting policies are usually adopted with management consideration of their effect and therefore provide a measure that is purely discretionary.

It has however been argued that this approach tend to use a dichotomous variable to capture income increasing (or decreasing) earnings management and therefore fails to capture the combined effect of the various choices. Managers can also manipulate earnings through real transactions.

For example, managers can accelerate sales through increasing discounts or by offering more favorable credit terms (Sun and Rath, 2010). However research has found it difficult to detect earnings management through this approach since there are no benchmarks to determine the right action that managers should have taken (Sun and Rath, 2010).

Income smoothing has a clear objective to reduce the short-term volatility of earnings and hence report a steady stream of profits (Imhoff, 1977). However the main difficulty with this approach is that it is difficult for the researcher to distinguish between normally smoothed earnings from the intentionally smoothed earnings.

Most prior research has attempted to detect earnings management using the accrual

estimation approach. It is argued that managers will use discretionary accruals to shift revenues between accounting periods or in deferring expenditures (Jones, 1991; Dechow et al., 1995). This approach therefore breaks down accruals into two components (discretionary and non- discretionary accruals). However the accrual approach has two main shortcomings; a) previous studies have found that they have a low earnings management detection power and b) the methods fail to consider other factors that influence earnings management such as firm size and growth rate.

The use of accrual based models to detect earnings management has been further complicated by the adoption of fair value accounting approach to financial reporting (Ratnatunga and Jones, 2012; Dechow et al., 2010). Under fair value accounting, companies report losses when the fair values of their assets decrease or liabilities increase and these losses may reduce companies' reported net income (Ratnatunga and Jones, 2012).

Although changes in the market values can be accounted for in the income statement, Laux and Leux (2009) have argued that the risk of management bias and the smoothening of performance remain a major issue. As one of the possible remedies, Kothari et al., (2005) has recommended the introduction of firm performance (return on assets) as an additional independent variable in to the modified Jones model (Dechow et al., 1995).

Despite their limitations there has been an explosive growth in the use of accrual models in earnings management research (Sun and Rath, 2010). It has been argued that managers are more likely to exercise discretion through accruals rather than cash flows, since accruals are less observable.

Furthermore, any change in accounting policy requires disclosure in the financial statements. Indeed Gaver et al., 1995, have argued that the level of discretionary accruals is the accounting variable least likely to be effectively monitored by outsiders and thus the prime candidate for earnings management. In addition we argue that manager's choice of an accounting method (policy) is mainly geared towards the accomplishment of a specific goal. On the other hand, an examination of accruals can capture the net effect of almost all the

accounting choices made by a firm in the period under consideration (Sun and Rath, 2010).

Hypotheses Development

Ownership Structure and Earnings Management

Theoretical arguments on the relationship between ownership structure and accounting information are based on agency theory (Firth et al., 2006). Jensen and Meckling (1976) argued that the separation of ownership and control results in agency costs due to the conflict of interests between managers and shareholders. When there is ownership diffusion, agency costs are high resulting in a high demand for informative disclosure to monitor managers (Fama and Jensen, 1983). As a result, the extent of disclosure is likely to be greater in widely held rather than in closely held corporations. Wang (2008) considers large stockholders to be the accounting information demanders and possess more power to govern and control quality of the accounting information.

Wustemann (2004) argued that in economies with a market-oriented financial system for example USA, where a large number of corporations are listed and publicly traded, full and fair disclosure serves to reduce agency costs that arise out of the separation of ownership and control. Corporate ownership structure is heavily dependent on the regulations operating in a specific country. In Kenya for example, the Nairobi Stock Exchange listing rules directs that following the public share offering at least 25% of the shares must be held by not less than 1000 shareholders excluding employees of the issuer for companies listed in the main investment market segment (NSE, 2010). KCMA Guidelines s.3.3(x) encourages institutional investors to make direct contact with the company's senior management and board members to discuss performance and corporate governance matters as well as vote during the annual general meetings. This enhances the role of institutional shareholders as a corporate governance control mechanism in that by directly contacting management, the institutional investors will be performing a monitoring function and management will be aware of their interest in company

performance, thereby enhancing good corporate governance.

It has been argued that Ownership concentration has both an entrenchment effect as well as an alignment effect. One argument has been that, concentrated control may be detrimental to minority shareholders as it induces insider expropriation and distorts management decision making (Bebchuk, et al., 2003). The other argument has been that the presence of controlling shareholders may help alleviate the traditional agency problems between owners and managers. However, the existing literature suggests that the alignment effect is subordinated to entrenchment effect under concentrated ownership structures (Lins, 2003)

Empirical studies associating ownership structure and quality of information reported have mixed conclusions. For example, Owusu-Ansah, (2002); El-Masry and Ezat (2008); Abdelsalam, and El-Masry, (2008) found a positive relationship between ownership structure and the timeliness of corporate internet reporting. However Abdelsalam and Street (2007) concluded that block ownership is associated with less timely corporate reporting. From the studies above the following hypothesis, emerge:

H1: There is a significant relationship between ownership structure and the level of earnings management;

The operational definition of ownership structure is the proportion of the largest five shareholders to the total outstanding shares.

Independence of audit committee and Earnings Management

Several research studies have investigated the impact of having an audit committee on financial reporting quality. A common hypothesis is that independent audit committee directors would ensure better financial reporting and the expectation is generally supported by existing empirical evidence. The evidence documented in these studies suggests that independent audit committees and audit committees with some level of accounting/financial expertise are more likely to take steps (such as hiring industry specialist auditors or monitoring the firm's internal audit

process) that help to ensure credible financial statements (Felo et al., 2003). Klein (2002), examined whether audit committee and board characteristics are related to earnings management by the firm. Their study examined whether audit committee and board characteristics are related to earnings management by the firm. They found a negative relationship between audit committee independence and abnormal accruals, reductions in board or audit committee independence are accompanied by large increases in abnormal accruals and that the most pronounced effects occur when either the board or the audit committee is comprised of a minority of outside directors. These results suggest that boards structured to be more independent of the CEO are more effective in monitoring the corporate financial accounting process. Biao et al., (2003) examined the role of the board of directors, the audit committee, and the executive committee in preventing earnings management. They concluded that board and audit committee activity and their members' financial sophistication may be important factors in constraining the propensity of managers to engage in earnings management.

Kelton and Yang (2008) discovered that firms with more diligent audit committees are more likely to provide internet financial disclosures. However, Rainsbury et al., (2009) found no significant association between the quality of an audit committee and the quality of financial reporting. Beasley (1996) conducted a study to predict whether inclusion of larger proportions of outside members on the board of directors significantly reduces the likelihood of financial statement fraud. The results of this study indicated that the presence of an audit committee does not significantly affect the likelihood of financial statement fraud.

Lin, et al. (2006) conducted a study to examine the association between the occurrence of earnings restatement and characteristics of the audit committee. The results supported the hypothesis that a larger audit committee may provide more oversight over the financial reporting process. Such oversight seems to improve earnings quality by reducing the probability of restating financial statements after their original filings with the SEC. However, the study provided no evidence that the other audit committee characteristics for example, independence,

financial expertise, activity, and share ownership have any impact on quality of reported earnings. These is consistent with a study carried out by Rainsbury et al., (2009), whose results show no significant association between the quality of an audit committee and the quality of financial reporting. The results suggest that the benefits of 'best practice' audit committees may be less than anticipated by regulators and policymakers.

Prior research on the association between audit committee characteristics and earnings management has yielded mixed results. For example, Baxter and Cotter (2009) provide evidence suggesting that audit committees are effective in reducing intentional accrual manipulations, which are better captured by the Jones model (Bekiris and Doukakis, 2011). Studies by Abbott et al. (2004), García-Meca and Sánchez-Ballesta (2009), and Kent et al., (2010), support the notion that the independence of the audit committee constrains earnings management. On the contrary, Peasnell et al., (2005); Yang and Krishnan, (2005) and García Osma and Noguera, (2007) have found no statistically significant relationship between these variables. From the studies above the following hypothesis is proposed:

H2: There is a significant negative relationship between independence of audit committee and levels of earnings management;

The operational definition of independence of audit committee is the proportion of independent audit committee members to total audit committee members.

Board Composition and Earnings Management

One of the major responsibilities of the board of directors is to ensure that shareholders and other stakeholders are provided with high-quality disclosures on the financial and operating results of the entity that the board of directors have been entrusted with governing (UNCTD, 2006). Good corporate governance by boards of directors is recognised to influence the quality of financial reporting, which in turn has an important impact on investor confidence (Levitt, 1998). Consistent with the agency theory, boards are charged with monitoring management to protect shareholders' interests, and it is expected that

board composition will influence whether or not a company engages in earnings management. He, et al., (2009), based mainly on US studies, concluded that board independence is the most effective deterrent of fraudulent financial reporting. This was consistent with independent directors having strong incentives to improve financial reporting quality or maintain it at an acceptable level to avoid being sued. Independent directors compete in the directors' labour market and they have incentives to establish and keep a reputation of professional experts who effectively monitor managers and who look for the shareholders' best interests (Fama and Jensen, 1983).

Empirical evidence in the developed countries (Beasley, 1996; Bedard et al., 2004; Farber, 2005; Peasnell et al., 2000; Xie et al., 2003), has found that firms with stronger board independence are less prone to accounting violations and frauds and are related to less severe earnings management practice. However there is no *a priori* reason to believe whether independent directors would or would not produce effective monitoring to constrain earnings management in Kenya, because the business environment and institutional features of Kenya differ substantively from those of the developed countries.

Abdelsalam and Street (2007) examined the timeliness of corporate internet reporting by U.K. companies listed on the London Stock Exchange (LSE). The research examined the significance of corporate governance and firm-specific characteristics as potential determinants of the timeliness of corporate internet reporting. The study found a significant association between timely corporate internet reporting and the corporate governance characteristics of board experience and board independence. Boards with less cross directorships, more experience in terms of the average age of directors, and lower length in service for executive directors provide timelier corporate internet reporting. These findings are consistent with those of Dimitropoulos and Asteriou (2010) whose study revealed that the informativeness of annual accounting earnings is positively related to the fraction of outside directors serving on the board, but it is not related to board size. Additionally, firms with a higher proportion of outside board members proved to be more conservative when reporting bad

news but on the contrary they do not display greater timeliness on the recognition of good news. Firms with a higher proportion of outside directors report earnings of higher quality compared to firms with a low proportion of outside directors. Results of a study involving 284 companies listed in the NASDAQ national market by Kelton and Yang (2008) supported that board independence is positively related to corporate internet disclosure. Abdelsalam and El-Masry (2008); El-Masry and Ezat (2008) also found a positive relationship between board composition and board of directors independence and the timeliness of corporate internet reporting.

Empirical studies on the relationship between roles of the board in minimizing earnings management have yielded mixed results. Whereas some studies have reported that independent boards play an effective role in constraining earnings management (Klein, 2002; Davidson et al., 2005; García-Meca and Sánchez-Ballesta, 2009), some others have not observed a statistically significant correlation between board independence and earnings management (Park and Shin, 2004; Bradbury et al., 2006). Garcia Osma (2008) provides evidence suggesting that independent directors have sufficient technical knowledge to identify opportunistic reductions in R&D and efficiently constrain real earnings management. Similar are the results regarding the effect of board size in earnings management. Chin et al. (2006) concluded that there is a positive relationship between board size and earnings management, whereas Xie et al. (2003) reported a negative relationship. Consequently, the following hypothesis is proposed:

H3: There is a significant negative relationship between board independence and the level of Earnings management.

The operational definition of board independence is proportion of independent directors to total directors.

Firm size and Earnings Management

Firms vary in many ways and it is worth considering how size affects the quality of reported information. According to Becker et al., (1998) firm size may affect corporate governance characteristics as well as the level

of earnings management. Watts and Zimmerman (1978) suggest that larger firms may face greater political costs relative to small firms because of higher analyst following and investor scrutiny. On the contrary, Lobo and Zhou (2006) suggest that larger firms may be more inclined to manage their earnings because the complexity of their operations makes it difficult for users to detect overstatement.

Prior studies have commonly used company size to represent political costs because there is a perception that large companies are subject to intense scrutiny, especially if they are reporting huge profits. These political costs may take the form of state interventions (via legislation, regulations) but also retaliations from unions and customers that may result in opportunity costs (i.e. abandoning profitable investments). The visibility of large companies, especially in terms of available wealth, tends more easily to attract the attention of numerous stakeholders, including elected representatives (and the electorate), employees, customers and competitors. As a result, managers of large companies may be inclined to select accounting methods that delay the reporting of income to reduce these political costs (Missonier, 2004). However Rahman and Scapens (1988) have questioned the universal application of the political cost theory. Tawfik (2006) and Astami and Tower (2006) also found no evidence to support that size influences accounting policy choices in Saudi Arabia and the Asian Pacific region respectively.

Therefore, the following hypothesis is proposed:

H4: There is a significant positive relationship between firm size and Earnings Management

The operational definition of firm size is the natural logarithm of end of year 2010 total assets

Firm Performance and Earnings Management

The main disclosure theories tend to indicate that there is a positive relationship between profitability and quality of reporting. As per the agency theory, the managers of profitable companies will tend to use information to stabilise their positions and increase their

levels compensation levels. According to Astami and Tower (2006), company profitability has been used in compensation contracts both explicitly and implicitly. For example Bushman and Smith (2001) note that there is widespread evidence of explicit usage of annual bonus plans in corporate executive's long-term performance plans. Furthermore, the implicit use of profitability measures to evaluate the board of directors and compensate top officers also exists in the relationship between profitability measure and various measures of executive pay. Summers and Sweeney (1998) argue that managers may use income increasing accruals when growth slows in order to maintain the appearance of sustainable growth while Watts and Zimmerman (1986) believe that, managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to the current period so as to increase company reported profits. Accordingly, if part of a manager's remuneration is derived from incentive plans which are related to accounting earnings, then management has an incentive to use accounting methods that increase accounting earnings (Hagerman and Zmijewski, 1979; Astami and Tower 2006).

According DeAngelo and Skinner (1994) there were evidences that accruals may be opportunistically manipulated by managers to conceal poor performance or postpone a portion of unusually good current earnings to future years. Burgstahler and Dichev (1997) argue that managers manage earnings to avoid reporting losses and earnings declines. Prior empirical research has yielded mixed results. Whereas Astami and Tower (2006) found no significant relationship between profitability and the manager's choice of accounting policy, Bekiris and Duokakis (2011) reported a significant negative relationship between profitability and earnings management. From the studies above the following hypothesis is proposed:

H5: There is a significant relationship between firm performance and Earnings Management

The operational definition of firm performance is the return on equity (net profit after tax divided by total equity).

Leverage and Quality of Reporting

Inoue and Thomas (1996) have shown that owner-managers have incentives to liquidate the assets of the company in the form of dividends and leave the debt holders with nothing but the shell of the company. However, a rational market for debt will price the debt accordingly and incorporate debt covenants into loan agreements to protect themselves. For example, debt covenants may restrict the payment of dividends at certain income levels. Prior literature links debt and accounting policy choice because debt covenants are usually based on reported accounting numbers and a violation of the debt covenants imposes costs on the company.

Bowen and Shores (1995) explain that managers seeking to reduce debt covenant costs may strive to adopt a set of accounting methods which enable them to report favourable financial statements in terms of creditworthiness. In addition, managers may try to improve the firm's financial flexibility in order to prevent them from reporting an "image of financial distress" (Easton et al., 1993). These considerations become more relevant as the company experiences financial debt increases, i.e. a higher total of financial debt over total assets (Cullinan & Knoblett, 1994; Piot, 2001; Zimmerman, 1986). According to the theory of accounting choices, to reduce the debt contracting costs, owner-managers have incentives to offer debt covenants which restrict some of their actions.

Despite the above arguments, Astami and Tower (2006) have found evidence suggesting that lower financial leverage is associated with income-increasing accounting techniques. We however observe that most of the countries surveyed in their study do not permit the use of IFRSs. In the context of Kenya, companies rely on bondholders and banks for financing (NSE Handbook, 2010). Given the reliance on debt, managers should have incentives to choose income increasing accounting policies to ensure that they abide by the debt covenants imposed by bondholders and banks and avoid renegotiation costs (Inoue & Thomas, 1996; Beatty & Weber, 2003). Furthermore, Bekiris and Duokakis (2011) have found that financial leverage is positively related to absolute abnormal accruals, consistent with managers of highly leveraged firms employing discretionary accruals to avoid debt covenant

violation (DeFond and Jiambalvo, 1994; Klein, 2002; Jiang et al., 2008). From the studies above the following hypothesis, emerge:

H6: There is a significant positive relationship between leverage and Earnings Management

The operational definition of leverage is measured as the ratio of total non-current liabilities to owners' equity

Research Method

Quantitative methods are employed to examine the relationships between the independent variables (Ownership Structure, Board Composition, independence of the Audit Committee, Firm performance, firm size and leverage) and dependent variable (Earnings Management). The data is drawn from annual reports of 37 companies listed on the NSE Securities Exchange of Kenya. Although the NSE has 52 companies, only 37 companies had the complete data that was required to compute accounting accruals over the five year period. The data collected is for a 5-year period from year 2006 to the year ended 2010, which result in 148-firm years.

The design is chosen because the population is small and the use of panel data increases the number of observations, thus allowing meaningful statistical analysis. In order to calculate values of variables to test the hypotheses, directors' report, profit and loss account, balance sheet and notes to the accounts were all read. The corporate annual reports are available from the KCMA website, and where not available, hard copies of the reports were used.

This study used accounting accruals approach to measure earnings management. Accruals includes a wide range of earnings management techniques available to managers when preparing financial statements, such as, accounting policy choices, and accounting estimates Healy (2001). Discretionary accruals are used extensively to demonstrate that managers transfer their accounting earnings from one period to another. Consistent with previous literature on earnings management (Dechow, Ge, and Schrand, 2010; Diamantopoulos and Asteriou 2010; Jianga, Leeb, and Anandarajan, 2008; Lai, 2011; Rodríguez-Pérez, and Hemmen, 2010; Klein

2002) the study used the modified Jones model to detect the extent of earnings management. Among others studies by Chen (2011) and Phillips, Pincus & Rego (2002) concluded that the modified Jones model was the best in estimating management earnings. Firms were considered to have engaged in income increasing (decreasing) discretionary accruals if they have positive (negative) estimated discretionary accruals.

Following Kothari et al. (2005), we include firm performance as an independent variable in the estimation of discretionary accruals in the modified-Jones Model (Dechow et al., 1995) and use the absolute value of such performance-adjusted discretionary accruals as the earnings management proxy in this study. To estimate the coefficient values, an Ordinary Least Squares (OLS) regression was employed. Discretionary accruals $DACC_{it}$ for firm i at year t is the absolute value of the residual from the estimation model as follows: $TACC_{it} / A_{it-1} = \alpha_1 t (1/A_{it-1}) + \alpha_2 i [(\Delta REV_{it} - \Delta REC_{it}) / A_{it-1}] + \alpha_3 i [PPE_{it} / A_{it-1}] + \alpha_4 i (ROA_{it}) + \varepsilon_{it}$

Where, TACC is the total accrual measured as the difference between net income and operating cash flows for firm i in year t . A_{it} is total assets for firm i in year t ; ΔREV is the change in operating revenues; ΔREC is the change in net receivables. PPE is gross property, plant, and equipment; ROA_{it} is ratio of net income divided by assets for firm i in year t . t and $t-1$ are time subscripts and i is the firm subscript. All variables are scaled by prior year total assets A_{t-1} to control for heteroscedasticity.

Data was summarised using descriptive statistics and the OLS multiple regression models below were used to examine whether there was a significant relationship between the selected firm corporate governance variables and earnings management.

$$EM = \beta_0 + \beta_1 OS + \beta_2 BC + \beta_3 IAC + \beta_4 FS + \beta_5 FP + \beta_6 Lev + \varepsilon$$

Where:

EM	= Earnings Management
β_0	= Intercept
OS	= Ownership Structure
BC	= Board Composition
IAC	= Independence of Audit Committee
FS	= Firm Size
FP	= Firm Performance

Lev = Leverage

ε = Residual

Results

Summary Statistics

Table 1 represent a summary of the absolute residual (absolute discretionary accruals) of thirty-seven companies, which had all the information required for the calculation of the discretionary accruals.

As noted by Lai (2011), at least twenty firms in any industry in a year were adequate in order to provide sufficient observations for estimation. As shown in Table 1 the mean absolute discretionary accruals for 2010, 2009, 2008, and 2007 were 2.799%, 3.306%, 2.437% and 2.295% respectively. These results indicate that Kenyan companies engage to a lesser extent in earnings management (hence higher quality reporting) as compared to companies in China where Lai (2011) had reported means of 5.86%, 6.21% and 6.45% respectively for years 2001 to 2003.

Descriptive and Regression results

Table 2 shows the descriptive statistics of the dependent and independent variables that were used in the regression model. The mean absolute discretionary accrual was 2.71% with minimum of 0.02% and a maximum of 16.7%. Mean ownership structure was 62.31% which indicates that Kenyan listed companies are closely held. Independence of audit committees had a mean of 94.28% while the board composition was 77.31%. The independence of the audit committees was expected to be high as it is a requirement of the Kenyan Capital Markets Authority. Mean firm performance was 15.27% while the average firm size was 23.66. The mean leverage was a minimum of zero percent to a maximum of 42.1%. The means for ownership structure, independence of audit committees and board composition are high which would suggest that the standards for corporate governance among Kenyan listed companies are high.

As shown in Table 3, the regression model has significant explanatory power. The adjusted R^2 of the model is 0.16 and the F-value of 4.570 is significant at the 1% level or better. The

Table 1: Descriptive Statistics Discretionary Accruals

	N	Minimum	Maximum	Mean	Std. Deviation
2007	37	.00017	.11261	.0229482	.02558088
2008	37	.00129	.12672	.0243687	.02690521
2009	37	.00059	.16703	.0330553	.04002368
2010	37	.00018	.11018	.0279873	.02965251
Valid N (listwise)	37				

Table 2: Descriptive Statistics on Earnings Management

	N	Minimum	Maximum	Mean	Std. Deviation
Discretionary Accrual	148	.0002	.1670	.027090	.0309921
Ownership Structure	148	.2672	.9410	.623080	.1540509
IAC	148	.0000	1.0000	.942793	.2026484
Board Composition	148	.4000	1.0000	.773137	.1397397
Firm Size	148	20.8800	26.2501	23.657576	1.5326974
Firm Performance	148	-.0731	.3690	.152700	.1067414
Leverage	148	.0000	2.0210	.420637	.5162229
Valid N (listwise)	148				

Table 3 Regression Results

	<i>B</i>	<i>Stand error</i>	<i>Beta</i>	<i>t</i>	<i>sig</i>	<i>VIF</i>
(Constant)	.038	.045		.854	.395	
Ownership Structure	.051	.017	.252	3.039	.003	1.16
IAC	-.021	.013	-.136	-1.644	.102	1.15
Board Composition	-.044	.018	-.197	-2.409	.017	1.12
Firm Size	-.000	.002	-.006	-.059	.953	1.52
Firm Performance	.045	.030	.156	1.514	.132	1.79
Leverage	.015	.006	.242	2.608	.010	1.45
F- statistics	4.57***					
Adjust. R- Sq	16.3					

adjusted R^2 of the model indicates that the model explains 16.3% of the variation in earnings management measure.

According to the regression results ownership structure has a significant relationship with earnings management thus H1 is supported. Consistent with the agency theory, the beta coefficient for ownership structure is positive which suggests that increases in ownership concentration increases earnings management, as there is no pressure from outsiders for higher quality reporting. This is consistent with the findings of Al-Fayoumi et al. (2010) who found a positive and significant relationship between ownership structure (insider ownership) and earnings management. The results suggest that investors can rely more on the financial disclosures of firms with more dispersed shareholdings. The N.S.E

listing rules require that following a public share offering, at least 25% of the shares must be held by not less than 1000 shareholders excluding employees of the issuer for companies listed in the main investment market segment (NSE, 2010). The rules also require listed companies to disclose the names and shareholdings of their ten largest shareholders. KCMA may want to incorporate this requirement in their guidelines so as to reduce ownership concentration in Kenyan public companies.

Our results indicate that board composition has a significant relationship with earnings management and the beta coefficient is negative thus H3 is supported. This means that companies with a higher composition of independent directors are less likely to engage in earnings management and therefore higher quality reporting. This is a significant finding as boards of directors play an important role in

the financial reporting process. Lai (2011) had also concluded that board independence especially where the adoption of the independent directors was voluntary reduces earnings management. However, it is important to note that independent audit committee and firm size have negative coefficients while ownership structure, leverage, and firm performance, have positive coefficients. Marion et al. (2008) also concluded that board independence is associated with lower performance-adjusted discretionary accruals.

Our findings suggest a significant relationship between leverage and earnings management, thus support for H6. Highly geared companies are also likely to engage more in earnings management as the beta coefficient is positive and significant. Consistent with the signaling theory, highly leveraged companies would engage in earnings management in a bid to have reports that will enable them to attract more capital at reasonable rates. Our results are consistent to those of Bekiris and Duokakis (2011) who found that financial leverage is positively related to absolute abnormal accruals, consistent with managers of highly leveraged firms employing discretionary accruals to avoid debt covenant violation (DeFond and Jiambalvo, 1994; Klein, 2002; Jiang et al., 2008).

The results suggest that investors can rely more on the financial disclosures of firms with lower debt to equity ratios. Therefore these findings are important not only to the market regulators in Kenya but also to those of other developing countries. As argued by Waweru et al., (2011) most companies in developing countries rely more on bank loans for external financing due to the weak capital markets. Bank loans in developing countries tend to be more expensive (than bonds) and their interest rates are more volatile (Waweru and Spraakman, 2012). Therefore Market regulators in developing countries may want require listed companies to disclose the nature (terms and conditions) of their bank borrowings in their annual reports.

Our results find that independence of the Audit Committee is not significantly related to earnings management. Although the direction of the relationship is negative as predicted our H2 is rejected. The results are not consistent with those of Abbott et al. (2004), García-

Meca and Sánchez-Ballesta (2009), and Kent et al. (2010), which support the notion that the independence of the audit committee constrains earnings management. However the negative co-efficient supports the theory that independent audit committee directors may ensure better financial reporting. Our findings are consistent with those of Marion, Majella, Leyal (2008) who found that board independence and audit committee independence are associated with lower performance-adjusted discretionary accruals. Investors are therefore more likely to receive better financial information from companies that have independent audit committees.

We find that firm size and firm performance are not significantly related to earnings management. Therefore, H4 and H5 are rejected. The results fail to support the view that larger firms may be more inclined to manage their earnings because the complexity of their operations makes it difficult for users to detect overstatement (Lobo and Zhou 2006). Astami and Tower (2006) found no significant relationship between profitability and the manager's choice of accounting policy. We however, note that in developing countries larger companies tend to attract more scrutiny from numerous stakeholders, since they are more visible (Waweru et al., 2011) and this may reduce earning management in such companies.

Conclusions

The main objective of this paper is to investigate the influence of corporate governance and firm specific characteristics on earnings management in Kenyan listed companies. The study extends research on the quality of reporting by examining the impact of corporate governance and firm specific variables on earnings management in Kenya. The results of this study are important to investors in developing countries, who must interpret financial statement numbers reported by companies while making investment decisions. Furthermore, the study contributes to our understanding of how corporate governance influences financial reporting in developing economies, such as Kenya.

Overall results indicate that corporate governance plays an important role in enhancing the quality of reporting in Kenya.

Specifically, the study found that companies with concentrated ownership structures are more likely to engage in earnings management. These findings are important to developing countries such as Kenya where ownership structures are reported to be highly concentrated, hence the need for regulators to offer more protection to the minority shareholders. Our findings also suggest that firms with more independent boards are less likely to manage their earnings. We therefore argue that the boards that are dominated by non-executive directors may constrain manager's motives hence improving the quality of reporting. The results support the recommendations of the KCMA (2002) which calls for a board consisting of a balance between executive and non-executive directors preferably with a majority of NEDs, of who a majority number should be independent.

The results provide empirical evidence to policy makers that corporate governance and firm specific variables are associated with quality of reporting. Therefore companies should re-examine the criteria used in selecting their directors and ensure that corporate boards are more independent. This will ensure that the directors are accountable to the shareholders with a ripple effect of improving investor confidence. Interestingly the relationship between the independence of the audit committee and the levels of earnings management was not significant. Previous studies Waweru and Uliana, (2005); Bokpin and Isshaq, (2009) and McGee, (2009) have argued that most developing countries suffer from a lack of skilled human resources, suggesting that companies in developing economies may experience difficulties in attracting people with accounting or finance knowledge to their audit committees. This may make it difficult for Kenyan boards and their audit committees to monitor and control financial reporting. Overall our findings suggests that investors can rely more on the financial reports of firms with lower debt to equity ratios, higher proportions of outside directors, and with more dispersed shareholding.

This study is not without limitations. First only listed companies have been included in the study and the quality of information reported by unlisted companies represents a limitation of the study. Restricting the study of quality of reporting to publicly traded corporations

excludes a significant and most efficient institutional arrangement for undertaking productive activities. Secondly like many empirical studies that rely on disclosed proxy data, proxy disclosures may not represent all aspects of corporate governance practices. As discussed in section 2.3, the accrual methods of detecting earnings managements have several shortcomings and these are some of the limitations of this study. Further research may be directed in comparing the findings of this study with findings that relate to firms operating in other developing countries of Africa.

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