

**THE RELATIONSHIP BETWEEN INTERNAL GOVERNANCE STRUCTURES  
AND EARNINGS MANAGEMENT OF COMPANIES LISTED ON THE  
NAIROBI STOCK MARKET**

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## ABSTRACT

Majority of stocks in many companies listed on the NSE are currently owned and controlled by large shareholders and institutions that consequently control boards and appointment of senior managers. This implies that management in most of these companies is thinly separated from ownership, raising concerns on the quality of governance mechanisms in these companies. Questions on the quality of governance at the stock market have come under scrutiny due to emerging low market confidence and investor apathy following the collapse of Uchumi, Francis Thuo and Nyaga Stock Brokers which led to investment flight, eroded share values and loss of investments. Uchumi Supermarkets, for instance, posted a healthy balance sheet in its annual financial report for the FY 2006/2007, creating false impressions for the capital markets, staff and suppliers when in actual sense it was on the verge of collapse. This implies that the managers of Uchumi had an incentive to manipulate the reported earnings opportunistically.

This study investigated whether a firm's corporate governance practices have an effect on the quality of its publicly released financial information. In particular, the study examined the relationship between audit committee and board of directors characteristics and the extent of corporate earnings management as measured by the level of positive and negative discretionary accruals. The research was based on a census study of 40 firms consistently listed on the Nairobi Stock Exchange, for the five year period beginning 2002 up to 2006. Modified cross sectional Jones model was used to determine the discretionary accruals. The design and analysis was done within the Random-effects pooled logistic regression framework. Secondary and primary data collection methods were used.

Using a three group segmentation of the studied firms, those with relatively high positive, high negative and low levels of DAC, the research finds that earnings management, at a p-value of 0.006, is significantly associated with some of the governance practices of audit committee and boards of directors. For audit committees, income increasing earnings management is negatively associated, at a p-value of 0.006, with a larger proportion of outside members who are not managers in other firms, a clear mandate overseeing both the financial statements and the external audit, and a committee composed only of independent directors that meet more than twice a year. It is found that short-term stock options held by non-executive committee members are associated, at a p-value of 0.006, with income increasing earnings management. Income decreasing earnings management is negatively associated with the presence of at least a member with financial expertise and a clear mandate for overseeing both the financial statements and the external audit. For board of directors, the research finds less income increasing earnings management in firms whose outside board members have long years of experience as board members with the firm and other firms. Larger boards, the importance of the ownership stakes in the firm held by non-executive directors, and experience of board members seems to reduce income decreasing earnings management.

The study results provide evidence that effective boards and audit committees constrain earnings management activities. Thus, these two corporate bodies should be strengthened to be effective as much optimally as possible. These findings have implications for capital market regulators, such as the NSE and the CMA, as they attempt to supervise firms whose financial reporting is gray area between legitimacy and outright fraud and where earnings statements reflect the desires of management rather than the underlying financial performance of the company.