EFFECT OF BOARD CHARACTERISTICS ON EARNINGS MANAGEMENT FOR NON-FINANCIAL FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE

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D61/8118/2005

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A RESEARCH PROJECT PROPOSAL PRESENTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION, SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

DECLARATION

This research project is my original work and has not been submitted for examination in any other university.

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This research project has been submitted for examination with my approval to the university supervisor.

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CHAPTER ONE: INTRODUCTION

1.1 Background to the Study

Over the years, a trail of firms that have gone under or experienced severe financial distress due to the failure of the board to perform its rightful role overseeing the activities of the managers is well documented. Cases that have gained international prominent as a result of their collapse and yet in a few years preceding the same had posted impressive earnings result Enron, Xerox, Parmalat, One-Tel, WorldCom in the developed world (Nalarreason, Sutrisno & Mardiati, 2019), as well as Uchumi, Chase and Imperial bank in Kenya have brought into focus concerns about corporate governance practices as spearheaded by the board and the financial reporting quality and the internal control systems that are weak in corporate firms. The collapse of these firms and significant financial distress that they go through is evident enough of artificial earnings management and existence of poor operations and inability of the management to control the managers on behalf of the shareholders (Schipper, 2010). There is need for the board to have the requisite capacity to monitor the management and should not collude with the same to report artificial earnings position. This implies that the board characteristics have important effect on how managers behave in regard to reported earnings (Fama and Jensen, 1983). The understanding of how the board characteristics influence the state of earnings management in a firm is of importance to the many stakeholders to a firm.

The agency theory is considered to be fundamental foundation of understanding the role of the board members in limiting the actions of managers in manipulating the firm earnings. As a result of Jensen and Meckling's (1976) agency theory, business managers have a better understanding of internal information and the company's future prospects than the company's owners. However, managers may be able to manipulate earnings in order to deceive the company's owner due to the knowledge asymmetry (Habbash, 2010). To keep managers from acting opportunistically, the board of directors must have an effective monitoring process in place to ensure that management decisions are in line with shareholders' interests. The fraud triangle theory as advanced by Cressey (1950) explains the earnings management behaviour of managers by opining that financial statement fraud occurs is as a result to the managers desire to meet internal and external expectations, rationalization and available opportunities (Albrecht et al., 2009). In Japan, for example, managers have been found to use real earnings management to smoothen the earning for a given year and also it has been found that certain board characteristics can act as preventive mechanism against such earning malpractice. The positive accounting theory was advanced by Watts and Zimmerman (1978). The theory identifies three factors that explain the performance of a firm, namely; debt, compensation and size of the company. The compensation to the executives depends on earnings generated and this might result to the managers seeking to portray better earnings than the true position. Similarly, level of debt and size of the firm are postulated by the theory to influence the manipulation of earnings by the managers.

Firms listed at the Nairobi Securities Exchange have faced its fair share of challenges that can be traced to the inability of board of directors to perform their function appropriately. Firms that have been suspended or delisted from trading at NSE include Uchumi Supermarket, Olympia Capital, Kenya airways, Mumias sugar company, Nairobi business ventures, Athi River Mining company and Deacons had reported positive return or turnaround signs before facing serious financial challenges. Considering that few firms will face drastic performance drop in one or few years that will warrant suspension, it is possible that such firms made have been posting artificial earnings which did not represent the true financial fundamentals. If this assumption is true then the board of directors might have failed to perform their duties well. The board of directors plays a critical role in adhering to corporate governance standards since the board's membership and characteristics impact the board's monitoring functions and the wealth of investors. It is therefore important, in the Kenyan context, to try and understand how the board characteristics influence the earnings management in listed firms.

1.1.1 Board Characteristics

Fama and Jensen (1983) highlight that the engagement of shareholders in a business is restricted as a result of the separation of firm control and management since management is allowed to act on behalf of the owners in good faith. Through this arrangement, managers tend to have an upper hand in the running of the firm and making of managerial decision. However, the expectation of the managers and that of the shareholders is not perfectly aligned – with the shareholders having less advantage; the board of directors are brought in to oversee the actions of the managers (Fitriya & Stuart, 2012). As a result, the board should have certain characteristics that will result in effective monitoring of the managers activities. These features is categorized into two broad categories, namely; board demography that encompasses such attributes as gender, ethnicity and age of the directors, and structure of the board which contains such features as the size, meetings, tenure, size of the committee and its perceived independence (Hu, Hao, Liu & Yao, 2015).

In an organization, Dalimunthe, Fadli and Muda (2016) argued that it is possible to use specific board characteristics in earning management while enhancing firms’ position in creation of stakeholders’ wealth. The scholars further opined that firms should not just focus on foreseeing manipulation of financial statements as a result of breaching of accounting principles by the managers but to also look for proper ways that will lead to increased organizational performance which may also encourage the management to report clean financial records without errors. This is because boards are made up of a group of people who are supposed to bring together their varied skills and talents to build a social capital synergy and therefore successful governance performance. The failure of many companies in both developed and developing nations has highlighted the limited role played by boards of directors due to a lack of commitment to corporate governance principles. Redzuan (2012) highlight that, the financial crisis in Asia brought into the open the weak checks and balances that resulted in increased focus on insider trading.

The incorporation of board of directors members that have financial experience is expected to constrain opportunistic behaviours of managers because they will be able to detect such activities much easily than board members with no or limited accounting background (Carcello & Neal, 2002). Similarly, when board of directors are populated with members that have a longer tenure of financial experience, firm managers will less likely be induced to practice earnings management. Furthermore, a big board size improves a company's capacity to comprehend the demands of a wide range of stakeholders and, as a result, better meet those needs. As a result, there is more openness and hence better information disclosure.

1.1.2 Earnings Management

One of the important content of financial statements at the end of a period is the earnings generated. This is because it represents the bottom line of the business activities as measured by the excess of revenue generated over the expenses incurred in that period. Due to the importance of earnings in a period, managers might be motivated to manipulate this variable with a view to changing the perception of different group of stakeholders including investors, shareholders, government policy holders and the general public (Hu, et al., 2015). Hence earnings management is an opportunistic behaviour by management to maximise personal benefits under debt covenant and compensation (Defond & Jiambalvo, 1994). In a similar manner, Healy and Wahlen (1999) describe the concept of earnings management as the purposeful application of managerial judgment in reporting of financial information to arrange financial data in order to deceive some stakeholders about reported accounting information. A similar view is taken by Scott (2015) who describe earnings management as that process in which a firm management choose an accounting policy that affect earnings. Financial reporting and transaction structuring decisions are made based on management's judgment, with the goal of changing financial reports to mislead some stakeholders or influence contractual decisions based on reported accounting figures.

As stated by Dechow, Ge, & Schrand (2015), management uses two ways to accomplish the EM goal: accrual-based earnings management (AEM) and real earnings management (REM). Under the accrual earnings management, the firm managers select an accounting method or change transactions in the financial statements with a view to achieving some desired results. This might take, for example, differing of some expenses to the next period or recognizing unearned revenue in the current period. Real earnings management, on the other hand, is defined by Osemene, Muritala, and Olawale (2014) as when managers change period activities to reach or exceed specified earnings criteria. As a result, according to Scott (2010), earnings management may be accomplished by implementing various techniques with the goal of achieving a pre-determined goal – such as minimizing income in order to reduce the company's tax burden to the government. Consequently, though the management of earnings could be reasonable or legal from the view point of the management decision making, it could also be illegal, unethical and fraudulent since it is geared to report financial results that do not represents the financial fundamental in the firm (Crumbley, Heitger & Smith, 2015).

1.1.3 Board Characteristics and Earnings Management

Various board characteristics have been linked to managerial outcomes. A high number of board members are predicted to increase the efficiency of management monitoring and assessment, lowering discretionary accruals and improving financial reporting quality (Fama & Jensen, 1983). From the perspective of an agency, bigger boards allow board members to focus more effectively on a limited number of committees that they share, since they will not be overrepresented in multiple sub-committees, enhancing their ability to monitor and assess management actions (Kiel and Nicholson, 2012). Larger boards are also expected to strengthen the board's negotiating position with the chief executive officer (CEO), a position that increases the efficacy of management oversight.

From management perspective and as also pinpointed by the agency theory, there is a rare case of abnormality of accounting information in cases where there is independence of the board. Independence of the board is proxied by many factors but the most outstanding measure is availability of independent directors. When Park and Shin (2004) looked at the influence of board composition on management profits manipulation, they discovered that having a significant number of nonexecutive members limits the ability for managers to violate accounting policies and principles. Non-executive directors with an accounting experience are advantageous since they are familiar with financial statement misrepresentations, a trait that causes management to be hesitant to adjust financial information for their own benefit. Indeed, the Cadbury report (1992) emphasizes the significance of board members' financial knowledge for successful leadership and management.

Attendance of the board members to board meetings affords them the privilege to continually inspect and supervise the financial statements prepared by the managers. One indicator of a board's success, according to Ronen and Yaari (2008), is how frequently the board members meet to discuss issues that impact the business now and in the near future. Boards that are diligent are able to scrutinise better the statements and therefore enhancing the level of oversight. Therefore, the higher the number of board meeting that are sat, the better the quality of financial reporting expected from the managers (Carcello &Neal, 2002).

Diversity of the board members as measured by representation of both genders is also expected to affect the earnings management position in a firm. Carter et al., (2010) suggests that female board members are considered to be more independent than the male counterparts because they are not considered not to be among the clique of the ‘‘old boys’’ network. Shareholders will feel more at ease with a board that includes a large number of women since it signals that change can easily be accepted and implemented, making them more confident in the company's success, resulting in a rise in share price. From the position of the agency conflict, the chair of the board and the CEO function need to be separated in order to reduce the power of one individual in management matters and at the same time board decisions.

1.1.4 Nairobi Securities Exchange

A business must have a minimum of seven members to be listed on the Nairobi Securities Exchange (NSE), according to Kenya's Companies Act, Cap 486. Majority of the firms ordinarily start by being private entities and then grow to open up its shareholding to the public and in the process gain addition capital injection for expansion purpose. Between 1954 and the present, the Nairobi Securities Exchange has transformed itself from being owned by an association of stockbrokers to what it is currently a public entity with its shares being traded in the same bourse (www.nse.co.ke). There is always high probability for players operating under bourse to participate in the exchange market either by introduction or through IPO. These firms finally get listed at the security exchange market under different segment such as Main Investment Market, Alternative Investments, Options Market as well as Fixed Income Securities Market. In addition, the shares of companies listed at the security exchange market are categorized into various segments that are determined by minimum capital of investment. For instance, the Growth Enterprise Market Segment (GEMS) is the least category as far as the cost of capital investment is concerned. The amount of capital under this segment is 10 million Kenyan shillings. Following the list of company shares categories is the Alternative Investment Market Segment (AIMS) where the minimum capital required for a company’s share to be listed is Kshs. 20 million. Similarly, another category in valuation of company shares requires a minimum capital of KShs. 20 million, the Main Investment Market Segment (MIMS) (www.nse.co.ke).

There are currently 64 firms that are listed at NSE under 13 different segments with the banking segment with highest firms listed under it of 12 firms while the investment services, telecommunication and real estate’s have one firm listed under it. Consequently, the non-financial firms total 52. Preference shares, Equities, Treasury Bonds, and Corporate Bonds are some of the most frequent products traded in the stock markets. The non-financial markets will be the focus of this study. Financial firms were not selected owing to the commercial banks' unique reporting practices, which are subject to close examination by regulators.

1.2 Research Problem

The annual report to a company is regarded as a vital medium for communicating an organization's financial and non-financial goals to the general public. As a result of the importance that these statements play to information dissemination to many categories of stakeholders, it is expected that its preparation is free from any form of manipulation from the managers to achieved specific objective. This is because managers can exercise discretion through adoption of particular accounting policies and practices that might mislead the user of the financial statements. If left unchecked managers have been known to distort the financial information with serious negative consequences to the general public. It is expected that the corporate governance mechanism in a firm should be able to protect investor and control the actions of the managers that is detrimental, but as Jha (2013) assert, some of them have not lived to their expectation and managers have been found to manipulate financial statements. Theoretical, the board should be the vehicle through which corporate governance and being the highest policy-making body, its performance is expected to affect the firm operations and activities.

At local and international level, board characteristics and earnings management as a study concept has attracted the attention of a handful of researchers. Starting from international perspective, Sri Lanka, Rajeevan and Ajward (2019) conducted a study that aimed to establish the relationship between bord characteristics and earnings management in Sri Lanka. The study focused on CEO duality as the main characteristic of the board and established that there is positive relationship between duality of a chief executive officer and earnings management. Adeyele, Adinnu, and Osemene (2018) on their part sought to establish whether organization structure of ownership and board characteristics influence earnings management among public listed commercial banks in Nigeria. Based on the findings, it was established that public listed commercial banks that are owned by government, foreign and local investors have poor earnings management record. In addition, irt also found that organizational board composition and the size of the board influenced earning management positively though to a small extent. Rauf, Johari, Buniamin, and Rahman (2012) is also an additional study that was done in Malaysia with an aim of establishing the impact of firm size and board characteristics on earnings management among 208 firms. The findings from the study demonstrated a positive relationship between firm size and earnings management. Similarly, a board with diversified personnel in terms of gender, education, experience and culture enhances earnings management. This implies that as firm total assets increase, the incentive to manage earnings by the management increases. Similarly, firms with negative operating cash flows were found to practice earnings management because of the negative and significant relationship between the variables.

Chemweno (2016) studied 42 NSE-listed businesses from 2010 to 2016 for a correlation between board features and performance. Researchers utilized audit committee independence, board independence, board diligence, board gender diversity, board expertise and board size to identify board characteristics. This study found that only the independence of the board had a substantial influence on the success of the companies. According to Owen (2018) research, gender diversity on boards of listed manufacturing companies at the NSE had a statistically negative effect on earnings management, a study that analysed secondary data from 2011 to 2017. Firm size, nationality, and board independence all had an impact on earnings management. According to Iraya, Mwangi, and Wanjohi (2014), there was a negative correlation between earnings management and ownership concentration, board independence, and board concentration in their study of how corporate governance influences earnings management practice among firms listed on the Nairobi Securities Exchange. Additionally, there was a link between the management of earnings, CEO duality, and board engagement.

Against this background, it can be deduced that a vibrant interest has recently been directed towards factors that might be influencing managers to adopt one form of earnings management or another. However, in contrast to developed nations where more study has been done, the influence of board features on the earnings management of Nairobi Stock Exchange-listed companies has received little attention in Kenya. Board features are likely to have a greater influence on earnings management even in the same environment as in developed nations. As a result of the current gap, this research will attempt to address the following question: what impact does board characteristic have on the management of earnings of non-financial companies listed on the Nairobi Securities Exchange?

1.3 Research Objective

To determine the effect of board characteristics on earnings management for non-financial firms listed at the Nairobi Securities Exchange

1.4 Value of the Study

Research on the effect of board characteristics on the earnings management has important implication to the policy makers and regulatory with regard to the firms listed at the NSE. The findings is expected to guide policy makers in coming up with appropriate decision on firm management and specification of the characteristics that board members should have before being appointed to head a company. In addition the regulators will be able to guide lenders on the correct financial standings of a firm before making investment decision. Therefore, the research finding will have important implications for policy makers, regulators and standard setters such as capital market authorities (CMAs) as well as other researchers on the importance of considering both earnings management strategies in order to come up with a definitive conclusion.

The practice of finance management will benefit from the study because the understanding of how earnings management might be influenced by board characteristics will be evaluated and therefore help in advising on an appropriate level policy with regard earnings management. Further, the research will allow the finance managers to conform to the set standards relating to the management of earnings. The management decision with regard to financing will further be discussed and therefore enhance the understanding of the finance function and how it can influence the financial accounting function of a firm.

From the perspective of a developing nation like Kenya, where there is a deficit in this area, the study contributes to the literature on the influence of board characteristics on earnings management. From the research, different gaps will be identified which can be pursued by other scholars through the use of different predictor variable.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter covers a review of the relevant literature in relation to the research objective which is to determine the effect of board characteristics on the earnings performance of non-financial firms listed at the NSE. A detailed discussion that covers the theoretical underpinning of the study, determinants of earnings management, empirical review and research gap is covered. In addition, the conceptual framework that presents diagrammatically the nexus between the relevant board characteristics and earnings management is presented.

2.2 Theoretical Review

The research will be anchored on three theories, namely; Agency Theory, Fraud Triangle Theory and Positive Accounting Theory. The relevance of the theories to this particular research is presented too.

2.2.1 Agency Theory

Jensen and Meckling (1976) proposed the agency theory, which states that an agency connection exists when one party delegated work or services to another and gave authority in decision-making. The primary feature of the agency problem is the existence of a conflict between the principal and agent's interests, as well as the principal's knowledge asymmetry concerning the agent's contribution (Bosse & Phillips, 2016). The theory is of the view that human beings always act in self-interest to maximise their own welfare by striking a balance between their risk aversion characteristic and bounded rationality. Similarly, information concerning an agent performance is incomplete and this position results in moral hazard and adverse selection (Eisenhardt, 1989). Due to the possible conflict that might arise between the managers and the shareholders, different mechanisms are used by the shareholders with a view to reducing the level of this conflict.

The agency theory advocates for an efficient governance mechanism – represented by the supervisory board, as opposed to emphasis being placed on the management board. Existence of a balanced board characteristic is able to generate maximum benefits from the management board on behalf of the owners whom they are acting on behalf. Due to the structure of their remuneration, managers have an incentive to manipulate earnings. Healy (1985) provides evidence that managers seek to manage profits downwards when their incentive compensation has reached a specified maximum level when earnings are on a downward track. Furthermore, there is ample evidence that managers falsify earnings when their job security is at risk. According to Goel (2012), existing managers would use accounting discretion to present a good picture of their own performance to voting shareholders during a proxy election at the annual general meeting of an organization. Similarly, in their final years of contract, CEOs prefer to reduce research and development expenses in order to boost reported profitability. Similarly, in the preceding years to an initial public offer (IPO), managers tend to smoothen up the earnings to show a favourable possible and this raises agency conflict between the management and shareholders.

Firms with high agency costs should display a larger degree of earnings management in instances where managers employ earnings management opportunistically, suggesting that earnings management is directly connected to agency conflicts. Similarly, earnings management may be used to disclose certain information that is privy to a given organization, implying that earnings management has an informational element (Habbash & Alghamdi, 2015). A higher level of management of earnings is expected from firms with more agency expenses to improve their internal organization outcomes. When there is less conflict between management and shareholders, managers are more likely to employ earnings management. This is because managers and shareholders have better communication. The negative correlation between agency expenses and earnings management is enough evidence to show that earnings management is helpful or at least not harmful as far as corporate image and valuation of shares are concerned. Despite the agency theory's ongoing use in describing managers' earnings management behavior, Ekanayake (2004) points out that the theory ignores the presence of social relationships and continues to believe that social life is a one-way process. In addition, the applicability of the theory in different cultural backgrounds seems not to be constant because in Asian organizations, agency cost tends to be lower than the European countries (Johnson & Droege, 2004).

2.2.2 Fraud Triangle Theory

The Fraud Triangle Theory (FTT) was advanced by Cressey (1953). A criminologist by profession, Cressey opined that there are three factors necessary for fraud to be perpetrated, namely, perceived pressure, existence of an opportunity and rationalization. The fraud vice however does not start when someone is employed but rather that initially people accept the responsibilities bestowed upon them in good faith and it is only the circumstances that make them negate the trust bestowed upon them. Cressey sought to identify the factors that drive people to change their initial state and notes that it included pressure, presentation of opportunities and rationalization. When trust violators perceive themselves as having a problem that cannot be shared with others and are aware that this problem can be solved secretly by a violation of the position of financial trust, they will be tempted to pursue the option, even if it is unethical, according to Abdullahi and Mansor (2015).

Financial or non-financial constraints may be perceived as driving an individual to do an immoral business conduct (Abdullahi and Mansor, 2015). However, the financial pressures have been identified as a common factor that drives people to commit fraud but upon satisfying the one need, it results to the desire to satisfy the subsequent financial need. In research carried out by Albrecht et al., (2006), it was found that 95% of all fraud cases perpetrated were as a result of the desire to meet certain existing financial need or measure to the society expectation. The role of pressure in committing fraud was reinforced by Lister (20070 who points out that employment and corporate pressures drive employees to commit financial fraud which eventually end up benefitting themselves. Managers will be tempted to manipulate earnings positions so that they can be paid a bonus at the end of a period which will eventually be used to pay expenses or personal debt (Vona, 2008)

The availability of an opportunity provided by an organization's poor control or governance structure that could lead an employee to conduct fraud is the second element that contributes to fraud (Florenz, 2012). A lack of an effective internal control mechanism will result in people taking advantage of prevailing circumstances available to commit fraud. Existence of an opportunity makes people to seize it and there will be need for establishment of an active board of directors that will monitor the activities of the managers (Kelly & Hartley, 2010). If the chance of managers being caught by undertaking earnings management is high, the more likely it is that fraud will take place. The board characteristics is an important signal to managers of their capacity to be caught or not if they are induced to practise earnings management. By having members of the board with financial acumen and understanding, this will discourage managers from manipulating the accounts for their selfish reasons since the chance of being caught is high.

Rationalization is that third dimension that makes people to engage in fraud. Hooper and Pornelli, (2010) assert that some people will justify the unethical actions by giving such excuses as “I was only borrowing the money”, or harbouring the feelings that his/her employer is cheating because of not compensating them adequately and they are induced to look for extra paying by overstating the earnings and therefore earning higher bonuses. Because of this, the board must come up with adequate remuneration for employees. Howe and Malgwi (2006) showed that explaining fraudulent behavior creates a link between incentive/pressure and opportunity. However, the board must first identify elements that lead to fraudulent behavior before putting up measures to minimize it (Thanasak, 2011).

2.2.3 Positive Accounting Theory

The positive accounting theory was advanced by Watts and Zimmerman (1978). The theory identifies three factors that explain the performance of a firm, namely; debt, compensation and size of the company. The compensation to the executives depends on earnings generated and this might result to the manager’s motivation to portray better earnings than the true position. Similarly, level of debt and size of the firm are postulated by the theory to influence the manipulation of earnings by the managers. Managers’ compensation in many jurisdictions is influenced by the earnings generated and in this context, the theory is of the view that managers will seek to realise high earnings through manipulation of the accounts to reflect increased earnings position (Milne, 2012).

The positive accounting theory suggests that if a firm finances its operations using debt, then it has convinced lenders through the financial statements that the financial health of the company is good to warrant increased lending. This motive can explain why managers will manipulate the accounting policies with a view to increasing their earnings position. The size of a firm also affects the earnings motive of mangers because large firms attract the interest of investors and regulators alike and therefore influencing managers in a way to post good results. However, Zadeh, Salehi and Alaei (2012) assert that large firms also attract good managers and good image in the eyes of stakeholder. The theory further postulates that the managers endeavour to represent their perceived fair value of their organizations assets.

Benston (2006), for example, opine that such firms as Enron tried to mask the fair value argument when confronted with the claim of manipulating the accounts.

The use of different rates and policies with regard to a firms wage growth rate, expected return on equity, equity return spread and the discount spread rate – in trying to find a fair value of a firm transactions (Byrne, Clacher, Hillier, & Hodgson, 2008). They further note that the variations in the accounting treatment of these transactions is not explained by difference in economic fundamentals but rather the management motives to register high earnings and then be paid higher compensation (Peasnell, Pope & Young, 2010). The question that the positive accounting theory tries to explain is whether the internally generated intangible assets need to be recognized in the financial statements or be excluded until when the asset is actualised in cash. The disclosure of intangibles in the financial statement, in itself, is value relevant and therefore negates the need to recognize such internally generated asset in the financial statements. Lev (2011) note that it is from this basis that accounting for intangibles need to be reviewed.

2.3 Determinants of Earning Management

Earnings management is a strategic accounting method that managers use to optimize on the firm productivity and at the same time reduce risk. It is from this perspective that earning manipulation results in conflict with the mainstream accounting practice. Different authors have identified the factors that might contribute the earnings management practice by managers. In this research, the relevant determinants of earnings management include, board characteristics, size of the firm, corporate governance and leverage.

2.2.1 Board Characteristics and Earning Management

Because earnings management includes the selection of accounting processes and estimations that adhere to widely accepted accounting principles, it happens within the boundaries of generally accepted accounting standards (GAAP). As a result, while it tends to deceive financial statement users, it is not illegal, but it is unethical. The board of directors, according to the agency theory, has a vital responsibility to play in ensuring that managers do not deceive investors in the financial statements they generate at the conclusion of a financial period. This implies that the board should be separate from management in order to provide an unbiased view on the financial statements. When Park and Shin (2004) looked at the influence of board composition on earnings management practice, they found that having a larger number of non-executive directors helps control earnings management and has a lower level of anomalous accruals. Dechow, Sloan, and Sweeney (1996) found that boards with a larger percentage of independent directors were less likely to be subjected to accounting enforcement procedures for alleged GAAP breaches. This has led to a long-standing relationship between board independence and earnings management being negatively correlated. Similarly, numerous studies have discovered a negative link between the number of independent outside directors and their ability to generate income for a company utilizing existing resources (Brickley and James, 1987; Weisbach, 1988). This is because the a higher board size enhances its monitoring capability of the managers, with a board size of between four and six being found to be more effective in monitoring due to associated improved communication and making of strategic decisions (Rahman & Ali 2007

Gender diversity on the board of directors has emerged as a significant element that, although being under the jurisdiction of corporate governance standards, has been linked to improved earnings management. According to Fondas and Sassalos (2000), a board with both genders represented is more efficient than one with only one gender represented. Indeed, the presence of female directors is linked to greater financial performance and management oversight, as it has been discovered that having more women on the board improves the quality of decision-making. Rose (2007), on the other hand, determined that presence of female board members had no impact on company performance. Studies by Adams and Ferreira (2009) confirm the same notion that there is insignificant relationship between availability of female board members and organizational performance.

Another element that has been shown to impact the degree of earnings management is the character of the board as defined by the participation of institutional directors. Institutional directors are generally bank or insurance company representatives, and Paquerot (1997) claims that their presence enhances governance efficiency since they are usually experienced agents or personnel appointed from the financial companies. Other studies, on the other hand, show no indication of a relationship between institutional directors and earnings management (McNichols, 1999). Institutional investors are typically interested in short-term increases in share price, and may be encouraged to push directors to manage their profitability in order to obtain a higher share price. If the share price is high, however, institutional investors will strive to maximize the bank's long-term value, and in order to do so, they will tighten management oversight.

The inclusion of an audit committee comprised of members who are familiar with accounting concerns enhances the board's ability to supervise management. Managers are deterred from engaging in earnings management techniques by an audit committee that meets frequently with auditors to evaluate accounts and audit procedures, internal control, and accounting systems. According to Muhamad Sori et al. (2001), an audit committee is crucial in overseeing the audit and financial activities. This justifies the conclusion that the presence of an audit committee might have a considerable impact on company's earning management efforts (Rahman & Ali 2007). In the same study, it was discovered that fewer audit committee members and sittings were linked to a higher degree of anomalous accrual. As a result, according to Park and Shin (2004), greater audit committee activity and members' enhanced financial knowledge helped to limit profits manipulation by management.

2.3.2 Company Size and Earnings Management

The size of a firm serves as a metric for determining whether it is deemed small or huge. The market capacity of a company indicates its size, and larger corporations are less likely to engage in earnings management since they are subject to public scrutiny. Lee and Choi (2012) found that larger companies will be more careful in reporting their finances and therefore report their conditions more accurately. The natural logarithm of the total asset is used to estimate the business size in the majority of studies. In terms of the agency relationship, it is hypothesized that the larger the firm, the greater the predicted agency problem that a given firm would face (Abed et. Al., 2012). This is because larger firms are expected, ceteris paribus, to generate more earnings because of the higher resources that they do have and further have less incentive to carry out earnings management through discretionary accruals (Barton & Simko, 2012).

In terms of the effect of the firm size on the earnings management practices in a firm, Zhu and Tian (2009) and Shehu (2011) highlight that there are two divergent opinions. A negative association between the two variables has been advanced with Abdul Rahman and Ali (2006) finding that larger firms with sophisticated internal control systems, large auditing firms and better reputations will be less likely to adopt earnings management practices so that they don’t comprise their reputations. Smaller businesses, on the other hand, that are not subject to regulatory constraints and want to represent high performance, will engage in earnings management efforts. On a different view, Myers and Skinner (2010) discover a positive link between earnings management and company size because larger businesses with commanding market shares and influence are more inclined to manage their earnings in order to preserve their position. Choutrou et al. (2011) while investigating the effect of firm size on performance suggest that large companies in terms of the asset base, lack the urge to do earning management than small companies.

2.2.3 Corporate Governance and Earnings Management

The manager’s behaviour is influenced by the corporate governance tenets practiced in an organization and the firm ownership structure. These firm characteristics will become critical as well if majority shareholders represent a significant proportion in the firm capital structure, and also when their legal protection is not guaranteed. The corporate governance characteristics of a firm is defined by the presence of an audit committee, level of independence, duality of the CEO and the chairman, the board’s size and audit by “big” auditors. Liu and Lui (2017) suggest that the nature of the corporate governance tenets that has been put in place in a firm defines the level of free cash flow that is held by a firm because the managers’ propensity will come into check.

The board of directors (BOD) in a firm is responsible for the governance structure that is implemented. However, the board effectiveness is influenced by such factors as size, experience of its members, qualification of each member and tenure. At the same time, though a large board size comes with extended benefits, it might also lead to slowing down of decisions due to the difficulty of coordinating individual contributions, high communication costs and slow decision making process especially when individual board member opinion is to be sought (Jensen & Meckling, 1976). Richardson (2006) highlight that the outside directors are found to identify better cases of over-investment that is common in situations where there is excess free cash flows in the firm. As a result, boards with a high degree of independence manage free cash flows and their use better. Fama and Jensen (1983) emphasize this notion by stating that independent board directors result in more effective supervision of managers and greater control on behalf of shareholders. Similarly, Iraya, Mwangi, and Wanjohi (2014) shown that a bigger board size has the related benefit of providing alternative expertise, which may reduce the occurrence of earnings management and related manipulations.

2.3.4 Leverage and Earnings Management

Leverage refers to the use of fixed cost sources of funds with intention of increasing the profits to shareholders. The management of such firms use operating and financial leverage with the hope that they can generate profits that is higher than the cost of financing the firm operations with such sources of capital. From another perspective, leverage has the potential that it increases the volatility of profits to the shareholders (Sartono, 2010). In order to avoid going against the debt covenants, managers might use earnings management to contravening the debt provisions with high debt levels being found to induce managers to adopt income increasing accounting policies (Waweru & Riro, 2013). Managers manipulate earnings with the intention of portraying a strong financial standing and that those firms that exhibit higher leverage showing the tendency to exhibit high earnings management that relate to profit smoothing.

According to Ujah and Brusa (2011), there is a link between earnings management and financially troubled businesses, which is backed by Fung and Goodwin's financial distress theory (2013). The study attempted to demonstrate a relationship between financially distressed firms and earnings management, and discovered that organizations with good earnings management were positively related to financially distressed enterprises in terms of short-term debt obligations. Compounded with the cash flow volatility, leverage was found to increase the incentive by managers to control earnings. This is because there exist a high probability of default for firms that are highly geared and in order not to fail, in fulfilling its obligations managers will be persuaded to undertake earning management. Jelinek (2007) highlight that a smaller firm leverage position will be seen by investors has having a lower chance of default and therefore having lower cumulative risk to the firm.

Higher financial leverage has been found to result in increased accrual earnings management and other earnings-related accounting decisions (Beatty and Weber, 2003). This is done with the sole aim of avoiding contravening debt covenant provisions. In a study by Zagers (2009), it was found that in the case of leveraged firms, earnings management is done, to among other, maintain the cash flows at a desired level. Further, Sari (2013) suggests that there exist a strong correlation between a firm leverage and capital expenditure. On the other hand, other studies have found that increased leverage results in reduced earnings management because they are likely to face tighter control from creditors (Zamri et al, 2013). As a result, managers will have fewer incentives to undertake earnings management because of the realization that the firm creditors will be taking keen interest on the financial statement. Vakilafard and Mortazavi (2015) further suggests that as the firm leverage increases, the resultant pressures from the debt covenant and frequent audits demanded by the creditors reduces the incentives of the firms managers to pursue earnings management.

2.4 Empirical Review

Al Azeez, Sukoharsono, and Andayani (2019) studied the impact of board features on earnings management in 71 oil and gas companies operating across the world, with an emphasis on how board characteristics such board size, gender, CEO duality, and board independence affect earnings management. The results showed that board independence had a substantial impact on earnings management, but that board size had no effect on earnings management since large boards were shown to be inefficient in monitoring management. Similarly, it was discovered that board gender and CEO dualism strongly influenced earnings management. This study backs up Abdul Rauf et al. (2012) findings that management ownership and CEO duality have a favourable influence on earnings management as assessed by discretionary accruals. Yugroho and Eko (2011) also discovered that CEO dualism has an impact on earnings management.

Osemene, Adeyele, and Adinnu (2018) studied the link between deposit-taking bank ownership structure and board characteristics in Nigeria, using panel data from 2011 to 2016. The data reveal that foreign, private, and government ownership of the businesses had a negative impact on the earnings management capability of the managers. The study findings, according to Kazemian and Sanusi (2015), demonstrate that board size and CEO tenure had an insignificant influence on the banks' earning management practices. However, the impact of foreign and private ownership on profits management is consistent with the findings of Alzoubi (2016), who looked at the impact of ownership structure among Jordanian commercial banks.

Isa and Farouk (2018) looked at board diversity and the function of the audit committee in the profits management of low and highly geared banks listed in Nigeria. The study utilized multiple regressions analysis to demonstrate the relationship using panel data from 2008 to 2015. The study's findings suggest that having more women on boards has a negative impact on banks' actual profits management methods. Similarly, board ownership was shown to have a positive influence on earnings management. The findings, however, contrast with those of Iraya, Mwangi, and Muchoki (2015), who found that board size was inversely associated to earnings management. Similarly, the findings contrast with those of Van den Berg (2015), who argue that a more diversified board in terms of nationality results in better profits management.

A Sri Lankan researcher, Kankanamage (2016), examined the connection between board features and profit management. Data from 160 Sri Lankan Securities Exchange-listed companies between 2012 and 2013 shows a strong link between board size, composition, financial acumen, and board meetings on earnings management strategies. This was due to the fact that a strong board improved the quality of financial reporting and transparency. According to the findings, increasing the board size is related with an increase in independent non-executive directors who provide strong financial competence and meet often, which is consistent with Beasley (1996) and Vafeas (2005) studies. As a result, the board's monitoring capacity is strengthened, and the chances for profits management are reduced.

Veronica (2015) used 30 manufacturing companies registered on the Indonesian Securities Exchange to study the combined influence of debt and company size on managers' inclination to manage earnings. A regression analysis was used by the researcher to test the study hypothesis. The findings indicated that operating leverage had a positive coefficient of 0.215, whereas financing leverage had a 50.5 percent impact on managers' earnings management capacity. The findings also show that a combination of operating leverage, financial leverage, and company size had no influence on earnings management technique. The findings support Goddess's (2007) conclusions, which established that financial leverage has little impact on managers' earnings management decisions. Similarly, this finding supports the Signaling theory, which claims that companies trade the interest cover advantage and the dangers associated with financing risk, and that the more the leverage, the higher the degree of profits management.

Mwendwa (2020) investigated the effect of corporate governance characteristics on the decisions made in regard to earnings management by Nairobi Securities Exchange-listed firms. The functions of the audit committee, board independence, concentration of ownership and board size were among the CG characteristics examined. A longitudinal method was used to look at 65 companies that were listed on the market exchange between 2015 and 2019. According to the research, the board size and audit committee have a negative and considerable impact on the businesses' profits management. Therefore, shareholders should keep an eye on the audit committee's independence and board size, as the data show that they have the most impact on profits management. According to Iraya, Mwangi, and Muchoki (2015), contrary to common assumption, earnings management is favorably linked with the size of the board and the concentration of ownership, but adversely correlated with board activity and CEO duality. Studying the relationship between ownership concentration, board size, and independence, and earnings management reveals that these factors are all negatively associated to earnings management, although board activity and CEO duality are favourably related.

Waithaka, Gakure, and Wanjau (2013) used board size, director compensation, board committees, board skills, and multiple directorships to represent board characteristics in a study on the impact of board characteristics on Microfinance Institutions' social performance in Kenya. The findings reveal a negative relationship between MFI social performance and board size, director compensation, and director independence. Multiple directorships, on the other hand, had no influence on social performance. Previous research by Abdullah (2004) and Sahin, Basfirinci, and Ozsalih (2011) has found that board committees, independent directors, and MFI social performance have a good and significant impact.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This section contains the various methodological processes and procedures to be followed in the research study. It presents the research design, empirical model, study population, sampling technique, and collection of data procedure and the analysis of data

3.2 Research Design

In research methodology, a research design is a well-structured framework that guides the researcher to achieve the intended research objective. It is a blue print, which is used by a researcher to generate answers to research problems (Mugenda & Mugenda, 2013).

A descriptive research design will be adopted because, as Maigua and Mouni (2016) point out, the benefit of this research design is that it requires reasoning to be related in order to apprehend reason and consequence. The researcher will not be able to clarify what is going on between the variables, since there will be no influence over the variables. As a result, the researcher will be able to analyse and explain the influence of board characteristics on the earnings management of non-financial firms listed at the Nairobi Security Exchange.

3.3 Population of the Study

The population of the Study will consist of the 54 non-financial firms listed at the NSE (Appendix II). The selection of the non-financial firms as the unit of analysis is because commercial banks financial statements is structured differently as opposed to the non-financial ones and hence the financial information that is necessary in the is not readily available. This challenge is further compounded by the demands by the Central Bank as the regulator that demands specific ways that the financial statements are presented. Since the population of the study is small, the research will be a census.

3.4 Data Collection

The data that will be used to analyse the research variables will be secondary data to be obtained from a variety of sources, such as audited financial statements of the respective firms and reports filled at the Capital Market Authority (CMA). The data to be collected will be covering five years from 2016 to 2020. The accounting data to be collected will be those that will facilitate measurement of board size, board independence, board diversity, CEO duality, and board meeting. The data to be collected will include total accruals and total assets,

3.5 Data Analysis

For purposes of interpretation, data analysis includes the translation of study data into functional formats, drawing conclusions and inferences. The analysis will be based on both descriptive and panel regression. The descriptive study will comprise of the following: the use of arithmetic mean, standard deviations, overall number of observations, maximum and minimum number of observations. The inferential analysis shall, on the other hand, be based on the regression analysis of the panel data.

3.5.1 Diagnostic Test

Before running a regression analysis, diagnostic tests are performed to establish if the data collected in regard to the study variables is suitable for inferential statistics computation and establishing a suitable relationship between the dependent and independent variables. There will be three major diagnostic tests performed. Normality, multicollinearity, and heteroscedasticity tests are the three types of tests. Normality tests are used to determine if data was collected from a normally distributed population (within certain limits).. The residuals in multivariate normality–multiple regression are assumed to be normally distributed. No Multiple regression suggests that the independent variables are not significantly linked with each other, which is known as multicollinearity. Variance Inflation Factor (VIF) values are used to evaluate this assumption.

Any connection of independent variables in a sample is known as multicollinearity (Wooldridge, 2013). Because they raise the p-values in a regression, high multi-colinearity levels contribute to incorrect predictions. The correlation matrix is used to determine the degree of correlation between the predictor variables. It aligns with Greene (2012), who found a significant degree of multi-colinearity in r or r^2 values greater than 0.8 or 64. In such a case, each of the variables involved would be omitted. Heteroscedasticity is a condition in which the residual variances are consistently different from each other (Verbeek, 2012). The Breusch Pagan Godfrey test will be used to determine heteroscedasticity. A p-value of more than 5% indicates that the model is free of heteroscedasticity problem.

3.5.2Analytical Model

Discretionary accruals will proxy the earnings management variable while the board characteristics will be proxied by board size, board independence, board diversity, CEO duality, and board meeting.

The analytical model will be as follows.

$Y = \beta o + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \boldsymbol{\varepsilon}$

Where:

Y = Earnings Management (EM) = Total Accrual / Total Assets

β_o = The Y intercepts is a constant coefficient and it is not influenced by other variables

X_1 = Board size = Total number of directors sit on the board.

X_2 = Board independence = The proportion of a company's board that are non-executive independent directors.

X_3 = Board diversity = The ratio of the number of women to total board size

X_4 = CEO duality = Dummy variable which is denoted as "1" If the CEO is also the chairperson of a company and as "0" otherwise

X_5 = Board meeting = The total number of board meetings attended by the majority of the company's directors in a given fiscal year.

X_6 = Firm Size; = (Log of Total Assets)

$\{\beta_{i\,;}i = 1.2.3,4,5,6\}$ = The coefficient of values representing the various independent v

ariables.

ε = the error term representing any other variable that can have an influence on earnings management of the non-financial firms listed at the NSE.

3.5.3 Significance Test

The regression significance will be determined using the F- test whereas R^2which is the coefficient of determination will determine the extent of variation in Y that will be described by X variables. 5% significance level or 95% confidence level will be used and correlation analysis will be determined to establish the direction and strength of the association between the board characteristics and earnings management.

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