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Corporate governance compliance and accrual earnings management in eastern Africa

Evidence from Kenya and Tanzania

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Abstract

Purpose – The purpose of this paper is to examine whether compliance with corporate governance (CG) requirements has constrained earnings management (EM) for companies listed in Kenya and Tanzania.

Design/methodology/approach – The sample comprises of 48 companies listed on the Nairobi Stock Exchange and the Dar es Salaam Stock Exchange. The data are collected from annual reports over the period 2005-2014, a total of 480 firm-year observations. Panel data models are used in the analyses.

Findings – The results show that discretionary accruals (DAs) average about 11.3 per cent, whereas audit quality is negatively and significantly related to DAs. However, board independence, board gender diversity and director share ownership were positively and significantly related to DAs suggesting that CG may not have constrained EM in eastern Africa.

Research limitations/implications – The findings should be understood within the context that only annual reports and audited financial statements that were filed with Capital Markets Authority (Kenya) and Capital Markets and Securities Authority (Tanzania) are used as source of information.

Originality/value – The study potentially contributes in three main ways. First, this is the first cross-country analysis that has examined the effect of CG structures on EM in an African context. Second, literature on CG and EM has been extended. Finally, the authors have extended research by observing the limitations of CG in reducing EM in an environment that is experiencing weaknesses in CG structures.

Keywords Discretionary accruals, Kenya, Corporate governance, Earnings management, Tanzania

Paper type Research paper

1. Introduction

The main purpose of this paper is to investigate whether compliance with corporate governance (CG) guidelines constrains earnings management (EM) in Kenya and Tanzania. Kothari *et al.* (2012) indicated that EM can occur through two channels: accruals management and real activities management but most studies have focused on discretionary accruals (DAs). Empirical evidence exists to show that EM can be reduced through the adoption of good CG practices although most of these studies have been carried out in developed countries (Warfield *et al.*, 1995; Alves, 2012; Bos *et al.*, 2013). However, Rahman and Ali (2006) and Mangena and Chamisa (2008) argued that unlike developed countries, most developing countries are characterized by weak legal protection of minority shareholders' interests and concentrated ownership structures. Therefore, this study aims at examining whether CG constrains EM in a developing country context. Black *et al.* (2012)

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justified emerging markets CG studies by arguing that governance may vary from country to country, in ways not well captured by multi-country indices. In other words, a majority of the studies in developed markets may not be generalized to emerging markets, such as Kenya and Tanzania.

As late as 2014, several listed companies in Kenya had reported losses several years in a row, contrary to the capital markets' requirements and in most cases, this occurred after the departure of powerful chief executive officers from those firms (CMA, 2014). To remedy this situation, the Kenya Capital Market Authority (CMA) has revised the CG code and also suggested mandatory guidelines contrary to the spirit of the current voluntary "comply and explain" CG code (CMA, 2014). The World Economic Forum (2012) reported that scandals involving companies listed at the Nairobi Securities Exchange (NSE) and the Dar es Salaam Securities Exchange (DSE) have dented investor confidence and raised questions on the integrity of the auditing and reporting standards, strength of investor protection and the protection of minority shareholders. Furthermore, a survey by Ernst and Young (2013) found that 53 per cent of the respondents believed that their companies had overstated their financial performance.

The preceding discussion motivated us to examine CG practices and analyse their relationship with EM in an East African environment. Tauringana and Mangena (2012) discussed a number of reasons why findings from other contexts may not apply in Africa, including low stages of economic development, corrupt practices and political interference in corporate affairs. Furthermore, unlike developed markets of the USA and Europe, which have highly dispersed shareholding (Allen, 2005), ownership of companies listed in the East African markets is highly concentrated (Waweru, 2014). According to the entrenchment effect hypothesis, firms with concentrated ownership may be subject to conflicts of interest between majority and minority shareholders, with controlling shareholders exercising their control rights to create private benefits (Shleifer and Vishny, 1997). Alves (2012) argued that large shareholders may intervene in the firm's management, and may even encourage managers to engage in EM to maximize their private benefits (Jaggi and Tsui, 2007). Therefore the results of studies that have been completed in developed markets may not be generalized to the East African context. The World Bank (2005, 2010) also suggested that corporate reporting in both Kenya and Tanzania is poor and, generally, the lack of transparency pervades the corporate reporting regime in the region and this may have contributed to the recent corporate failures (Uchumi in 2006 and CMC holdings in 2011). Several studies in developing countries have also reported mixed findings. For example, while Alzoubi (2016) reported a negative and significant relationship between independent boards and EM in Jordan, Mohammad *et al.* (2016) found a positive and significant relationship in Malaysia before the revision of the Malaysian CG code in 2007. An earlier study by Rahman and Ali (2006) found no significant relationship between independent directors and EM in Malaysia.

The decision to focus the research on Kenya and Tanzania derives from a number of factors. First, the two countries, respectively, are the largest and second largest economies in the East African region, with efficiently functioning stock exchanges (Nyange, 2011). Second, in 2002, both the CMA in Kenya and the Capital Markets and Securities Authority in Tanzania issued CG codes for listed companies[1]. The two codes are modelled in a similar fashion (CMA, 2002; CMSA, 2002). Third, both Kenya and Tanzania are members of the East Africa Community. Fourth, the two countries share a common language. These factors demonstrate similarities, making it appropriate to examine and compare the effects of governance on EM in the two countries.

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In this study, we use the modified Jones model (Dechow *et al.*, 1996) to compute DAs and then apply panel data models to investigate the relationship between DAs and selected CG indicators. As suggested by Kothari *et al.* (2005), we add firm performance to the modified Jones model. We find that DAs averaged 11.3 per cent and audit quality (AQ) (measured as the ratio of audit fees to sales) was significant and negatively related to EM. However, board independence, board gender diversity (BGD) and the proportion of director share (DS) ownership were positively and significantly related to DAs. The current study potentially contributes to literature in three main ways. First, this is the first cross-country analysis that has examined the effect of CG structures on EM in an African context. Second, we extend research on CG and EM and their relationship in listed companies operating in Kenya and Tanzania. Finally, we extend research by showing the limitations of the "comply or explain" CG model in reducing EM. Regulators, policymakers and boards of listed companies may find the study findings useful.

The rest of the paper is organized as follows. Section 2 reviews the regulatory environment, Section 3 explains the theoretical framework of the study, whereas Section 4 reviews literature and develops the hypothesis. Section 5 discusses the methodology, whereas Section 6 discusses the findings. Section 7 concludes the paper, discusses the contribution of the study and provides suggestions for further research.

2. Corporate governance reforms

In Kenya, the CMA issued guidelines on good CG practices by public listed companies in 2002. The guidelines were prepared in recognition of the role of good CG in corporate performance, capital formation and maximization of shareholders' value as well as the protection of investors' rights (CMA, 2002). According to these guidelines:

- The board should be composed of a balance of executive directors and non-executive directors.
- There should be a clear separation between the role and responsibilities of the chairman and the chief executive officer.
- All listed companies should establish at least an audit and nominating board committee.

The code also requires the board to annually disclose, in its annual report, its policies and breakdown for remuneration for the board and senior management, a list of ten major shareholders and aggregate directors' loans and related party transactions. One of the greatest weaknesses of the Kenyan CG guidelines of 2002 is that they did not specifically require a CG report other than a mere disclosure of and communication on various matters on board performance to shareholders. In 2014, the Corporate Governance Steering Committee issued a draft blue print that proposed a series of actions that could be taken by a variety of stakeholders to improve CG in Kenya. According to the blue print, the country was lowly ranked on governance and accountability, competitiveness and investor protection.

In Tanzania, the Capital Market and Securities Authority (CMSA) issued the first guidelines on CG in 2002. These guidelines were similar to those that were issued in Kenya, emphasising the role of the board of directors in corporate reporting. Both guidelines require that all listed companies should include in their annual reports statements of the directors as to whether their companies are complying with the guidelines. When the company is not fully compliant, the board is required to identify the reasons for non-compliance and indicate the steps being taken to become compliant (CMSA, 2002). This is similar to the "comply or

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explain" approach that is required by the Johannesburg Stock Exchange[2] (Mangena and Chamisa, 2008).

In January 2016, the Corporate Governance Steering Committee draft blue print was adopted by the CMA with the CMA (2002) CG code being replaced by the CMA (2015) CG code (CMA, 2015). The revised code changed the "comply or explain" principle to "apply or explain". Unlike the "comply or explain" approach which requires companies to abide by the governance standards or explain why they choose not to do so, the "apply or explain" CG standards are recommendations on principles or practices rather than strict rules that companies are advised to act accordingly to (King Report 111, 2009). According to CMA (2015), this new approach is principle-based rather than rule-based, and recognizes that a satisfactory explanation for any non-compliance will be acceptable in certain circumstances. Furthermore, the approach requires boards to fully disclose any non-compliance with the code to relevant stakeholders (including the CMA) and include a firm commitment to move towards full compliance. The code has also made some CG guidelines mandatory for all listed companies. In addition to stating the recommended policies, the new code includes a detailed implementation guideline for each policy which is expected to enhance compliance. Furthermore, the revised code has set the maximum age of directors to 70 years and the maximum number of years that a director can serve the board as an independent director to nine years. Also the code requires at least one of the audit committee (AC) members to hold a professional qualification in either auditing or accounting and be in good standing with his or her respective professional body.

3. Theoretical framework

Agency theory suggests that, in the presence of information asymmetries, managers will choose the set of decisions required to maximise their usefulness. Therefore, the theoretical basis of this study is anchored on the agency theory which posits a negative relationship between CG and EM. According to the agency theory, separation of ownership and control leads to a divergence of interests between managers and shareholders and thus monitoring managerial decisions becomes an essential tool for boards of directors to assure that shareholders' interests are protected and to ensure reliable and complete financial reporting. The overall aim of CG mechanisms is to reduce agency problems by aligning the interests of managers and owners and thereby improving firm value (Jensen and Meckling, 1976).

The implications of the agency theory in the current study are that the principals will rely on the CG and financial reporting codes to monitor the agents to eliminate information asymmetry. Klein (2002) and Dechow *et al.* (1996) argued that the reliability and quality of accounting earnings are enhanced when managers' opportunistic manipulation is monitored by CG. According to Sun *et al.* (2010), there are three major factors that influence corporate activities with respect to the link between CG and EM: managerial ownership, board composition and AQ. Cai *et al.* (2008) observed that EM in International Financial Reporting Standards (IFRS)-adopting countries has been decreasing in recent years especially in countries with stronger enforcement. However, Capkun *et al.* (2013) posited that the IFRS standards that went into effect in 2005 provide greater flexibility of accounting choices because of vague criteria, overt and covert options and subjective estimates coupled with the lack of clear guidance on how to implement these new standards and this may have led to greater EM. Furthermore, according to Riro *et al.* (2016), the political cost hypothesis predicts that large firms, rather than small firms, are more likely to use accounting choices that reduce reported profits.

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4. Literature review and hypothesis development

A few studies have investigated the effects of CG on EM in eastern Africa. Amidu and Kuipo (2015) investigated the implications of EM for funding and diversification strategies of banks in Africa. Using a sample of 330 banks from 29 African countries (including Kenya and Tanzania), they found that banks that diversify across interest income tend to engage less in EM. Waweru and Riro (2013) investigated the influence of CG and firm characteristics on EM by companies listed on the NSE. They found that companies with concentrated ownership were more likely to engage in EM, whereas companies with a higher proportion of independent directors were less likely to manage earnings. Although Waweru and Riro (2013) included firm performance in their modified Jones Model (Dechow *et al.*, 1996), their sample included banks and other financial institutions. Waweru *et al.* (2011) investigated the factors which influence the choices of accounting policies by managers of listed companies in Tanzania. They found that when the proportion of non-executive directors is higher, managers are unlikely to choose income increasing accounting policies.

Unlike the above studies, our current study investigates CG and EM over the 2005-2014 period, which is more recent and extensive when compared with the periods examined by existing studies. Therefore, the current investigation can also be considered as an extension to prior studies (Ntim *et al.*, 2012a).

CG guidelines are sets of nonbinding recommendations aimed at improving and guiding the governance practices of corporations within a country's specific legal environment and business context. According to World Bank (2005), they provide clear guidance for financial and non-financial disclosure, foster better engagement of minority shareholders and clarify respective roles of managers and directors.

Few studies exist on the effectiveness of the "comply or explain" CG code particularly on the African continent. Nerantzidis (2015) using a sample of 144 Greek listed companies found that although the degree of compliance was low, the evaluation of explanations of non-compliance was even lower. The study concluded that companies tend to avoid compliance with these recommended practices, raising questions regarding the effectiveness of the "comply or explain" CG code.

Several studies have examined CG practices in Africa. For example, Outa and Waweru (2016) found a positive and significant relationship between CG, firm performance and firm value in Kenya. Ntim *et al.* (2012b) investigated whether listed corporations in South Africa (SA) voluntarily complied with the recommended CG practices and the factors that influence such compliance. Their study reported that block ownership was negatively associated with voluntary CG disclosure, whereas board size (BS), audit firm size, cross-listing, government ownership and institutional ownership were positively related to voluntary CG disclosure. Using a sample of 169 SA listed companies, Ntim (2013a) investigated the relationship between an integrated CG index and financial The performance. study reported a statistically significant and positive relationship between compliance with CG provisions and financial performance. Ntim (2013b) also reported a significant and positive association between a composite CG index and firm value in SA. However, their results revealed a reverse association between their CG index and firm value, thus the need for future research (Ntim, 2013b). Waweru (2014) examined the factors influencing the quality of CG in SA and Kenya. The study found that AQ and firm performance were the main factors influencing CG quality in these two countries.

According to Waweru (2014) and West (2006), most commonwealth African countries have many similarities, resulting from the cultural influences of the country that occupied them (Britain). Furthermore, Rossouw (2005a) argued that all sub-Saharan African countries

except Nigeria have adopted an "inclusive" approach to CG. According to Mangena and Chamisa (2008), SA was the first African country to develop a CG code in 1994. Other African CG codes such as those of Ghana, Kenya, Tanzania and Zimbabwe have been borrowed heavily from the SA CG code.

Our study contributes to the literature by investigating how the "comply or explain" model of CG (Waweru, 2014; West, 2006) is associated with EM. In the following section, we examine the effect of independent directors, BGD, AQ and directors' share ownership on EM. We focus on these factors because they are more applicable in the specific context of the East African economic and institutional environment.

4.1 Board independence

The agency theory assumes that the inclusion of independent directors will make the board more effective in its monitoring function. By independent directors I mean the proportion of non-executive directors to the total number of directors who increase a board's independence from management. According to PWC (2012), non-executive directors have the ability to provide meaningful input to the complex set of challenges facing the company and provide the appropriate leadership to drive results at an operational level. Marra *et al.* (2011) found that board independence provides an essential tool in reducing the magnitude of EM.

In South Africa, Ntim (2011) found a statistically significant and positive relationship between the presence of independent non-executive directors and firm value. Dechow *et al.* (1996) found that firms with a large percentage of non-executive members on the board are less likely to receive accounting enforcement actions by the US securities exchange commission (SEC). Lee *et al.* (1992) and Klein (2002) found evidence supporting a negative relationship between independent directors and EM. Alzoubi (2016) found a negative and significant relationship between board independence and EM in Jordan. However, Rahman and Ali (2006) found a positive and insignificant relationship between board independence and EM in Malaysia. Their findings suggest that independent directors may not always be an effective tool in constraining EM. We hypothesize that:

H1. There is a negative relationship between levels of earnings management and the proportion of independent directors.

4.2 Board gender diversity

According to the resource dependence theory, board diversity holds the potential to improve the information provided by the board to managers due to the unique information held by diverse directors. Carter *et al.* (2003) argued that differences in gender will likely produce unique information sets that are available to management for better decision-making because diverse directors may have access to important constituencies in the external environment. Both the CMA and the CMSA recommend that the process of the appointment of directors should be sensitive to gender representation. Therefore, we use gender as the proxy for board diversity in this study.

In France, Aguir *et al.* (2015) found a negative and significant relationship between the proportion of women on the board and EM. Their results support current literature which suggests that female directors provide greater supervision and monitoring thus reducing agency costs (Adams and Ferreira, 2009). Gul *et al.* (2011) examined the effect of women directors on earnings quality in the USA. Their study show that US firms with higher levels of BGD have better quality reports and are less likely to manage earnings.

Adams and Ferreira (2009), in a sample of US firms, found that female directors have better attendance records than male directors and women are more likely to join monitoring

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committees, suggesting that gender diverse boards allocate more effort to monitoring. Recently Abbott *et al.* (2012) reported that women on US corporate boards encourage better financial reporting. They hypothesized that women are more conservative and risk averse when making financial investment-related decisions which can lead to greater board vigilance in the monitoring of financial statements. In South Africa, Ntim (2015) found a significant positive relationship between BGD and firm value. Other studies did not find a significant relationship between BGD and EM (Rose, 2007; Emilia and Sami, 2010). We hypothesize that:

H2. There is a negative relationship between levels of earnings management and proportion of female directors appointed to the board.

4.3 Directors' share ownership

An important requirement for listing on both the NSE and the Dar es Salaam Securities Exchange is that at least 25 per cent of the shares must be held by the public and that the company's shareholders must not be less than 1,000 (CMA, 2002; CMSA, 2002). Warfield *et al.* (1995) argued that under the convergence-of-interest hypothesis, insider ownership can be seen as a mechanism to constrain the opportunistic behaviour of managers. Therefore, EM is predicted to be negatively associated with executive director ownership (Alves, 2012). On the other hand, it can be argued that when there is narrow separation between owners and managers, managers face less pressure from financial markets to signal the firm value to the market and tend to give less consideration to the short-term financial reports (Al-Fayoumi *et al.*, 2010). Alves (2012) and Bos *et al.* (2013) also argued that greater managerial ownership may provide managers with deeper entrenchment and therefore, greater scope for opportunistic behaviour. Therefore, companies with high managerial ownership are more likely to experience earnings manipulation.

Prior research has reported a negative relationship between DS ownership and EM. For example, Alves (2012) found that DAs, a proxy for EM, were negatively related with managerial ownership in Portugal. In the UK, Bos *et al.* (2013) found that share ownership by executive directors had a significant negative impact on the level of DAs. Hanson and Song (2000) also indicated that higher levels of managerial ownership will force managers to bear the costs related to negative synergies and thus, provide incentives to sell assets that reduce firm value. In Jordan, Al-Fayoumi, *et al.* (2010) reported a positive and significant relationship between insider ownership and EM. Kim *et al.* (2004) and Warfield *et al.* (1995) found a curvilinear relationship between DS ownership and financial restatements. We hypothesize that:

H3. There is a negative relationship between levels of earnings management and the ownership of shares by directors.

4.4 Audit quality

The agency theory postulates that governance regarding the compensation of directors and managers aims to motivate managers to behave in the best interests of shareholders and monitoring management leads to a reduction of agency conflicts (Sun *et al.*, 2010). Previous research indicates that AQ is an important element of efficient equity markets because external audits can enhance the credibility of financial information and directly support better CG practices through transparent financial reporting (Chee Haat *et al.*, 2008; Francis *et al.*, 2003). According to DeAngelo (1986), large public accounting firms with greater investment in reputational capital have more reason to minimize audit errors

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via "auditor-reputation effects". They will also experience a greater loss through reputation damage if the quality of their audit does not meet the accepted quality standards (Chee Haat *et al.*, 2008). Mitton (2002) argued that firms which are audited by one of the Big Four audit firms (a proxy for AQ) are more likely to have a better market performance as well as greater transparency.

Wooten (2003) found that even after controlling for audit risk, client size and audit complexity, there is an additional premium based on auditor identity. DeFond and Jiambalvo (1993) found that large audit firms are more independent of management. Therefore, empirical evidence seems to support the differential AQ based on the type of audit firm. There are a number of empirical studies supporting the positive relationship between AQ and audit firm size (Francis and Simon, 1987; Jang and Lin, 1993; Hogan and Jeter, 1997). Ferguson *et al.* (2005) and Chee Haat *et al.* (2008) also found a positive relationship between audit firm size and audit fee. Alzoubi (2016) found a significant negative relationship between AQ and EM in Jordan. As argued by Chee Haat *et al.* (2008), the use of ratio of audit fees to sales (as a proxy for AQ)[3] would be expected to provide more robust results compared to the dummy variable used for audit firm size. However, their study found no significant relationship between higher AQ and firm performance. We hypothesize that:

H4. There is a negative relationship between levels of earnings management and the quality of external audit.

4.5 Control variables

We control for the effect of other factors through the inclusion of CG characteristics (BS, board meetings (BMs), presence of an AC and ownership concentration) and firm-specific variables (cash flow, firm size and leverage), which have been used in previous studies and have been found to be associated with EM (Chen *et al.*, 2007). Choi *et al.* (2004) and Park and Shin (2003) found a significant relationship between the presence of an AC and EM, whereas Shleifer and Vishny (1997) and Alves (2012) found that concentrated ownership can increase the effectiveness of the board in monitoring management and thus, reduce EM.

5. Methodology

5.1 Research design

We apply the modified Jones model and also include firm performance as suggested by Kothari *et al.* (2005). Following Klein's (2002) study, the model is estimated for all the firm years. We also control for firm-specific variables, such as cash flow, size and leverage. These three variables control for influence of firm profitability, size and capital structure on EM (Chen *et al.*, 2007). As Bartov *et al.* (2000) indicated, failure to control for confounding factors may result in falsely rejecting the null hypothesis of no abnormal accruals when in fact the null hypothesis is true.

Following previous studies (Habbash *et al.*, 2013, Chen *et al.*, 2007; Kothari *et al.*, 2005), we first compute total accruals ($TACC_{jt}$) of firm j in the year t calculated as the difference between earnings before extraordinary items and discontinued operations ($EARN_{jt}$) and net cash flow from operations (CFO_{jt}) as follows:

$$\mathrm{TACC_{jt}} = \mathrm{EARN_{jt}} - \mathrm{CFO_{jt}} \tag{1}$$

We then estimate the following regression for every firm and firm-year combination:

$$TACC_{jt}/TA_{jt-1} = \beta_{o+}\beta_1(1/TA_{jt-1}) + \beta_2(\Delta Sales - \Delta Rec/TA_{jt-1}) + \beta_3 GPPE/TA_{jt-1}) + \beta_4 ROA_{jt-1} + \acute{e} \quad (2)$$

where:

β_o = Intercept;
TA_{jt-1} = Lagged total assets for firm j in year t−1;
Δ Sales = Change in sales for firm j in year t;
Δ Rec = Change in receivables for firm j in year t;
GPPE = Gross property plant and equipment for firm j in year t;
ROA = Rate of return on lagged assets for firm j in year t; and
é = Error term for firm j in year t.

To obtain industry-specific estimates of the coefficients βo, β_1, β_2, β_3 and β_4, we follow previous studies (Mostafa, 2017; Habbash *et al.*, 2013; Lai, 2011) and run a pooled cross-sectional and time series regression for each of the industry sectors; agricultural, manufacturing and commercial and services sectors, using equation (2). This is to ensure that we had sufficient observations available in each industry to estimate DAs.

Following prior studies (Mostafa, 2017; Habbash *et al.*, 2013; Lai, 2011 and Chen *et al.*, 2007), DAs are the residual values (é) obtained from equation (2) and are computed by deducting the non-discretionary accruals (NDA_{jt}), i.e. the predicted values obtained from equation (2), from the total accruals ($TACC_{jt}$) as follows:

$$DA = TACC_{jt} - NDA_{jt} \quad (3)$$

To test for the relationship between CG and EM, the general least squares random effects regression model is applied as shown in equation (4) below. As recommended by Gujarati and Porter (2009), we run the Hausman test, which tests whether the errors are correlated with the independent variables. The results demonstrate that the random effects model is the most appropriate for our data:

$$DA = \beta_0 + \beta_1 BIND + \beta_2 BGD + \beta_3 DS + \beta_4 AQ + \beta_5 Controls + \varepsilon \quad (4)$$

The variables are defined in Table I

To test for endogeneity, after completing the regression, the error term was extracted and correlated with all the independent variables. The results indicated that there were no significant correlations between the error term and the independent variables suggesting that endogeneity was not a major problem in the data. We also include dummy variables to control for temporal and country effects. Temporal effects are represented by 10-year dummies, whereas the country effect is captured by a country dummy that take the value of 1 for Kenya and 0 otherwise.

We also follow Greene's (2008) study to control for heteroscedasticity in the standard errors, that is; we use the "robust" option in STATA. According to Tauringana and Chithambo (2016), this command apart from addressing heteroscedasticity issues also deals with other minor concerns bordering on failure to meet other regression analysis assumptions like normality or excessively large residuals, or influence from a particular variable. Our results (not reported here for brevity) remain the same as those shown in Table V.

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Dependent variable	Definition and operationalisation
Discretionary accrual (DA)	This is the proxy for earnings management computed using the modified Jones model (Dechow *et al.*, 1996) and also including return on investments as suggested by Kothari *et al.* (2005)
Independent variables	
Board independence (BIND)	The number of outside directors as specified in the annual reports scaled by total number of directors on board at the financial year end
Board gender diversity (BGD)	The number of female directors divided by the total number of directors
Director share ownership (DS)	The number of shares held by the company directors divided by the total number of shares for firm at the financial year end
Audit quality (AQ)	Measured as the annual statutory audit fees divided by amount of annual sales
Control variables	
Board meetings (BM)	Natural Logarithm of the number of board meetings held in a year
Board size (BS)	Natural Logarithm of the total number of directors in the firm
Audit committee (AC)	A dummy variable taking the value of 1 if an audit committee exist and 0 otherwise
Ownership concentration (OC)	Percentage cumulative shareholdings by ten top shareholders
Cash flow (CF)	Cash flow from operations divided by total assets
Firm size (FS)	The natural log of total assets at the financial year end
Leverage (DE)	Financial leverage is the ratio total debt at the end of the financial year scaled by the total book value of assets at that date

Table I. Definition and operationalisation of variables

5.2 Sample selection

We selected a sample of 48 companies from a total of 77 companies listed in the DSE and the NSE. The companies selected are shown in Table II.

Bank and insurance companies were excluded from this study, consistent with Klein's (2002) study, because of their additional distinct regulations and disclosures together with the complexity of determining accruals. Companies with missing data were also excluded. The 48 companies are considered a good representative of the population as they constitute 88 per cent of the non-financial listed companies.

6. Findings

6.1 Descriptive statistics

Table III reports descriptive statistics of the variables included in the regression analysis. The results show that DA ranges from a minimum of −64.7 per cent to a maximum of 50.3 per cent with a mean of −4.8 per cent. We consider firms to have

Sector	Population	Sample	
	No. of firms	No.	Firm years
Agricultural	7	7	70
Commercial	22	18	180
Manufacturing	25	23	230
Sub total	54	48	480
Banks and insurance	23	0	0
Total	77		770

Table II. Population and characteristics

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Variable	Observation	Mean	SD	Minimum	Maximum
BS	480	7.6	2.422	3	16
BIND	480	79.5%	0.149	28.6%	100%
BGD	480	9.2%	0.111	0	50%
BM	480	4.5	1.755	2	14
DS	480	7.5%	0.146	0	71.1%
OC	480	67.6%	0.175	0.2	100%
DA	480	−4.8%	0.1745	−64.7%	50.3%
Abs DA	480	11.3%	0.117	0	64.7%
AC	480	82.7%	0.378	0	100%
AQ	480	0.002	0.003	0.00004	0.06
FS	480	15.143	1.684	10.789	19.338
DE	480	40.1%	0.226	1.0%	87.2%
CF	480	11.2%	0.149	−57.1%	82.9%

Table III.
Descriptive statistics

engaged in income increasing (decreasing) DAs if they have positive (negative) estimated DAs. Our findings show that listed companies in East Africa engage in income decreasing DAs. The average absolute DAs were 11.3 per cent which is considered high. Waweru and Riro (2013) reported an average of 3 per cent in Kenya, whereas Lai (2011) reported an average of 6.45 per cent in China. Our results appear to confirm the high cases of EM in East Africa (Ernst and Young, 2013; World Economic Forum, 2012). Capkun *et al.* (2013) reported that greater flexibility in accounting choices and lack of clarity of the IFRS's may have led to an increase in EM.

The average proportion of independent directors was 79.5 per cent suggesting that most of the East African listed company boards comprised a high number of independent directors. This finding compares favourably with those of Waweru and Riro (2013) who reported an average of 77 per cent. Most of the sampled companies had few female directors on their boards; hence, the low mean of 9.2 per cent. Indeed the proportion of women on the East African boards ranged between a minimum of 0 per cent and a maximum of 50 per cent. The average BS was 7.6 directors, whereas the average number of BMs was 4.5 times a year, which is consistent with CMA and CMSA requirements. The average director's shareholding was 7.5 per cent which is considered low, an indication that most directors have not acquired shares in their companies. Our study found that the average ownership concentration was 67.6 per cent which compares favourably with the 62 per cent that was reported by Waweru and Riro (2013). This confirms earlier findings that ownership of companies operating in most developing countries of Africa is highly concentrated (Mangena and Chamisa, 2008). The average number of companies that had established an AC was 82.7 per cent, whereas AQ averaged 0.002. Generally, all the selected CG indicators are well within the CMA and CMSA requirements.

The leverage ratio of 40.1 per cent is considered low and is consistent with Waweru (2014), who reported a leverage ratio of 42 per cent. Our findings indicate that most of the sampled firms rely more on equity than debt, suggesting a low likelihood of EM arising from pressure of debt holders.

The results of the Pearson pair wise correlation among the independent variables are shown in Table IV. According to the results, none of the correlation coefficients is greater than 0.7 suggesting that multicollinearity is not a serious problem in our data (Gujarati and Porter, 2009). In addition, we calculated the variance inflation factors (VIF) and found that

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Table IV.
Correlation matrix

Variable	FS	DE	CF	BS	BIND	BGD	BM	DS	OC	AC	AQ
FS	1.0000										
DE	−0.2768	1.0000									
CF	−0.0017	−0.2469	1.0000								
BS	0.5881	−0.0874	0.0827	1.0000							
BIND	0.0769	−0.0465	0.0058	0.2188	1.0000						
BGD	0.4636	−0.2289	0.1484	0.3520	0.0536	1.0000					
BM	0.4905	−00.3102	−0.1353	0.3043	0.1200	0.2922	1.0000				
DS	−0.1527	0.0259	−0.0856	−0.0436	0.2017	−0.1452	0.0405	1.0000			
OC	−0.2537	0.0219	0.01148	−0.3479	−0.1438	0.0239	−0.1943	−0.1344	1.0000		
AC	0.4207	0.0007	0.0674	0.3827	0.2369	0.215	0.1394	0.0644	−0.3060	1.0000	
AQ	−0.4113	0.0073	−0.1561	−0.3327	−0.1677	−0.2512	−0.1095	0.1725	0.1372	−3,401	1.0000
VIF	1.99	1.49	2.97	1.46	1.30	1.14	2.01	1.12	1.97	2.28	1.57

all were below 10, confirming that multicollinearity is not a problem in our data (Gujarati and Porter, 2009).

6.2 Random effects regression results

Table V presents the multivariate regression model results that measure the explanatory power of the independent variables and the DAs. The R^2 for the cross-country model was 29.8 per cent indicating that the model explains 29.8 per cent of the variations in EM. The Wald χ statistic was 195.2 and is significant at 1 per cent or better.

In terms of the explanatory factors, our *H1* predicted a negative relationship between board independence (BIND) and EM. However, the results show a positive and significant relationship between BIND and EM, thus rejecting *H1*. Our findings are consistent with those of Mohammad *et al.* (2016) but are inconsistent with the agency theory predictions. The results suggest that the high proportion of independent directors (board independence) does not reduce EM in East Africa. These results are inconsistent with those of Alzoubi (2016) and Waweru and Riro (2013), who reported a negative and significant relationship. We argue that boards in East Africa may be independent in form (structure) but not in substance (actual effectiveness) probably because of the presence of "grey" directors (Mangena and Chamisa, 2008). We also found a positive and significant relationship between BGD and EM thus, rejecting *H2*. The results are inconsistent with those of Aguir *et al.* (2015) and Gul *et al.* (2011) who reported a negative and significant relationship. Our results suggest that the presence of women on East African listed company boards does not help in constraining EM.

Our study found a positive and significant relationship between DS and EM. However *H3* predicted a negative relationship between DS and EM. Therefore, *H3* is not supported. The findings are inconsistent with the convergence-of-interest hypothesis, but support the view that greater managerial ownership may provide managers with deeper entrenchment and therefore, greater scope for opportunistic behaviour (Alves, 2012). Our findings are inconsistent with those of Alves (2012) and Bos *et al.* (2013) who reported a significant and

	Across country		Within country			
	All data		Kenya		Tanzania	
Variable	Coefficient	*Z*-statistic	Coefficient	*Z*-statistic	Coefficient	*Z*-statistic
BS	0.0036	1.41	−0.0004	0.8830	0.0023	0.7610
BIND	0.1131	3.41***	0.0044	0.9060	0.3556	4.39***
BGD	0.2727	5.55***	0.1872	4.46***	0.2875	2.89***
BM	0.0038	1.20	0.0019	1.51	0.0332	1.87*
DS	0.1879	5.56***	0.1322	3.24***	0.1098	1.78*
OC	0.0523	1.71*	−0.0021	0.9460	−0.0999	0.3140
AC	−0.0097	−3.66***	−0.0068	−2.6550***	−0.1147	−2.47***
AQ	−3.0048	−1.97**	−1.8931	−2.74***	−1.9056	−1.97**
FS	−0.0301	−6.79***	−0.0093	−2.40**	−0.0691	−5.23***
DE	0.0665	2.85***	0.0432	1.76*	0.0956	0.0990
CF	0.1533	4.45***	0.0386	0.3180	0.2654	3.61***
Year effect	*Included*	*Included*	*Included*	*Included*	*Included*	*Included*
Country effect	*Included*	*Included*				
R^2	29.8		15.3		65.1	
Chi	195.2***		31.7***		141.9***	
N	480		380		100	

Note: ***, **, * Significant at the 1, 5 and 10%, respectively

Table V. Random effects regression results

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negative relationship in Portugal and in the UK, respectively. Our findings are also inconsistent to those of Xie *et al.* (2003) and Mohamad *et al.* (2012) who reported a negative relationship.

In *H4* we predicted a negative relationship between AQ and EM. Our results show a negative and significant relationship between AQ and EM suggesting that high-quality external audit constrains EM among the sample companies. Our findings are consistent with those of Francis *et al.* (2003), Cai *et al.* (2008) and Alzoubi (2016) who reported that companies that are audited by the non-Big Four have significantly higher levels of DAs than those audited by the Big Four auditors.

Among the control variables, we did not find any significant relationship between BS, BM, OC and EM. Possible reasons could be the "box ticking" approach (Outa and Waweru, 2016) which may be different from the reality on the ground. Our findings are consistent with those of Rahman and Ali (2006) and Koh (2003) who found an insignificant relationship between BS and EM. Our results also suggest that a higher level of block ownership does not reduce EM in East Africa. Our findings are also inconsistent with those of Sarkar *et al.* (2008) and Xie *et al.* (2003) who found a negative relationship between BMs and DAs. Consistent with the findings of Choi *et al.* (2004) and Park and Shin (2003) we found a negative and significant relationship between the presence of an AC and EM. The results suggest that ACs play an important role in constraining EM among the subject firms. Furthermore, we found a negative and significant relationship between FS and EM suggesting that larger firms have lower levels of EM thus providing further support to the Political Cost hypothesis (Riro *et al.*, 2016).

6.3 Additional analysis

To provide more insights and understanding of our results, we split the data into individual countries and run within-country level models. The results of these analyses are presented in Table V. The results reported in Table V demonstrate differences on the effects of BIND on EM in the two countries. Whilst we find a positive and significant relationship between BIND and EM in Tanzania, the relationship is positive but insignificant at the 5 per cent level in Kenya. Also, the relationship between DS and EM is positive and significant in Kenya but is insignificant at 5 per cent level in Tanzania. The rest of the results are consistent with those reported for the cross-country model. In particular, we find that both AC and AQ are negatively and significantly related to EM in both countries.

We did not consider industry in the original analyses, but Barako *et al.* (2006) suggested that industry might affect the quality of reporting. Therefore we classify the sample into two industries: manufacturing and nonmanufacturing (commercial services and agricultural)[4] and run within industry-level models. The results that are presented in Table VI are consistent with those of the main model (Table V). However, whereas we find a positive and significant relationship between BGD and EM among manufacturing firms, the relation is negative and insignificant among nonmanufacturing firms.

6.4 Robustness of the results

We run additional analyses to test the robustness of the results (not tabulated in the paper). In particular, we test the sensitivity of the results to the inclusion of additional variables and alternative measures. First, although the correlation results (Table IV) suggested that the independent variables are not highly correlated, the correlation between BS and FS (r = *0*.5881) is high when compared to the other correlations. The study therefore estimates the regressions by including these two variables in separate models. The results as reported in Table V remain unaffected.

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Variable	Manufacturing		Non-manufacturing	
	Coefficient	*Z*-statistic	Coefficient	*Z*-statistic
BS	0.0401	1.32	−0.0001	−0.003
BIND	0.1512	3.17***	0.1026	2.26**
BGD	0.2093	3.08***	−0.0066	−0.34
BM	0.3948	1.28	0.0161	0.66
DS	0.3254	4.83***	0.1231	3.08***
OC	0.0117	0.45	0.0363	0.82
AC	−0.1202	−4.54***	−0.0381	−2.33**
AQ	−0.1544	−2.79***	−0.5472	−2.86***
FS	−0.0368	−5.77***	−0.0154	−2.50**
DE	0.0669	1.74*	0.0459	1.55
CF	0.0312	0.62	0.2799	5.88***
Year effect	*Included*		*included*	
Country effect	*Included*		*Included*	
R^2	41.9		48.2	
Chi	157.1***		163.6***	
N	230		250	

Note: ***, **, *Significant at the 1, 5 and 10%, respectively

Table VI.
Random effects regression results (industrial sectors)

Second, we selected firms that are likely to manage earnings based on managerial incentives and classified them "poor performers". In an exploratory study, Kaboyo and Wamwea (2014) found that poor financial performance of a company that negatively affects its reputation with the public may induce management to mis-report financial performance. In Egypt, Mostafa (2017) found that DAs were positive and significantly higher for firms with low operating performance, suggesting that low operating performance firms may increase the EM practices by increasing their reported earnings opportunistically to mask their low performance. Using the median return on assets, a dummy variable of poor performers and good performers (0, 1) was introduced, and we re-ran the regression model. The findings as reported in Table V remain similar.

Finally, we run a pooled ordinary least squares regression model, including year and country dummies. The results (not tabulated here for brevity) are similar to those reported in Table V, suggesting that our findings are robust across different statistical models. We therefore concluded that our findings are robust.

7. Conclusions

The purpose of this paper was to investigate whether CG guidelines constrain EM in companies listed in Kenya and Tanzania. The study was motivated by the reported existence of EM evidenced by previous exploratory research, and reports of the existence of troubled companies [Ernst and Young (2013); CMA (2014)]. DAs regarded as a proxy for EM were regressed against selected CG indicators. Three CG characteristics (BIND, BGD and DS) were positively and significantly related to EM. This leads to the conclusion that CG guidelines requirements may not have played a significant role in reducing EM in the DSE and the NSE listed firms probably because of the voluntary application of these guidelines ("comply or explain" principle). There may be a need for developing countries to shift the CG culture from mere adherence to rules and regulations and "box ticking" to one that captures the essence of good governance. In this regard, effective January 2016 Kenya has changed its CG code from

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the "comply or explain" principle to the "apply or explain" principle and some CG guidelines have been made mandatory for all listed Kenyan companies.

From an agency theory perspective, some of our findings are inconsistent with the agency theory propositions. According to the agency theory, independent directors are viewed as effective monitors but our results suggest that this CG mechanism is not an effective deterrent of EM in East Africa. As argued by Mohammad *et al.* (2016), this evidence appears to support the managerial hegemony theory that top management has greater authority in terms of decision-making and may elect independent directors who are their close allies and who may not act as effective monitors and active participants in the board's decision making.

The current study is important to the investing public in East Africa who rely on financial statements for capital allocation. Moreover, the study potentially contributes in three main ways. First, this is the first cross-country analysis that has examined the effect of CG structures on EM in an African context. Therefore, the study provides empirical insights on the development of capital markets in Africa, specifically in Kenya and Tanzania. Second, our study contributes to CG and EM literature by providing evidence from a developing economy context. In particular, we provide evidence to show that the choice of a reputable external auditor has an effect on the quality of financial reporting in East Africa. Finally, the study extends research by showing the ineffectiveness of the "comply or explain" CG model in reducing EM particularly in countries that are experiencing weak legal enforcement structures (Mangena and Chamisa, 2008). Our findings raise questions on the effectiveness of the "comply or explain" CG codes.

These conclusions should be understood within the context that only annual reports and audited financial statements that were filed with CMA and CMSA were used as source of information. Model limitations may also impact the findings. Given that there have been reasonable efforts towards compliance with CG guidelines, it is suggested that future research could explore why, in spite of these efforts, EM has not been reduced significantly in Kenya and Tanzania. Future research may also investigate the effectiveness of the revised CMA (2015) CG code in constraining EM by comparing the pre- and post-revision periods.

The study has implications for capital market regulators, boards of listed companies, academics and stakeholders of capital markets such as the World Bank. Capital markets authorities and stakeholders need to examine the effectiveness of the "comply or explain" code. Boards of companies too may need to examine their CG compliance levels and ensure that EM is constrained, because doing so will likely boost investor confidence in the East African capital market.

Notes

1. In Kenya, the CMA regulates all listed companies and enforces corporate reporting requirements, disclosure and the publication of financial statements (World Bank, 2010). Similarly in Tanzania, the CMSA is empowered to regulate all entities whose shares or debt are publicly listed (World Bank, 2005).
2. In 2010, South Africa adopted the "apply or explain" approach to corporate governance (King Report 111, 2009).
3. Almost all the listed companies in Kenya and Tanzania are audited by the BIG Four, thus the need for a different proxy for audit quality.
4. We combine commercial services and agricultural because the agricultural sector has only seven firms.

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