

**EARNINGS MANAGEMENT AND FINANCIAL PERFORMANCE OF LISTED NON  
FINANCIAL FIRMS IN NAIROBI COUNTY, KENYA**

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REG. NO: D53/CTY/PT/29022/2013**

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## **DECLARATION**

### **Declaration by Candidate**

I the undersigned declare that this research project is my original work and confirm to the best of my knowledge that this has not been presented for any academic award in any other University.

Signed: \_\_\_\_\_ Date: \_\_\_\_\_

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### **Declaration by Supervisor**

I confirm that the work reported in this project was done by the candidate under my supervision

Signed: \_\_\_\_\_ Date: \_\_\_\_\_

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## **DEDICATION**

This research project is dedicated to my mother, Mrs. Alice Ndung'u for her strength and tireless effort to put me through school, my brother and sister, Elvis Muya and Elizabeth Ndung'u for their support and encouragement. I also dedicate the project to my Husband, James Kinene for being my pillar of strength and for urging me on to complete the project.

## **ACKNOWLEDGEMENT**

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## **LIST OF ABBREVIATIONS AND ACRONYMS**

<b>CMA</b>	Capital Markets Authority
<b>FIFO</b>	First In Last Out
<b>GAAP</b>	Generally Accepted Accounting Principles
<b>IASB</b>	International Accounting Standards Board
<b>ICPAK</b>	Institute of Certified Public Accountants of Kenya
<b>IFRS</b>	International Financial Reporting Standards
<b>IMF</b>	International Monetary Fund
<b>KU</b>	Kenyatta University
<b>LIFO</b>	Last In First Out
<b>MLM</b>	Maximum Limit Method
<b>NACOSTI</b>	National Commission for Science, Technology and Innovation
<b>NSE</b>	Nairobi Securities Exchange
<b>RAM</b>	Real Activities Manipulation
<b>R &amp; D</b>	Research and Development
<b>SM</b>	Senior Managers
<b>SG&amp;A</b>	Selling, General and Administrative Expenses
<b>SPSS</b>	Statistical Package for Social Sciences
<b>US</b>	Unite States

## OPERATIONAL DEFINITION OF TERMS

**Asset and Liability Management** refers to the approaches used by firms to address risks it faces as a result of mismatch between assets and liabilities. It thus the management of use of assets and cash flows to meet firm obligations and increase profits.

**Earnings Management** is the process by which financial information is manipulated to provide a firm's financial position and performance (Salim, 2012).

**Expense Management** refers to the systems in place to process, pay and audit expenses associated with a business firm. In this study, it provides control to monitor and audit reports on expenses and allows the flexibility of customizing the system for evolving expenses

**Financial Performance** This is the economic output of a firm during a given financial year

**Non Financial Firms** The term refers to listed companies which are not in the banking or insurance industry in Kenya

**Revenue Management** is the application of analytics to predict consumption behaviour in the market and thus optimizing product availability and price to maximize growth of revenue.

## ABSTRACT

Earnings management practices have taken center stage in most businesses; today, most firms have adopted various practices to enhance financial performance. Even though these practices have in some instances been used for wrong reasons that have led to business failures, the practices are still embraced by most firms to boost performance. It is in this light that this study sought to determine the effect of earnings management practices on financial performance of firms in Nairobi. The specific objectives of the study were to determine the effect of revenue management, expense management and assets and liability management on financial performance of non-financial firms listed with NSE in Nairobi. The study was anchored on: signaling theory which enable firms to send signals to stakeholders on financial health, performance and future prospects; agency theory which explains the relationship between principles and agents and; institutional theory which looks at how firms interact with environment. This study is useful to the management and shareholders of firms in Kenya, Institute of Certified Public Accountants of Kenya [ICPAK]. Using descriptive and inferential research designs, the study sampled 164 senior managers drawn from accounts departments in 41 non-financial firms listed with NSE in Nairobi using stratified sampling procedures with 80 responding to questionnaires. Data analysis was done by use of SPSS version 21.0. Both descriptive and inferential analyses were done. The study found that revenue management enhanced financial performance of firms and that the firms undertook various revenue management practices among them revenue timing, revenue projections, shifting of earnings and revenue recognition to enhance financial performance. The study also found that expense management practices promoted financial performance of non financial firms listed with NSE and that good expense management practices involving recognition of expenses, reserves and inventory as well as reduction in discretionary expenditures influenced the firms' performance. The study found assets and liability management by firms does not promote financial performance of firms and that overstating assets and understating liabilities, and concealment of liabilities negatively affected financial performance of firms. However, it was also found that proper inventory management practices, proper management of accrued payable expenses and accounts payable promotes profitability performance of firms. Further, the study found that accounting regulations did not fully mediate in the relationship between earnings management practices and firms' financial performance and that accounting flexibilities allowed firms to engage in inappropriate earnings management. The study recommends that firms need to come up with appropriate rules and guidelines on earnings management practices. It further recommends that ICPAK to develop policies supporting appropriate earnings management practices by firms so as to promote financial performance.

## CHAPTER ONE

### INTRODUCTION

#### 1.1 Background of the Study

One of the objectives of any particular company is profit maximization. Earnings are therefore considered to be a firm's final fiscal yield in any given period (Tabassum, Kaleem & Nazir, 2013). Earnings not only serve as a financial performance checklist for internal users, but also external users. Financial performance is usually communicated to its users through financial reporting; an accounting language used by management to communicate private information regarding the firm's performance to stakeholders. Financial reporting allows financial statements to effectively portray differences in firms' economic positions and performance in a timely and credible manner. To strengthen financial reporting, managers are allowed to exercise judgment in selecting reporting methods and estimates that match the firm's economics; however, this create opportunities for them to manage earnings (Healy & Whalen, 1999). Earnings management is the process by which financial information is manipulated to provide a firm's financial position and performance (Salim, 2012).

Earnings Management takes advantage of loopholes in accounting policies to falsify books of account either to mislead shareholders on the actual financial performance of an organization or to influence contractual agreements which may rely on the financial numbers. The practice allows companies to produce accounts that flatter their financial performance while still conforming to the Generally Accepted Accounting Principles [GAAP] (Ijeoma, 2014). It is a major problem that has increased both in its severity and frequency; it undermines the integrity of financial reports, contributed to significant economic losses, and eroded investors' confidence regarding the usefulness and reliability of financial statements (Bhasin, 2013)

The process of preparing financial statements by firms is guided by various policies which have been put in place by various bodies that is; International Financial Reporting Standards [IFRS] in Europe and the GAAP in the United States [US]. These policies provide the basis through which financial information is prepared and reported. The primary objective of the accounting standards is to enable corporations to provide investors and creditors with relevant, reliable and timely information which is in line with the IASB's accounting framework for the preparation and presentation of Financial Statements (Outa, 2011). However, questions are raised as to how the practice of earnings management is continuing to accelerate despite the amount of regulations and standards governing the reporting process (Rani *et al.*, 2013). It has been noted that financial managers tend to window dress their figures in order to increase their compensation and job security, avoid breaching contracts with lenders, reduce regulatory costs or increase regulatory benefits (Healy & Wahlen, 1999).

The practice of earnings management is not only experienced in developed nations, it is also common in the emerging markets. In India, companies have become notorious for practicing earnings management for various reasons such as performance based incentives, personal gain of management and to achieve certain earnings targets. The reasons for growth in this practice include: flexibilities in the Indian regulatory bodies, unclear lines that can differentiate fraud and earning manipulation; weak market competition; information asymmetry; investors' lack of awareness about the accounting concepts among others (Gill *et al.*, 2013). India is however not the only country affected, empirical evidence has shown that earnings patterns of non-financial companies in Singapore display earnings management behavior to meet thresholds: to avoid reporting losses and/or to avoid reporting negative earnings growth, whereas both financial and non-financial companies in Thailand exhibit earnings management behavior

(Charoenwong & Jiraporn, 2009 as quoted in Manzalawy & Rwegasira, 2013). It has also been noted that many firms in the Egyptian Stock Exchange engage in various earnings management practices to influence their stock prices (Manzalawy & Rwegasira, 2013).

In Kenya, the council of the Institute of Certified Public Accountants [ICPAK] adopted the use of the IFRS as the basis for preparation of financial statements. The Kenyan market is considered a developing economy and therefore strives to meet the global standards of business performance. Companies in Kenya are usually operated by observing the companies Act- Cap 486, which requires all limited liability companies to keep proper books of account (Outa, 2011). With the standard of reporting being adopted as that adopted globally, companies were under more pressure to present their financial statements in a manner that would give them a competitive edge. However, according to Outa (2011) there are weak links in the organization of the profession, industry regulators, registrar of companies in Kenya (Custodian of the Company's act), the Constitution and the International Standard Setters.” Such weak links in our own accounting profession led to the various accounting malpractices that have been witnessed in the recent past, most recently being the Imperial bank scandal.

### **1.1.1 Measurement of Financial Performance**

In the corporate world, financial performance is what is used to determine the health of an organization. Financial Performance is measured in various ways such as shareholders wealth maximization, profitability and components of financial statements such as sales, total assets and equity. Profitability is the main reason people venture into business. Rarely does one find people in business just for the fun of it. According to Oxford dictionary, profitable refers to that which makes or is likely to make money. A business that is highly profitable has the ability to reward its owners with a huge return on their investment (Yekira & Okeoma, 2013).

Profit is the ultimate goal of any company. All the strategies designed and activities performed thereof are meant to realize this grand objective (Ongore & Kusa, 2013). Profitability is usually measured through the use of profitability ratios which measure the profitability of a firm in relative terms such as return on assets, return on equity and profit margin. Investors tend to invest in companies which have been profitable in previous years. Achieving acceptable financial performance is a must, otherwise the organization's financial standing can alarm creditors and shareholders, impair its ability to fund needed initiatives and perhaps even put its very survival at risk (Yekira & Okeoma, 2013)

Shareholders wealth maximization is also an important aspect in a company. Every company wants to achieve this goal as it is one of the very reasons of a company's existence. Under shareholders wealth maximization, there are two aspects to be considered that is; Economic Value Added and Market Value Added. Under economic value added, these are the benefits that are enjoyed by a company during its operations. In market value added, there is market share. Market share is important because it enables one to know the strength of the organization whether they are leaders or minor players and also if the organization is still holding, gaining or losing share of its target market. Market ratios measure how the firm is performing in terms of the dividends, share earnings and price earnings (Yekira & Okeoma, 2013). Companies are usually in competition to ensure that they enjoy a large share of the market as this improves their profitability. They offer very attractive deals that would appeal to potential customers and also existing customers to take advantage of them.

### **1.1.2 Earnings Management Practices**

Despite the efforts to normalize and regulate accounting internationally, the accounting information succeeds in fulfilling its duties only partially. The most eloquent proof is



represented by the numerous financial scandals in the global market (Constantin, 2013). Some of these financial scandals include; Enron Corporation which through its auditors Arthur Andersen produced financial information that did not present a true and fair view of the company. They hid their debt by using Special Purpose Entities to increase capital and improve their ratings (Edelman & Nicholson, 2014). Arthur Andersen was one of the largest accounting firms that was recognized as being trustworthy and reliable until they were involved in financial scandals that led to their fall. Its fall was brought about by the fall of most of their clientele as it was accused of presenting unqualified reports instead of qualified reports (Ferrell, 2014). Another company involved in this practice was Tyco International; which was involved in misappropriation of its assets and which led to losses for the investors and an immense drop in the share prices. Although the share prices did drop, the company was fortunate enough not to suffer the threat of bankruptcy (Kennedy, 2012).

Earnings Management is not only prevalent on a global scale, but it is also present in Asia and other emerging markets. In India, Satyam Computers Services Limited under reported its liabilities, overstated assets, included fictitious loans and cash balances and also overstated income in order to meet analyst expectations (Bhasin, 2013). It is a vice that is not only prevalent in companies but it is also prevalent in the government (Ozkaya, 2014). In 1999, the Turkish government took a stabilization program with the IMF to regularize its public debt. Despite the program working out, a huge liquidity problem hit the market making the government unable to meet their direct liabilities and this led to bail outs by the IMF. The study showed that the accurate/ real public sector debt was actually greater than the announced public sector debt (Ozkaya, 2014).

Within the African continent, in Nigeria for example, there was an outcry for more to be done to regulate the markets as accountants and auditors are pushing more and more beyond the acceptable limits in the accounting profession(Ijeoma, 2014). Further, the continent also experienced its own version of the Enron scandal through the Cadbury PLC saga where the top management of the company was engaged in doctoring of accounts in a bid to cover up certain inadequacies and other unscrupulous deals (Okeoma, 2014). In Kenya, there have been falls and closures of certain entities suspected of engaging in this vice; for instance, Uchumi Supermarket, Mumias Sugar Company and banks such as Dubai Bank, Imperial Bank and most recently Chase bank which was put under receivership. The increasing cases of earnings management practices have led to companies issuing profit warnings. According to the NSE, these profit alerts have been blamed on factors including weak local currency, accounting fraud and increased competition (The East African, 2015).

### **1.1.3 Listed Companies in Kenya**

In Kenya, companies that trade in securities are usually listed by the Nairobi Securities Exchange. The Nairobi Securities exchange began operations in the 1920s as Nairobi Stock Exchange; however, it was registered under the societies Act as a voluntary association of stockbrokers in 1954. From then, it continued operations and even at one time extended trading facilities to the East African region. It later changed its name from Nairobi Stock Exchange to Nairobi Securities Exchange on July 6<sup>th</sup> 2011. This was in line with its strategic plan to evolve into a full service securities exchange that supports trading, clearing and settlement of equities, debt, derivatives and other instruments.(Source: NSE Website, 2016).

Currently, the NSE boasts of sixty four listed companies in Kenya as at the end of 2015. These companies fall under certain business segments/ sectors which were reclassified in

2011. They were divided into ten industry Sectors and three sectors for the debt securities including preference shares. Some of the sectors include; Manufacturing, Agricultural, Insurance, Construction and Allied, Banking, Automobile, Investment, Energy and Petroleum, Commercial and Services, Telecommunication and Technology, Real Estate investment trust. The growth of the NSE has seen it from being a voluntary association to offering its shares and becoming a listed company in 2014.

For the purpose of this study, the research focused on listed non financial firms since financial firms are heavily regulated. Commercial banks in addition to being regulated by the Central Bank of Kenya also adhere to the regulations under BASEL II. Insurance firms also fall under financial firms and also have their share of regulations which are guided by Solvency II which are risk management frameworks.

## **1.2 Statement of the Problem**

Earnings management, a practice that is used to misrepresent financial information by accountants; has been in existence for decades but has more recently gained ground due to the scandals that have faced the corporate world. Such scandals involved the misappropriation of shareholders investments, doctoring of financial statements, colluding with auditors to issue unqualified reports. These scandals saw the collapse of industry giants such as Uchumi supermarket and Mumias Sugar company, have undermined the integrity of financial reporting, which then raised questions as to the reliability of financial statements and the information that is availed to users (Hussain & Chand, 2013). The recent rise in the practice of earnings management has led to uncertainty among shareholders as to the reliability of financial statements and consequently the true performance of firms.

The dwindling performance of the accounting profession both locally and globally only serves as proof that accounting regulations are not fulfilling its intended aim. Proof of this failure can be seen from the various accounting scandals that have been witnessed in the recent past in the global arena. Some of these companies include high flying companies not only in Kenya but also in the world over such as Enron Corporation which overstated its net worth and World Com Inc which had also overstated its earnings and cost its shareholders billions of dollars as a result of its bankruptcy. There is also the case of Adelphia Communications Corporation which was involved in underreporting its liabilities in the form of a bank debt which was not included in their financial statements (Kennedy, 2012).

In Kenya, cases where Managers and Directors have been accused of poor corporate governance resulting to corporate scandals that led to the collapse of Euro Bank in 2004, the placement of Uchumi Supermarkets under receivership in 2004 largely due to mismanagement, the near collapses of Unga Group, National Bank of Kenya, board room wrangles and the abuse of office by directors at CMC Motors (Madiavale, 2011). Most recently we have the accounting scandals at Dubai bank, Imperial bank and Chase bank which have been put under receivership by Central Bank of Kenya. According to the World Economic Forum (2012) as quoted by (Kaboyo & Wamweya, 2014), scandals from 2000 to 2012 involving companies listed at the NSE dented investor confidence which resulted in the downgrading of the country's global competitiveness standing in 2012.

Various research has been done in this area on a global scale; Tabassum et al, (2013) studied the impact of real earnings management on Subsequent Financial Performance; Bhasin, (2013) studied corporate accounting fraud in the case of Satyam Computers in India; Salim (2012) studied earnings management practices and the role of Corporate Governance and

External Audit in Emerging Markets, evidence from Saudi listed Companies. In Kenya, very few studies have been done on earnings management. However, most of the studies do not focus on the effect of earnings management on financial performance of Listed non financial firms but rather as a blanket issue, for instance, Kamau *et al.*, (2012) looked at creative accounting and tax avoidance; Iraya *et al.*, (2015) studied the effect of corporate governance practices on earnings management of companies listed at the NSE. The lack of sufficient studies has created a gap that this study sought to fill by asking the question, what the effect of earnings management on financial performance of listed non financial firms in Kenya?

### **1.3 General Objective**

The general objective of the research was to determine the effect of earnings management on financial performance of non financial firms listed with NSE in Nairobi, Kenya.

#### **1.3.1 Specific Objectives**

- i. To establish the effect of revenue management on the financial performance of listed non financial firms.
- ii. To determine the effect of expense management on financial performance of listed non financial firms.
- iii. To establish the effect of asset and liability management on financial performance of listed non-financial firms.
- iv. To establish the mediating effect of accounting regulations on the relationship between earnings management and financial performance of listed non financial firms.

#### **1.4 Research Questions**

- i. What effect does revenue management have on the financial performance of listed non financial firms?
- ii. What effect does expense management have on financial performance of listed non financial firms?
- iii. What effect does asset and liability management have on financial performance of listed non financial firms?
- iv. What is the mediating effect of accounting regulations on the relationship between earnings management and financial performance of listed non financial firms?

#### **1.5 Significance of the Study**

The study highlighted the effect of earnings management on financial performance of firms. The finding of the study is significant to the Institute of Certified Public Accountants in Kenya [ICPAK], Capital Markets Authority [CMA] and, Shareholders of firms. It provides useful information that will enable ICPAK to formulate policies that may be used to streamline the accounting profession and promote corporate governance in Kenya.

The findings will enable CMA keep track of the market and how the various companies are competing. Further, the study provides investors with more information on earnings management which they can use to make well informed investment decisions.

Finally, the study is useful to researchers and other research scholars' who may use the study to induce further research in areas of earnings management. This study also contributes to the existing body of knowledge and fills in the gap on earnings management by business firms.

## **1.6 Scope of the Study**

This study was limited to finding the effects of earnings management on profitability performance of firms with specific reference to the listed non financial firms in Nairobi, Kenya. The scope was limited to finding the influence of revenue management, expense management, and asset and liability management as well as the mediating effect of accounting regulations on financial performance of non financial firms listed with NSE. The choice of firms was due to: first, the firms have recorded significant improvements in financial performance thus calling for the need to establish the earnings management practices by firms and; secondly, listed non financial firms have not been the focus of many research studies.

In geographical terms, the area of study covered the headquarters of listed non-financial firms in Nairobi, largely due to ease of accessibility, and limitations of resources to enable wider coverage. The study was conducted within a period of five months and the study report contains information gathered between the months of March 2017 to July 2017.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter looks at the various literatures that will guide the research study. It looks at what other authors have been able to establish with regards to the research topic.

#### **2.2 Theoretical review**

##### **2.2.1 Signaling Theory**

This theory came to being in the 1970s based on the contributions of Arrow and Spence (Dainelli, Bini, Giunta, 2011). This theory is based on the signals that a firm sends to its users. It tends to imply that the most profitable companies provide more and better financial information to its users in order to acquire more capital. Through financial reports, firms are able to send signals to different stakeholders about the financial health, performance and its future prospects. Stakeholders use the information presented in the financial reports to make decisions regarding the returns on their investment. Since financial reporting carries such an enormous weight with regards to the investment decisions of the shareholders, managers may then make use of this situation to manipulate the information in the reports in order to get the investors to act in a preferred manner (Bjurman & Weihagen, 2013).

It is simply put that when a firm reports lower profitability and performance, it sends negative signals to prospective investors and if they report higher profitability and performance, they send positive signals that attract prospective investors; managers therefore may find it necessary to engage in earnings management due to the signaling effect that financial reports have on the financial performance of a firm.



### **2.2.2 Agency Theory**

This is a theory that has been used over time to explain the relationship between principals who are owners of the company and the agents who are the managers tasked with responsibility of managing the principals' interests and making beneficial decisions (Salim, 2012). Agents are involved in the day to day running of the firm based on the contract between them and the principals; therefore, they are engaged in more groundwork than the shareholders who find out how the firm is doing during meetings. Due to the operational nature of the agents, they usually possess more relevant information with regards to the company than the principals who rely on the information they get from the agents. Since managers act on behalf of the principals, his performance will be based on the performance of the firm and the shareholders will use this information to appraise the managers and as such, managers will only reveal such information that will not be detrimental to their appraisal. This may lead to information asymmetry where the managers reveal only that information which may not be used against them (Salim, 2012). While both the shareholders and the managers are utility maximizers, it is also reasonable to believe that the manager may not always act in the best interest of the Shareholders which brings about the agency problem (Rani et al, 2013)

It has been noted that there is a positive relationship between information asymmetry and earnings management (Richardson as quoted in Rani et al, 2013) and that this problem can be mitigated by establishing appropriate incentives for the agents and incurring the costs designed to limit the irregular activities of the age (Salim, 2012).

### **2.2.3 Institutional Theory**

This is a theory that attempts to explain the rationale between an organization and its environment. It looks at how a firm interacts with its environment, which comprises of the

social, political, technological, cultural and religious factors. This theory has evolved over time from the old institutional economics to the new institutional sociology (Salim, 2012). According to DiMaggio and Powell (1983), as quoted by Salim (2012), it is a theory that explains the mechanisms for a firm's perceived accounting practice and the society's socio-cultural practices in order to obtain legitimacy.

According to this theory, firms may change their institutional practices due to pressure from the stakeholders; desire to imitate or enhance institutional practices of other organizations in the industry and/or pressure from group norms. In relation to earnings management, a firm may engage in this practice due to informal or formal pressure and may create change in their accounting policies in order to model themselves to other organizations in the industry (Salim, 2012). The Institutional theory is partly linked to the prospect theory which states that a firm's decision makers derive value from gains and losses rather than absolute levels of wealth. Therefore, managers feel the need to engage in earnings management in a bid to increase the value of a firm. By increasing the value of a firm, managers are able to portray to stakeholders that the firm is financially healthy and can meet its obligations as and when they fall due (Bjurman & Weinhagen, 2013).

#### **2.2.4 Income Smoothing Theory/Model**

Income smoothing is an aspect that is usually considered when discussing about earnings management. It has been noted that smoothing occurs either intentionally or during recognition, measurement and disclosure of financial information (Almeida, Neto, Bastianello & Moneque, 2012). There are various models that have been developed over time to measure income smoothing practices among companies. The most notable model is the Eckel's model which was developed in 1981 (Almeida *et al*, 2012). According to his model, income

smoothing is divided into: designed smoothing - which is the management's intentional practice to manipulate earnings and; natural smoothing - that which occurs naturally without resulting in the manipulation of a firm's profits (Jafarpour & Gilianiniay, 2014).

Eckel's model is based on the assumption that revenue and costs tend to become linear over a period of time. This means that they grow and decline at the same rate therefore, in a situation where a linear relationship is not observed means that management may have engaged in income smoothing. This model uses the coefficient percentage variations of profit and sales revenue. When the coefficient for profits fall below that of revenues then it goes to show that the company is engaging in artificial smoothing of the profits.

## **2.3 Empirical Review**

### **2.3.1 Revenue Management and Financial Performance**

Earnings management involves taking advantage of loopholes in accounting policies to falsify books of account. Revenue is an important factor that influences the financial performance of a firm. Firms that make great revenues usually show better performance than firms that make minimal revenues as the margins are much greater. Reported revenue provides a preliminary indication of the success of a firm and it directly affects the earnings reported and the firm's earning power (Mulford, 2002). Revenue management is mostly engaged in by companies that have been making a string of losses and expect future losses to continue (Callen *et al*, 2010). However, that is not to mean that only companies that are making losses engage in revenue management. It is undertaken by firms that value revenues as a measure of market capitalization (Callen *.et al*, 2010). Revenue Management can be in the form of recognizing fictitious revenue and timing of actual transactions (Colby, 2012).

Accountants and finance managers may time transactions in order to influence outcomes in the financial statements. This offers management an opportunity to increase revenues when the operating profit is not satisfactory and to create the desired impression in the accounts (Sanusi, 2013). It involves the recording of revenue in the improper period. Recognizing revenue early, before it is earned, will immediately increase the organization's income using legitimate sales, rather than creating phony sales (Colby, 2012). By increasing income, a firm can portray better performance in terms of increased margins which then translates to higher profitability. In 2002, Xerox Corporation was taken to court for having used a variety of accounting actions and opportunities to exceed Wall Street expectations (Colby, 2012).

Artificial transactions are those transactions that do not exist in entirety. They are often entered into both to influence balance sheet amounts and to shift profits between accounting periods (Colby, 2012). This is achieved by entering into two or more related transactions with an obliging third party, normally a bank. For example, supposing an arrangement is made to sell an asset to a bank then lease that asset back for the rest of its useful life. The sale price under such a 'sale and leaseback' can be pitched above or below the current value of the asset, because the difference can be compensated for by increased or reduced rentals (Sanusi, 2013). They can also refer to creating fake customers and sales and/or using legitimate customers by creating false invoices or increasing quantities and prices (Colby, 2012). A company that was discovered for recording fictitious revenue was Mercury Finance Company. It announced that it had uncovered phony bookkeeping entries including fictitious revenues that resulted in overstatement of its earnings (Mulford, 2002).

Various researchers have studied the area of revenue management in order to identify whether there is a relationship between revenue management and financial performance. Callen *et al*,

(2004) studied revenue manipulation and restatements among loss making firms. In their study, revenue manipulation is through accounts receivable in form of unearned revenue and/or premature recognition of genuine transactions. They concluded that the main incentive for revenue management is to achieve high market capitalization and create positive expectations of future growth through sales. Aljifri, (2007) studied earnings management through accruals accounting choices that is timing of expenses and revenue recognition; and accounting method changes. Defond and Park (1997) demonstrated that managers tend to shift earnings between good and bad years in order to even them out. Nelson, Elliott and Tarpley (2002, 2003) provide survey data confirming that income-increasing earnings management involving revenue recognition are common occurrences.

### **2.3.2 Expense Management**

Earnings management can also take the form of expense management. If a firm's value is capitalized using earnings then managers have the incentive to manipulate earnings through expense rather than revenue. This is especially true when managers do not anticipate any future losses and expect the market to value the firm using earnings (Callen *et al.* 2004). Expenses are usually an income statement item and therefore, when expenses are manipulated, they have an impact on the financial statements and essentially the financial performance of a firm. This form of management may include: making inadequate provision, capitalizing rather than expensing expenditure (Salim, 2012). The firm may also depreciate or amortize assets slowly thus manipulating the expenses (Colby, 2012).

Through aggressive capitalization and extended amortization, companies minimize expenses by aggressively capitalizing expenditures that should have been expensed. It also involves recording of current period expenses or losses as assets thus postponing expense recognition

and boosting current period earnings. These deferred expenses are then amortized to be expensed over future periods (Mulford, 2002). An example of amounts that should be expensed includes the costs for purchasing equipment which are capitalized into the equipment account and depreciated over the useful life of the equipment. By doing so, near-term earnings are increased thus showing increased earning power (Mulford, 2002). When a firm reports its expenses as assets, the value of the total assets is increased which therefore shows a more positive financial position of the firm and essentially the financial performance of the firm. Extended amortization involves depreciating capitalized assets for an extended period than is the norm. It has the effect of boosting a firm's pre-tax income as seen in the case of American Software Incorporation (Mulford, 2002).

Another form of expense management is the reduction in discretionary expenditures. Discretionary expenditures include expenses such as Research and Development [R&D], selling, general and administrative expenses, advertising expenses among others. Under normal circumstances, these expenses are usually expensed in the period in which they are incurred (Sugata, 2006). Managers usually reduce expenses to increase earnings especially when these expenses do not generate immediate revenue and income (Sugata, 2006).

Gunny (2005), focused on companies with limited ability to inflate accruals. By using estimation models of SG&A, R&D, gain on asset sales and production costs, the author proxies firms engaged in RAM. The author also investigates the adjacent performance of firms engaged in RAM. Firms with constrained possibility to manipulate earnings via accruals reduce SG&A expenses to achieve earnings objective. Sugata (2006) studied the Real Activities Manipulation to avoid reporting losses. The author found evidence of overproduction to reduce cost of goods sold. Dharan (2003) studied earnings management

with accruals and financial engineering; with accruals management being management of the income statement. Amat et al (2003) examined the audit reports of 35 listed companies in the Spanish stock exchange concluded that, managers use various techniques to practice earnings management such as charging expenses to reserves, expense capitalization, altering the inventory, accelerated depreciation methods, extraordinary fees for pension plans, and reduction of earnings because of future losses.

### **2.3.3 Assets and Liabilities Management and Financial Performance**

Revenue management and expenses management focus on managing the income statement but managers may go as far as managing assets and liabilities which are balance sheet items in order to portray a more stable financial position and higher earning power (Mulford, 2002). Under this management, assets are overvalued and liabilities understated.

One aspect of asset valuation is through inventory management. Inventory is an appealing item in the financial statements for managers to use to engage in earnings management. This is because its records are complex and inventory items are normally transferred to manufacturing processes (Colby, 2012). By overvaluing inventory, the cost of goods sold is reduced which then overstates net income. Inventory can be managed by using different methods of measuring inventory costs such as Last In, First Out [LIFO] and First In First Out [FIFO]. When the inventory costs changes, each inventory cost methods will have an impact on the earnings in the income statement and consequently, inventory and shareholder's equity in the balance sheet (Mulford, 2002).

Apart from inventory management, a manager may also take to improperly value fixed assets. There are various ways in which assets can be improperly valued that is; booking fictitious

fixed assets, misrepresenting the asset value, improper capitalization, or the misclassification of assets (Colby, 2012). Through improper capitalization, non asset items are included in the fixed assets total. This may include costs of acquiring an asset which should be expensed and not capitalized. When these assets are valued at amounts higher than can be realized through operations or sale, expenses or losses are postponed, thereby resulting to inflated earnings.

Liabilities normally represent a firm's current obligations to outsiders and are normally reported at the present value of the resources to be provided for their settlement (Mulford, 2002). A company that has high figures for liabilities is not usually looked upon as a favorable company to invest in, as it shows that the company relies heavily on debt financing. Therefore, managers tend to conceal their liabilities in order to show better financial position. When Liabilities are concealed, a firm's equity, assets and/or net earnings are inflated (Colby, 2012). Liabilities can be managed through accrued payable expenses and accounts payable.

When accounts payable are understated, inventory purchases often are understated as well. An understatement of inventory purchases combined with an accurate beginning inventory valuation will result in an understatement of the cost of goods available for sale. Subtracting a properly valued ending inventory from an understated cost of goods available for sale will result in an understatement of cost of goods sold. Thus, an understatement of accounts payable can be linked to an understatement of cost of goods sold and, correspondingly, an overstatement of net income (Mulford, 2002).

#### **2.4 Accounting Regulations and Financial Performance**

The process of preparing financial statements is guided by various policies/standards that are set in place by the International Accounting Standards Board [IASB]. These policies are



usually adopted by the accounting bodies worldwide. The goal of IASB is to issue high quality accounting standards, so that mandatory adoption of the accounting standards would improve quality of financial reporting across European countries (Cimini & Mechelli, 2012). Accounting regulations are usually based on two perspectives: Rule Based and Principle based. Principle based perspective allow managers to use their judgment when disclosing financial information (Bjurman & Weinhagen, 2013); through this perspective, the issue of earnings management arise. This is so because the accounting regulations allow for flexibility in terms of the policy a firm may choose during financial reporting. As a result of such flexibility, companies in similar circumstances may report dissimilar results (Mulford, 2002).

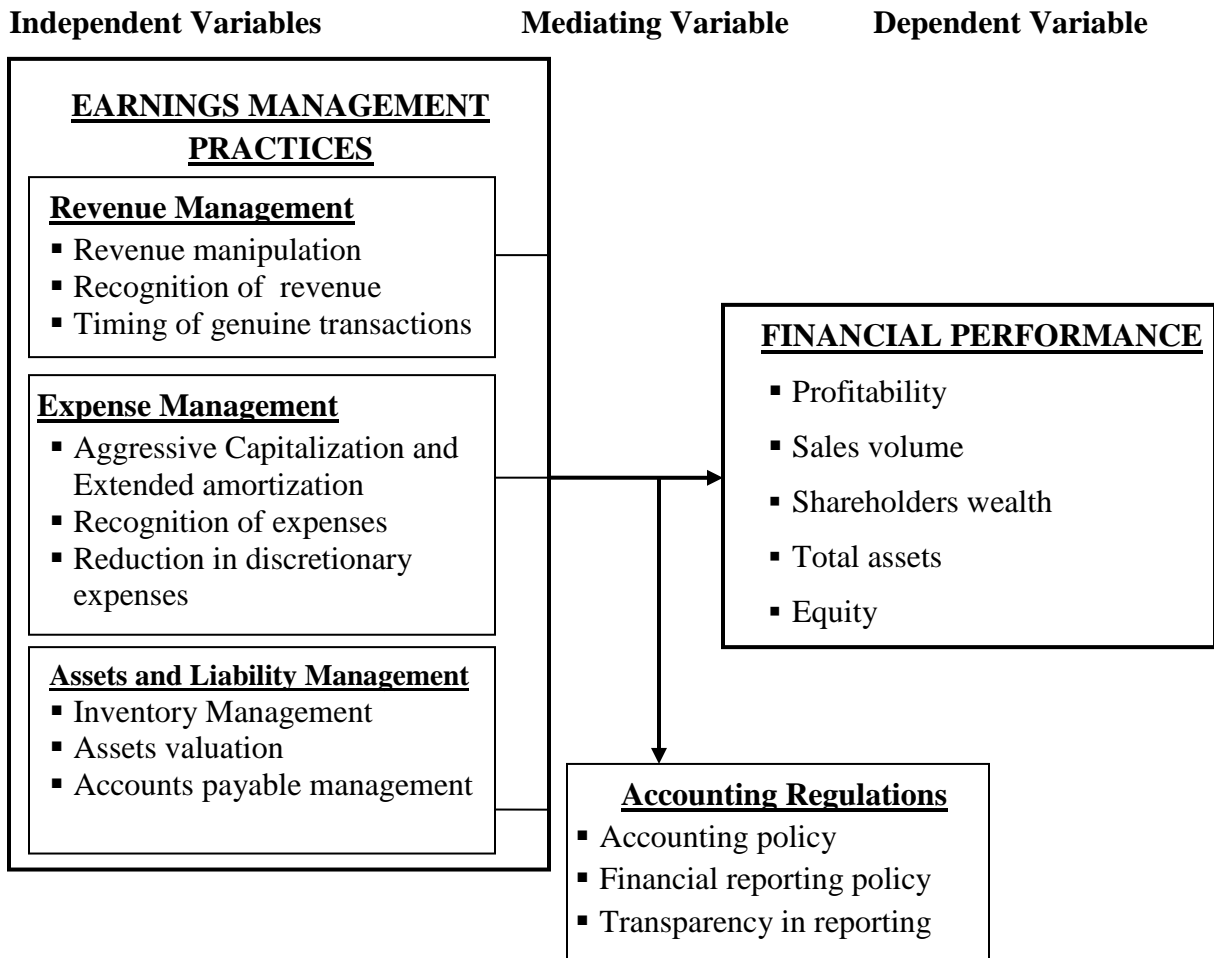
While flexibilities in the accounting policy may not cease to exist since economic conditions vary, firms may tend to apply a particular policy aggressively instead of taking advantage of the flexibilities (Mulford, 2002). The purpose of this aggressive application of accounting principles is to alter their financial results and financial position in order to create a potentially misleading impression of their firms' business performance. The ultimate objective is to achieve some of the game's rewards that may accrue to them (Mulford, 2002).

It has been shown that there is a significant relationship between reduction of earnings management and the extent to which IFRS/IAS regulates issues that are not covered by the domestic government or local accounting bodies (Cimini & Mechelli, 2012). There is also reason to believe that accounting standards are used to improve the quality of earnings information. That the recent changes in accounting standards, auditing and corporate governance have risen from the need to enhance transparency in financial reporting (Ewert & Wagenhofer, 2013). However, accounting standards are not the only factors that reduce earnings management and improve reporting quality; institutional factors are also required.

Studies have shown that management incentives and national institutional factors play a very important role in shaping financial reporting characteristics instead of relying on accounting standards alone (Stolowy & Jeanjean, 2012).

## 2.5 Conceptual Framework

The conceptual framework presents the relationship between variables in the study. The independent variables are revenue management, expense management, and assets and liability management; the mediating variable is the accounting regulations while the dependent variable is the financial performance. The conceptual framework is shown in figure 2.1.



**Figure 2. 1**Schematic Diagram on Conceptual Framework

*Source: (Author, 2017)*

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter describes the methodology that was used in the research study. It details out the various steps that was adopted to solve the research problem. The chapter discusses the research design, target population, sampling procedure and sample size, research instruments, methods of data collection, reliability and validity of instruments, ethical considerations and methods of data analysis

#### **3.2 Research Design**

Research design has been referred to as a structure that guide in the execution of a research method as well as in the subsequent analysis of collected data (Bryman & Bell, 2007). The structure thus provides a framework for the generation of evidence suited to a certain set of criteria and in line with research questions. In this study, a descriptive survey research design The descriptive design was chosen due to its ability to provide detailed description of the trends in earnings management, conditions and the status of current events and their implication to users of financial information using descriptive statistics (Tappen, 2010). The approach has been credited for allowing analysis of variables and enhances greater flexibility in terms of money and time (Saunders *et al*, 2009). Further, correlation analysis was done to test the relationships between the selected variables of interest in the study and to determine the strengths of the relationships.

#### **3.3 Target Population**

Target population has been referred to as the universal set of all elements in which the characteristics under consideration are present (Thomas, Buckland, Rexstad, Laake,

Strindberg, Hedley, Bishop & Marques, 2010). In this study, the population was staffs and employees in 64 firms listed with NSE in Kenya; however, the target population for the research study comprised of 164 Senior Managers [SM] in the accounts department from 41 firms listed with NSE in Nairobi. To arrive at the number, Maximum Limit Method [MLM] was used to select 4 senior managers in each of the 41 firms in Nairobi County. (See appendix IV for the list of non financial firms listed with NSE in Nairobi).

**Table 3.1 Target Population**

<b>Sector</b>	<b>No. of Listed Companies</b>	<b>MLM for SM per firm</b>	<b>Total No. of SM</b>	<b>Percentage</b>
Agricultural	6	4	24	14.6
Automobiles and Accessories	3	4	12	7.3
Commercial	11	4	44	26.8
Construction and Allied	5	4	20	12.3
Energy and Petroleum	5	4	20	12.3
Manufacturing and Allied	10	4	40	24.3
Telecommunication & Technology	1	4	4	2.4
<b>Total</b>	<b>41</b>		<b>164</b>	<b>100.0</b>

*Source: Author (2017)*

### **3.4 Sampling Procedure and Sample Size**

Sampling has been referred to as a procedure, process or technique of choosing a sub-group from a population to participate in a study (Ogula, 2005). This study used purposive sampling and stratified random sampling procedures to select participants. In this case, the firms listed with NSE were divided into subgroups or strata on the basis of sector, listing period and, influence in their particular industry. Participants were selected on the basis of being in the accounts department and seniority in the firms. Thereafter, the researcher selected 50% of the target population as the appropriate sample for study; thus the sample size was 82 senior

managers. To ensure each participant had equal chance of participating in the study, simple random sampling procedure was used. The sample size is shown in table 3.2

**Table 3.2 Sample Size**

<b>Sector</b>	<b>No. of Listed Companies</b>	<b>Target Population</b>	<b>Sample Size</b>	<b>Sample Percentage</b>
Agricultural	6	24	12	14.6
Automobiles and Accessories	3	12	6	7.3
Commercial	11	44	22	26.8
Construction and Allied	5	20	10	12.3
Energy and Petroleum	5	20	10	12.3
Manufacturing and Allied	10	40	20	24.3
Telecommunication & Technology	1	4	2	2.4
<b>Total</b>	<b>41</b>	<b>164</b>	<b>82</b>	<b>100.0</b>

*Source: Author (2017)*

### **3.5 Data Collection Instruments**

The researcher used structured questionnaires to collect primary data (see appendix D). Questionnaires have been referred to as data collection techniques in which each person is asked to respond to the same set of questions in a predetermined order (Saunders *et al.*, 2009). The questionnaires consist of closed ended 5 point–likert scale questions ranging from not at all to strongly agree. The questionnaire was divided into four subsections: subsection A collected data on the general demographic information; subsection B collected primary data on revenue management; subsection C collected data on expense management; sub section D gathered data on assets and liability management; subsection E gathered data on accounting regulations and subsection F gathered data on financial performance.

### **3.6 Data Collection Procedures**

In this study, only primary data was utilized. Questionnaires were used to collect primary data from senior managers in the listed firms. In conducting the research study, permission was sought from relevant institutional authorities. The researcher first sought for an authorization letter from Kenyatta University [KU] allowing her to proceed with the study as well as to acquire authorization permit for research from the National Commission for Science, Technology and Innovation [NACOSTI]. Thereafter, the researcher visited the selected firms to seek for permission to undertake the research study and giving reasons for the study.

In administering questionnaires, both face-to-face and delivery and collection methods were used. The use of face-to-face method enabled clarification of any issues with instructions or meaning of particular items in the questionnaire while the delivery and collection method was used on those who cannot respond to the questionnaires immediately due to tight work schedules or other reasons. The researcher used four research assistants to deliver or administer the questionnaires to the respondents and to enable the study to be completed within the stipulated time-frame. This was after briefing them on the overall purpose of study.

### **3.7 Validity and Reliability of Research Instruments**

Validity has been defined as the degree to which results obtained from the analysis of data actually represent the phenomenon under study (Mugenda & Mugenda, 2003). It ensures that the results of study adequately cover each of the constructs that constituted the objectives of the study. In this regard, the questionnaire was subjected to scrutiny by the internal control expert (supervisor) to ensure both content and face validity.

On the other hand, reliability is the measure of the degree to which a research instrument yields consistent results after repeated trials (Mugenda & Mugenda, 2003). To ensure reliability the questionnaires were pretested (piloted) on a sample of 15 respondents to determine soundness, accuracy, clarity and suitability of the research instruments before the final field survey was carried out. In this respect, Cronbach Alpha ( $\alpha$ ) model for internal consistency based on average inter-item correlation with cut off level of 0.70 was used to reliability of scaled items. This helps improve the quality of final questionnaires (Leedy & Omrod, 2005). Necessary adjustments were made to guarantee data reliability.

A pilot reliability test results was conducted on 5 items using a sample of fifteen respondents drawn from each of the selected non financial firms listed with NSE in Nairobi and who were not allowed to participate in the final study. The pilot test results gave an alpha level of  $\alpha = 0.842$  as compared to the final reliability test results of  $\alpha = 0.850$  as shown in table 3.3. From the two reliability test results, the instruments were considered reliable for the study.

**Table 3.3 Reliability Test for Pilot and Final Study**

<b>Variable</b>	<b>Number of Items</b>	<b><math>\alpha</math> Pilot Study</b>	<b><math>\alpha</math> Final Study</b>	<b>Comment</b>
Revenue management	3	0.737	0.770	Reliable
Expense management	3	0.740	0.783	Reliable
Assets and liability management	3	0.780	0.860	Reliable
Accounting regulations	3	0.795	0.827	Reliable
Financial performance	3	0.829	0.835	Reliable
<b>Total</b>	<b>15</b>	<b>0.840</b>	<b>0.850</b>	Reliable

*Source: Research Data (2017)*

### **3.8 Ethical Considerations**

Research ethics are the norms of conduct that distinguishes acceptable from unacceptable behavior in research (Shamoo & Resnik, 2009). In collecting data for study, the researcher first sought for authority from Kenyatta University, School of Business Administration and

authorization permit from NACOSTI before seeking for permission from the management of listed firms to gather data for the study. The researcher also ensured respondents were well informed about the research study, ensured the rights of respondents to make informed choice on participation in study was respected, ensured confidentiality of identity and information provided by participants, referred to firms employees as respondents' or participants to guarantee anonymity of their identities; promised no rewards for participation, ensured the findings were reported without any manipulation.

### **3.9 Data Analysis and Presentation**

Data analysis is the processing of the gathered data to get meaningful information (Saunders et al, 2009). The collected data was checked for completeness and accuracy and thereafter analyzed using descriptive and inferential statistics by use of Statistical Package for Social Science [SPSS]. Descriptive statistics was used to summarize and describe findings from the units of analysis such as simple mean, standard deviations and percentages. On the other hand, inferential analysis was used to determine the relationship between the independent variables (revenue management, expense management, assets and liability management) and dependent variable (financial performance) as well as the mediating effect of accounting regulations on the relationship between independent variables and dependent variable. In this regard, Karl Pearson correlation analysis was used to determine the strength of relationships between independent variables and dependent variable. Thereafter, regression analysis was conducted to find out and to predict the effect of revenue management, expense management, assets and liability management on financial performance of firms as well as the mediating effect of accounting regulations on the relationship between variables. The regression coefficients illustrated the magnitude and direction of the relationship. The  $\beta$  took a value of



between 0.000-0.999 and was used to indicate the change in independent variable that was required to occasion a unit change in financial performance.

The regression coefficients were used to formulate regression models that illustrated the general relationship between variables in the study.

The reduced model for the study was computed as:  $Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$

Where Y is financial performance;  $\alpha$  is the regression constant;  $\beta_1, \beta_2, \beta_3$  are the regression coefficients;  $X_1$  = revenue management;  $X_2$  = expense management;  $X_3$  = asset and liability management and;  $\varepsilon$  = error term

The full model for the study was computed as:  $Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$

Where Y is financial performance;  $\alpha$  is the regression constant;  $\beta_1, \beta_2, \beta_3, \beta_4$  are the regression coefficients;  $X_1$  = revenue management;  $X_2$  = expense management;  $X_3$  = asset and liability management;  $X_4$  = accounting regulations and;  $\varepsilon$  = error term

### **3.10 Diagnostic Tests**

The study used multicollinearity test using Variance Inflation Factor [VIF] and tolerance. The reciprocal of tolerance known as the VIF showed how much the variance of the coefficients estimate was inflated by multicollinearity. A VIF value of less than 3 [ $VIF \leq 3$ ] indicates no multicollinearity while a  $VIF \geq 3$  indicates collinearity and more than 10 indicates a problem (Myers, 1990). The tolerance statistics value below 0.1 indicates a serious problem while those below 0.2 indicate a potential problem (Menard, 1995).

## **CHAPTER FOUR**

### **DATA ANALYSIS, RESULTS AND PRESENTATION**

#### **4.1 Introduction**

This chapter presents data analysis and findings on the earnings management practices and financial performance of non financial firms listed with NSE in line with research objectives. It thus presents demographic information, analysis of descriptive statistics and inferential results, and a discussion and comparison of the findings with the existing body of literature. The results are mostly presented in tables.

#### **4.2 Demographic Information**

This subsection presents general information on the demographic features of respondents such as gender, age bracket, work experience, designation and, highest education level.

##### **4.2.1 Response Rate**

Response rate refers to the number of study participants who complete a given set of questionnaires in comparison to the total number of those requested to participate (Centre for Disease Control [CDC], 2010). It is thus the percentage of those who respond to research questions. In this study, out of the 82 participants drawn from 41 non financial firms listed with NSE who were selected to participate in the study, only 80 participants fully responded to the questionnaires thereby enabling the study to attain 97.6% response rate while two respondents representing 2.3% were considered not participate in the study since they failed to return the questionnaire within the stipulated time frame of two (2) weeks. From the results, the response rate was considered excellent in the light of experts' assertion that response rate of 50% is adequate for analysis and reporting; response rate of 60% is good and; that of 70% and above is excellent (Mugenda & Mugenda, 2003).

**Table 4. 1 Response Rate**

	Frequency	Percentage	Cumulative percentage
Response rate	80	97.6	97.6
Non-response Rate	2	2.3	100.0
<b>Total</b>	<b>82</b>	<b>100.0</b>	

*Source: (Research Data, 2017)*

#### 4.2.2 Reliability Test

The study determined the internal consistency of data using Cronbach's Alpha on 5 items as shown in table 4.2 that yielded overall Cronbach's Alpha value of 0.850. This value is high and above the recommended value of 0.70 (Mugenda & Mugenda, 2009) thus indicating strong internal consistency between the constructs. Reliability test results also indicated that all the corrected item-total correlations were above 0.3; therefore, removal of any item would not result to a reduced Cronbach's Alpha. This further indicates that all the questions used in the study were reliable to produce valid results.

**Table 4. 2 Cronbach's Item-Total Statistics**

Items	Corrected item total correlation	Cronbach's $\alpha$ if item deleted
Revenue management	0.832	0.770
Expense management	0.785	0.783
Assets and liability management	0.486	0.860
Accounting regulations	0.646	0.827
Financial Performance	0.603	0.835
<b>Average Cronbach's alpha (<math>\alpha</math>)</b>		<b>0.850</b>

*Source: (Research Data, 2017)*

#### 4.2.3 Gender

The study sought to establish respondents' gender in order to determine gender representation in the listed firms. Results showed that majority (66.3%) of the respondents were males while

33.8% were females. The results imply that the firms were gender sensitive since more than a third ( $\frac{1}{3}$ ) of the respondents were females in the study. The results are shown in table 4.3

**Table 4. 3 Respondents' Gender**

Gender	Frequency	Percentage	Cumulative Percentage
Male	53	66.3	66.3
Female	27	33.8	100.0
<b>Total</b>	<b>80</b>	<b>100.0</b>	

*Source: (Research Data, 2017)*

#### 4.2.4 Age of Respondents

The study sought to find out the respondents ages in order to determine their level of maturity. Results showed that none (0%) were aged between 20-25 years, 8.8% between 26-35 years, 40% between 36-45 years and 51.3% were aged more than 45 years old. The results imply majority of the respondents were mature enough to make well informed decisions on earnings management and to understand financial performance of firms. Results are shown in table 4.4.

**Table 4. 4 Age of Respondents**

Ages	Frequency	Percent	Cumulative Percent
Between 20-25 years	0	0.0	0.0
Between 26-35 years	7	8.8	8.8
Between 36-45 years	32	40.0	48.8
More than 45 years	41	51.3	100.0
<b>Total</b>	<b>80</b>	<b>100.0</b>	

*Source: (Research Data, 2017)*

#### 4.2.5 Respondents Work Experience

The study sought to find out for how long respondents had worked in the firms in order to determine whether they had gathered necessary work experiences to enable them make well

informed decisions or advices on earnings management practices. Results indicate 5% had worked for between 1-5 years, 32.5% had worked for between 6-10 years, 27.5% had worked for between 11-15 years and 35% had worked for more than 15 years in the firms. Majority (35%) had thus the necessary work experience. Results are shown in table 4.5

**Table 4. 5 Respondents’ Work Experience**

	Frequency	Percent	Cumulative Percent
Between 1-5 years	4	5.0	5.0
Between 6-10 years	26	32.5	37.5
Between 11-15 years	22	27.5	65.0
16 years and above	28	35.0	100.0
Total	80	100.0	

*Source: (Research Data, 2017)*

#### 4.2.6 Respondents Designation

The study sought to find out the respondents designations in their respective firms so as to determine whether they were participants in earnings management practices. It was found that 8.8% of the participants were accountants; 22.5% were auditors, 26.2% were Chief Accountants and that 42.5% were Finance Managers. The findings imply that majority (42.5%) of the participants in earnings management practices by firms were the Finance Managers. The findings are shown in table 4.6 below

**Table 4. 6 Respondents Designation**

Designation	Frequency	Percent	Cumulative Percent
Accountants	7	8.8	8.8
Auditors	18	22.5	31.3
Chief Accountants	21	26.2	57.5
Finance Managers	34	42.5	100.0
Total	80	100	

*Source: (Research Data, 2017)*

#### 4.2.7 Highest Level of Education

The study sought to find out the respondents' academic qualifications in order to determine their competency on earnings management practices. Results indicate that 38.8% of the respondents were Masters Degree holders, 27.5% were Bachelors Degree holders, 5% were Diploma holders, none (0%) was Secondary certificate holders and 28.7% were CPA/ACCA certificate holders. The results indicate respondents were competent to provide relevant responses in their areas of duty. Results are shown in table 4.7

**Table 4. 7 Respondents' Highest Education Level**

	Frequency	Percentage	Cumulative Percent
Masters Degree	31	38.8	38.8
Bachelors Degree	22	27.5	66.3
Diploma	4	5.0	71.3
Secondary	0	0.0	71.3
CPA/ACCA	23	28.7	100.0
Others	0	0.0	100.0
Total	80	100.0	

*Source: (Research Data, 2017)*

#### 4.3 Analysis of Descriptive Statistics

This section presents descriptive statistics to determine respondents' degree of agreement with statements on earnings management practices. Statements with mean scores  $< 1.4$  represents no agreement at all; those with mean scores between  $\geq 1.5$  and  $\leq 2.4$  represents strong disagreement; those with mean scores between  $\geq 2.5$  and  $\leq 3.4$  represents disagreement; those with mean scores between  $\geq 3.5$  and  $\leq 4.4$  represents agreement and; those with mean score  $\geq 4.5$  represents strong agreement. Standard deviation  $>1$  indicates no consensus on the responses obtained while that of  $< 1$  indicates consensus was obtained on responses.

### 4.3.1 The Influence of Revenue Management on Financial Performance of Firms

Revenue management as one of the earnings management practices can greatly influence financial performance of firms. This study sought to determine respondents' degree of agreement with statements on the influence of revenue management on the financial performance of non financial firms listed with NSE. The results are presented in table 4.8

**Table 4. 8 The influence of revenue management on financial performance of firms**

Statement	Mean	Std. Dev
Whether the firms embrace revenue management as one of the earnings management practices	4.1000	0.7564
Whether revenue management affects financial performance of firms	4.4875	0.5510
Whether revenue timings enable firms to detect fictitious revenues that may result to losses	4.5000	0.5277
Whether revenue projections aimed at creating positive impression in accounts translate to good financial performance of firms	4.3250	0.7425
Whether shifting of earnings influence profitability earning power and success of financial performance of firms	4.3375	0.6549
Whether revenue recognition promote high market capitalization, enhances future sales growth and consequently, future profitability	4.4500	0.5489

*Source: (Research Data, 2017)*

From table 4.8, respondents were in agreement and consensus that listed firms embraced revenue management as one of the earnings management practices and that revenue management affected financial performance of firms as shown by mean scores of 4.1000 and 4.4875 respectively. They were also in a strong agreement that revenue timings enabled firms to detect fictitious revenues that may result to losses by a mean score of 45000. Respondents were in agreement that revenue projections aimed at creating positive impression in accounts normally influence good financial performance of firms and that shifting of earnings also influences profitability earning power and promotes success of financial performance of firms by mean scores of 4.3250 and 4.3375 respectively. Further, respondents agreed that revenue

recognition influences market capitalization, enhances future sales growth and consequently, future profitability of firms by a mean score of 4.4500. Overall, respondents were in consensus with the various statements on revenue management practices.

#### 4.3.2 The influence of Expense Management on Financial Performance of Firms

The study sought to determine respondents’ opinions on the influence of expense management as one of the earning management practices by firms on the firms’ financial performance. The findings are presented in table 4.9 below

**Table 4. 9 The influence of expense management on financial performance of firms**

Statement	Mean	Std. Dev
Whether the firms embrace expense management as one of the earning management practices	4.0375	0.8779
Whether expense management practices influence financial performance of firms	4.4250	0.7593
Whether companies engage in expense management out of the need to remain profitable	4.4000	0.8050
Whether inadequate provision, aggressive capitalization and extended amortization by the firms poses risks to financial performance	4.5500	0.5489
Whether recognition of expenses, reserves and inventory helps project future sales, hence promoting profitability performance of firms	4.1875	0.7646
Whether reduction in discretionary expenditures promotes financial performance of the firms	4.4125	0.6501

*Source: (Research Data, 2017)*

From table 4.9, respondents were in agreement and consensus that the firms embraced expense management and that expense management practices influenced financial performance of firms by mean scores of 4.0375 and 4.4250 respectively. They also agreed that the firms engaged in expense management practices out of the need to remain profitable as shown by a mean score of 4.4000. Respondents strongly agreed that expense management practices involving inadequate provision for expenses, aggressive capitalization and extended amortization posed risks to the firms’ financial performance as show by a mean score of



4.5500 and that recognition of expenses, reserves and inventory helps firms to project future sales, hence promoting profitability performance as shown by a mean score of 4.1875. They further agreed that reduction in discretionary expenditures promotes financial performance of firms as indicated by a mean score of 4.4125.

### 4.3.3 The Influence of Assets and Liabilities on Financial Performance

This subsection sought to determine respondents' opinions on the influence of assets and liabilities management as one of the earning management practices by firms on their financial performance. The findings are presented in table 4.10 below

**Table 4. 10 The influence of assets and liabilities on financial performance**

Statement	Mean	Std. Dev.
Whether the firms embrace assets and liability management as one of their earnings management practices	4.3250	0.5460
Whether assets and liability management affects financial performance of firms	4.3875	0.5845
Whether there are instances when the firms overstated assets and understated liabilities	4.3500	0.5975
Whether concealment of liabilities by the firms negatively impacts on financial performance of firms	4.3125	0.6078
Whether the firms practiced proper inventory management to promote profitability performance	4.4625	0.5724
Whether the firms properly managed accrued payable expenses and accounts payables in order to promote profitability performance	4.3500	0.6384

*Source: (Research Data, 2017)*

Table 4.10 indicates that respondents were in agreement and consensus that the firms embraced assets and liability management practices as shown by a mean score of 4.3250 and that asset and liability management practices affected financial performance of the firms as shown by a mean score of 4.3875. They were also in agreement that there were instances when the firms overstated assets and understated liabilities as shown by a mean score of 4.3500 and that concealment of liabilities by the firms negatively impacts on financial

performance of the firms by a mean score of 4.3125. Further, respondents were in agreement that the firms practiced proper inventory management to promote profitability performance and that they also properly managed accrued payable expenses and account payable to promote profitability performance as shown by mean score of 4.4625 and 4.3500 respectively.

#### 4.3.4 The Mediating influence of Accounting Regulations on Financial Performance

This subsection sought to determine respondents' opinions on the mediating influence of accounting regulations on the relationship between earnings management practices, namely; revenue management, expense management and assets and liability management on the financial performance of non financial firms listed with NSE. Results are shown in table 4.11

**Table 4. 11 The mediation of accounting regulations on firms' financial performance**

Statement	Mean	Std. Dev.
Whether the firms abides by existing accounting regulations	3.9875	0.9612
Whether accounting regulations influence earnings management practices adopted by firms to promote financial performance	4.3625	0.8151
Whether accounting policies aim to enhance transparency in financial reporting hence promoting financial performance of firms	4.4000	0.7564
Whether the flexibilities of accounting policies encourage earnings management practices practiced by the firms	4.2375	0.7334
Whether adoption of IFRS has helped minimize unethical earnings management practices by the firms	4.2125	0.9098
Whether accounting laws do not make it difficult for the firms to create potentially misleading impressions of their financial performance	4.3375	0.7106

*Source: (Research Data, 2017)*

Table 4.11 indicates respondents were in agreement and consensus that the firms abide by the existing accounting regulations by a mean score of 3.9875. Respondents also agreed that accounting regulations influence earnings management practices adopted by firms to promote financial performance by a mean score of 4.3625 and that accounting policies aim to enhance transparency in financial reporting hence promoting financial performance of firms by a mean

score of 4.4000. They agreed that the flexibilities of accounting policies encouraged earnings management practices by firms by a mean score of 4.2375 and that adoption of IFRS had minimized earnings management practices by firms by a mean score of 4.2125. Further, respondents agreed that the accounting laws did not make it difficult for firms to create potentially misleading impressions of their financial performance by a mean score of 4.3375.

#### 4.3.5 Financial Performance of Firms

This subsection sought to determine respondents' opinions on the statements on the state of financial performance of non financial firms listed with NSE. The findings are presented in table 4.12 below

**Table 4. 12 Financial Performance of firms**

Statement	Mean	Std. Dev.
Whether the firms recorded improvement in financial performance in the recent past	4.2750	0.7627
Whether the firms have recorded improvement in profitability ratios in the recent past	4.5750	0.5905
Whether the firms have improved sales volume due to proper earnings management practices	4.5875	0.4954
Whether the firms maximizes on shareholders wealth and that the firm regularly pays out dividends to its share holders	4.2750	0.6931
Whether there has been increases in total assets of the firm in the recent past	4.4625	0.5499
Whether the amount of shares bought or held in stock at the NSE by the firms have has increased in the recent past	4.4625	0.5499

*Source: (Research Data, 2017)*

According to table 4.12 above, respondents were in agreement and consensus that the firms recorded improvement in financial performance in the recent past as shown by a mean score of 4.2750. They were in strong agreement that the firms had registered improvement in profitability ratios in the recent past as shown by a mean score of 4.5750. Respondents were in strong agreement that the firms had improved sales volume due to proper earnings

management practices as shown by a mean score of 4.5875 and that the firms were able to maximize shareholders wealth as well as regularly pay out dividend to share holders as shown by a mean score of 4.2750. Further, respondents agreed the firms had recorded increases in total assets and that the amount of shares bought or held in stock at the NSE by the firms had increased in the recent past as shown by means scores of 4.4625 and 4.4625 respectively.

#### 4.4 Inferential Analysis

Inferential analysis was conducted to determine the strengths of the relationships between the independent variables (revenue management, expense management and, asset and liability management) and the dependent variable (financial performance) as well as the mediating effect of accounting regulations on the relationship between independent and dependent variables using Karl Pearson correlation analysis, coefficient of determinant and multiple regression analysis. In this regard, a collinearity test was conducted to detect presence of high inter-correlation between predictor variables and dependent variable as well as between the mediated variables and dependent variable in the regression model. It was found that all the values obtained by the predictors were below the VIF value of 3 thus indicating the absence of higher inter-correlations in the model. Results are shown in table 4.13

**Table 4. 13 Collinearity test coefficients**

Model	Collinearity Statistics	
	Tolerance	VIF
1 Revenue management	.354	2.824
Expense management	.474	2.110
Assets and liability management	.687	1.456
Financial performance	.432	2.314

a. Independent Variable: Financial performance

#### 4.4.1 Correlation Analysis

The study used Karl Pearson's correlation coefficients (r) to quantify the strength of the relationship between the independent variables and the dependent variable as well as the mediating variable in the study. The results are presented in table 4.14 below

**Table 4. 14 Karl Pearson's Correlation Coefficients**

	Revenue management	Expense management	Asst & liability mgt	Accounting regulations	Financial performance
Revenue management Sig. (2-tailed)	1				
Expense management Sig. (2-tailed)	.676** .000	1			
Asset & liability mgt Sig. (2-tailed)	.507** .000	.505** .000	1		
Accounting regulations Sig. (2-tailed)	.732** .000	.616** .000	.352** .000	1	
Financial performance Sig. (2-tailed)	.660** .000	.670* .000	.263* .018	.378** .001	1

\*\* . Correlation is significant at the 0.01 level (2-tailed).

\* . Correlation is significant at the 0.05 level (2-tailed).

From table 4.14 above, correlations analysis results indicate revenue management was strongly and positively correlated to financial performance with a correlation coefficient of 0.660; expense management was strongly and positively correlated to financial performance with a correlation coefficient of 0.670; asset and liability management was weakly and positively correlated to financial performance with a correlation coefficient of 0.263 and; the intervention of accounting regulations was moderately and positively correlated to financial performance with a correlation coefficient of 0.378.

#### 4.4.2 Regression Analysis

The regression analysis was conducted to find out the effect of revenue management, expense management and assets and liability management on financial performance of firms as well as

to find out the mediating effect of accounting regulations on the relationship between earnings management practices and financial performance of firms. This was to enable the study to determine how well the proposed statistical model is likely to predict future outcomes of the earnings management practices adopted by firms on their financial performance. In this study, the model explains the extent to which variations in financial performance can be explained by changes in revenue management, expense management and assets and liability management as well as the intervening effect of accounting regulations on the relationship between the earnings management practices and financial performance of firms. The findings are presented in table 4.15 below

**Table 4. 15 Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.746 <sup>a</sup>	.556	.539	.22517	.556	31.734	3	76	.000
2	.788 <sup>b</sup>	.621	.600	.02956	.064	12.747	1	75	.001

a. Predictors: (Constant), Assets & liability management, expense management, revenue management

b. Predictors: (Constant), Assets & liability management, expense management, revenue management, accounting regulations

c. Dependent variable: Financial performance

From the results shown in table 4.15, both the models are statistically significant. Further, model 1 shows goodness of fit as indicated by the adjusted R<sup>2</sup> value of 0.539. This implies that the three independent variables, namely revenue management, expense management and assets and liability management explain 53.9% of the variations in financial performance by listed firms while 46.1% of the variations in financial performance by listed non financial firms are due to other earnings management practices not captured in this study. On the other hand, with the intervention of accounting regulations, the three independent variables:

revenue management, expense management and assets and liability management explain 60% of the variations in financial performance [see model 2].

The study further used Analysis Of Variance [ANOVA] to determine the significance of the relationship between the explanatory variables and financial performance of firms. Both the regression models are statistically significant given the level of significance at 0.000 ( $p = 0.000$ ) and 0.000 ( $p=0.000$ ) respectively for models 1 and 2 which were all below 0.05. The obtained F ratio for model 1 was 31.734 while the critical value of F was 2.73; thus the obtained F ratio was larger than the critical F value implying that the obtained F ratio is likely to occur by chance with a  $p<0.05$ . On the other hand, the obtained F ratio for model 2 was 30.667 while the critical value of F was 2.49; thus the obtained F ratio was larger than the critical F value implying that the obtained F ratio was likely to occur by chance with a  $p<0.05$ . The results for analysis of variance are shown in table 4.16 below

**Table 4. 16 ANOVA <sup>a</sup>**

Model	Sum of Squares	Df	Mean Square	F	Sig.
1 Regression	4.827	3	1.609	31.734	.000 <sup>b</sup>
Residual	3.853	76	.051		
Total	8.680	79			
2 Regression	5.387	4	1.347	30.667	.000 <sup>c</sup>
Residual	3.294	75	.044		
Total	8.680	79			

a. Dependent Variable: Financial performance

b. Predictors: (Constant), Asset & Liability management, Expense management, Revenue Management

c. Predictors: (Constant), Asset & Liability management, Expense management, Revenue management, Accounting regulations

The study conducted a regression analysis to determine the effects of revenue management, expense management and asset and liability management practices on financial performance of firms and also to establish the intervening effect of accounting regulations on the

relationship between the earnings management practices and financial performance of firms. Table 4.17 shows regression coefficients of the models which provide answers to the regression models. Model 1 provides answer to the reduced model ( $Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$ ) which now becomes  $Y = 1.981 + 0.44 X_1 + 0.472 X_2 - 0.200 X_3 + \varepsilon$ . On the other hand, model 2 presents solution to the full model ( $Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$ ) which now become:  $Y = 12.053 + 0.678 X_1 + 0.567 X_2 - 0.232 X_3 - 0.386 X_4 + \varepsilon$ : where: Y=financial performance;  $X_1$ =revenue management;  $X_2$ =expense management;  $X_3$ =asset and liability management;  $X_4$ =accounting regulations;  $\varepsilon$ =error term

**Table 4. 17 Regression Coefficients**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	
	B	Std. Error	Beta			
1	(Constant)	1.981	.354		5.599	.000
	Revenue management	.407	.099	.444	4.131	.000
	Expense management	.342	.078	.472	4.397	.000
	Asset & Liability management	-.184	.084	-.200	-2.185	.032
2	(Constant)	2.053	.330		6.224	.000
	Revenue management	.622	.110	.678	5.670	.000
	Expense management	.412	.075	.567	5.488	.000
	Asset & Liability management	-.213	.079	-.232	-2.697	.009
	Accounting regulations	-.279	.078	-.386	-3.570	.001

a. Dependent Variable: Financial performance

From regression coefficients in model 1, all the three variables namely, revenue management, expense management and asset and liability management were statistically significant ( $p=0.000$ ) and could be relied upon in explaining variations in firms financial performance. In this regard, taking the three variables constant at zero, financial performance of the listed firms will be 1.981 units. Further, it was also found that revenue management ( $p=0.000$ ;  $\beta=$



0.444), expense management ( $p=0.000$ ;  $\beta=0.472$ ) and; assets and liability management ( $p=0.032$ ;  $\beta=-0.200$ ) were all statistically significant to financial performance of listed firms. Further, with the intervention of accounting regulations, the three variables were still statistically significant to firms financial performance ( $p=0.001$ ;  $\beta=-0.386$ ). As such, with the intervention of accounting regulations, when the three variables are taken constant at zero, financial performance of the listed firms will increase to 2.053 units. It was also found that with the intervention, revenue management ( $p=0.000$ ;  $\beta=0.678$ ), expense management ( $p=0.000$ ;  $\beta=0.567$ ) and; assets and liability management ( $p=0.009$ ;  $\beta=-0.232$ ) were all statistically significant to financial performance of listed firms.

#### **4.5 Discussion of the Findings**

The results of this study have shown that non financial firms listed with NSE recorded improvements in financial performance in the recent past as evidenced by improved profitability ratios, improved sales volume, increased shareholders wealth maximization, increase dividends paid out to share holders, increased assets and, the amount of shares at the NSE. However, the study has also shown that the performance level can be attributed to various earnings management practices embraced by the firms such as revenue management, expense management and, assets and liability management.

From the finding, revenue management is one of the earning management practices embraced by non financial firms to influence their financial performance. Most firms' had put much emphasis on revenue timing, projections, shifting of earnings and revenue recognition to detect fictitious revenues that could lead to losses. The firms also relied on creation of positive impression of their accounts, market capitalization and, enhancement of future sales growth largely to influence future their profitability. The findings of this study concur with

previous studies that revenue management enable firms to achieve high market capitalization and to create positive expectations on future sales growth (Callen *et al.*, 2010) and that it enable firms to recognize fictitious revenues and to detect actual transactions useful to future financial outcomes (Colby, 2012).

It was also clear from the study that most non financial firms listed with NSE embraced expense management practices out of the need to remain profitable. Even though some of the firms engaged bad practices such as inadequate provisioning for expenses, aggressive capitalization and extended amortization thereby posing risks to financial performance; however, with good expense management practices involving recognition of expenses, reserves and inventory as well as reduction in discretionary expenditures the firms were able to record better financial performance. The findings on provisioning, aggressive capitalization and extended amortization concur with earlier findings that making inadequate provision, capitalizing (Salim, 2012; Amat *et al.*, 2003) and amortization (Colby, 2012) impacts on the financial performance of firms

Further, even though most non financial firms listed with NSE embraced asset and liability management as one of the earnings management practices; however, the use of asset and liability management negatively affected the firms' financial performance. Though the firms encouraged proper management of inventory, accrued payable expenses and accounts payable; however, there were instances when the firms overstated assets and understated or concealed some of their liabilities so as to portray good financial position and higher earning power thereby negatively affecting the firms' financial performance.

Overall, it was also clear that any increases in revenue and expense management practices would most likely promote financial performance of non financial firms listed with NSE while asset and liability management practices had inverse relations with financial performance hence any increases would most likely reduce the firm's financial performance. Empirically, previous studies have also shown that revenue management, expense management and assets and liability management can have significant impact on the financial performance of firms (Salim, 2012; Amat *et al.*, 2003; Callen *et al.*, 2010; Colby, 2012); hence the need for proper management of the factors.

Accounting regulations is a major factor that influenced the earnings management practices adopted by non financial firms listed with NSE to enhance their financial performance. Even though accounting rules aimed to minimize earnings management practices and to enhance transparency in financial reporting by firms; however, the flexibilities of accounting allowed the non financial firms listed with NSE to engage in inappropriate earnings management practices to influence their financial performance. Empirically, this study concurs with previous studies that found accounting regulations enhance transparency in financial reporting (Ewert & Wagenhofer, 2013) and that flexibility of accounting allows firms to adopt different policies in financial reporting (Bjurman & Weinhagen, 2013). However, the flexibility could also lead to inappropriate practices aimed at influencing financial performance.

## **CHAPTER FIVE**

### **SUMMARY, CONCLUSIONS AND RECOMMENDATIONS**

#### **5.1 Introduction**

This chapter presents a summary of the findings, conclusions, recommendations and suggestions for further studies.

#### **5.2 Summary of Findings of the Study**

The study sought to determine the effect of earnings management on financial performance of non financial firms listed with NSE in Nairobi, Kenya where 164 senior managers in the accounts department of 41 firms were targeted. A sample of 82 senior managers drawn from accounts departments in 41 firms listed with NSE were selected using stratified random sampling procedures. The collected primary data using structured 5-point likert scale questionnaire where both face to face and a drop and pick method were used to serve questionnaires. Both descriptive and correlation research designs were adopted in the study.

A total of 82 questionnaires were administered to respondents with 80 of them returning the questionnaires fully filled. The internal consistency of data was determined using Cronbach's Alpha on 5 items that yielded overall value of 0.850. Results on gender indicated that 66.3% of the respondents were males while 33.8% of them were females. Majority (51.3%) of them was aged more than 45 years old and that 35% of them had worked in the firms for more than 16 years thus gathering the necessary work experience on earnings management practices. It was clear that majority (42.5%) of the participants in earnings management practices by firms were the finance managers and that most (38.8%) of the respondents were holders of Masters Degree thus were competent to provide relevant responses in their areas of duty.

The study found that most firms had adopted different earnings management practices to enhance performance. It was also clear that the firms had recorded improvements in financial performance as shown by a mean score of 4.2750. This improvement was evident in profitability ratios by a mean score of 4.5750, improved sales volume by a mean score of 4.5875, maximization of shareholders wealth and regular payment of dividends as shown by a mean score of 4.2750, increases in total assets by a mean score of 4.4625 and increase in the amount of shares bought or held in stock at the NSE by mean score of 4.4625.

### **5.2.1 The effect of Revenue Management on Financial Performance of Firms**

Descriptive results indicated that most firms embrace revenue management and that the practice affects financial performance of firms as shown by mean scores of 4.1000 and 4.4875 respectively. It was found that the firms benefited from various revenue management activities; for instance, revenue timings enabled the firms to detect fictitious revenues that may result to losses as shown by a mean score of 4.5000 and that revenue projections aimed at creating positive impression in accounts normally translates into good financial performance as shown by a mean score of 4.3250. Further, it was found that shifting of earnings influence profitability earning power and promotes success of financial performance by a mean score of 4.3375 and that revenue recognition promotes high market capitalization, enhances future sales growth and consequently, future profitability of firms by a mean score of 4.4500. Inferential analysis results indicated that revenue management was strongly and positively correlated to financial performance with a correlation coefficient of 0.660. Further, regression results found that revenue management was statistically significant to financial performance ( $p=0.000$ ;  $\beta=0.444$ ); this imply that a significant increase in revenue management by one standard deviation would lead to increase in financial performance of firms by a factor of

0.444 units. It was also clear that even with the intervention of accounting regulations, revenue management was still statistically significant to loan default ( $p=0.000$ ;  $\beta=0.678$ ); thus an increase in revenue management practices by one standard deviation would still lead to increase in financial performance by 0.678 units.

### **5.2.2 The effect of Expense Management on Financial Performance**

Descriptive results found expense management is a common practice by listed firms and that the practice affects financial performances of firms by mean scores of 4.0375 and 4.4250 respectively. It was found that firms engaging in expense management practices do so to remain profitable as shown by a mean score of 4.4000. However, it was also found that expense management practices involving inadequate provision for expenses, aggressive capitalization and extended amortization poses risk to financial performance as show by a mean score of 4.5500 and that recognition of expenses, reserves and inventory enable firms to project future sales, hence promoting profitability performance as shown by a mean score of 4.1875. Further, it was found that reduction in discretionary expenditures promotes financial performance of firms as shown by a mean score of 4.4125. Inferential analysis results found that expense management was strongly and positively correlated to financial performance with a correlation coefficient of 0.670. Further, regression analysis results found that expense management was statistically significant to financial performance ( $p=0.000$ ;  $\beta=0.472$ ); thus, a unit increase in expense management efforts would predict a significant increase in financial performance by a factor of 0.472 units. The study found that even with the intervention of accounting regulations, expense management was still statistically significant to financial performance ( $p=0.000$ ;  $\beta= 0.567$ ), hence an increase in expense management practices by one standard deviation would lead to increases in financial performance by 0.567 units.

### **5.2.3 The effect of Assets and Liability Management on Financial Performance**

The study found that most listed firms embrace assets and liability management practices and that the practice affect financial performance of firms as indicated by mean scores of 4.3250 and 4.3875 respectively. It was also found that various factors hold explanatory power on the influence of assets and liability management practice on financial performance of firms; among them that overstating assets and understating liabilities affects financial performance of firms as indicated by a mean score of 4.3500 and that concealment of liabilities negatively impacts on financial performance of firms by a mean score of 4.3125. Further, it was found that proper inventory management practices promote profitability performance of firms and that proper management of accrued payable expenses and accounts payable promotes profitability performance of firms as shown by mean score of 4.4625 and 4.3500 respectively. On inferential analysis, correlation results found that assets and liability management was weakly and positively correlated to financial performance with a correlation coefficient of 0.263. Regression analysis results found that assets and liability management was statistically significant to financial performance of listed firms ( $p=0.032$ ;  $\beta=-0.200$ ); thus a significant increase in assets and liability management would lead to a decrease in financial performance of listed firms by a factor of -0.200 units. Further, it was found that even with the intervention of accounting regulations, assets and liability management was still statistically significant to loan default ( $p= 0.009$ ;  $\beta= -0.232$ ); thus an increase in assets and liability management efforts by one standard deviation would lead to reduction in financial performance by -0.232 units.

### **5.2.4 The Mediating effect of Accounting Regulations on Financial Performance**

The study found that most listed firms abide by the existing accounting regulations as indicated by a mean score of 3.9875 and that the regulations influence earnings management

practices that the firms adopt to promote financial performance by a mean score of 4.3625. The study found that accounting policies are aimed at enhancing transparency in financial reporting hence promoting financial performance of firms by a mean score of 4.4000 and that the flexibilities of accounting policies encourage earnings management practices aimed at promoting financial performance by a mean score of 4.2375. It was also found that adoption of IFRS has helped minimize earnings management practices and enhanced profitability performance of firms by a mean score of 4.2125 and that accounting laws do not make it difficult for firms to create potentially misleading impressions of their financial performance by a mean score of 4.3375. On inferential analysis, correlation results found that accounting regulations was moderately and positively correlated to financial performance with a correlation coefficient of 0.378. Regression analysis results found that the mediation of accounting regulations in the relationship between earnings management practices was statistically significant to financial performance ( $p=0.001$ ;  $\beta=-0.386$ ); hence a significant increase in the intervention of accounting regulations by one standard deviation would most likely lead to a decrease in financial performance by listed firms by a factor of -0.386 units.

### **5.3 Conclusions**

The study concludes that financial performance of non financial firms listed with NSE is affected by the various earnings management practices embraced by the firms, among them revenue management, expense management, and assets and liability management. It is also concluded that the earnings management practices affect profit earnings, sales volume, shareholders wealth, firm assets and firm equity.

The study concludes that revenue management practices embraced by the non financial firms contributed positively to good financial performance of the firms. As a consequence, the non



financial firms have come up with a host of practices including revenue timings, revenue projections, shifting of earnings and revenue recognition, creation of positive impression, and market capitalization as means of enhancing their financial performance.

This study adduced that even though non financial firms listed with NSE embraced expense management practices to enable them remain profitable; however the practice also encouraged inappropriate earnings management practices such as inadequate provisioning for expenses, aggressive capitalization and extended amortization which exposes the firms' to risk.

Further, it was concluded that continued use of earnings management practices involving assets and liability management do not help enhance the financial performance of non financial firms and that even though the firms strived for proper management of inventory, accrued payable expenses and accounts payable; however, there were instances when the firms overstated assets and understated/concealed liabilities to portray good financial health thereby negatively affecting the firms' financial performance.

Furthermore, this study concluded that though accounting regulations play influential role that enable the non financial firms to minimize use of earnings management practices as well as to enhance transparency in financial reporting by firms; however, the flexibilities of accounting are to blame for the firms' participation in inappropriate earnings management practices.

#### **5.4 Contribution to Knowledge**

The study provides firms' management and investors with useful information on earnings management practices which they can consider in their investment decisions so as to promote financial performance. The accounting fraternity also stands to gain useful information that they can use to formulate appropriate policies to streamline the accounting profession and to

promote firms' performance. Further, academicians stand to gain useful information on earnings management practices and firms' financial performance which they can use in future studies and as basis to critique the present study.

### **5.5 Recommendations on Research Findings**

This study recommends that since earnings management practices were found to significantly affect financial performance of non financial firms listed with NSE, the management of firms, investors and stake holders need to consider the influence of the earnings management practices in investment decisions in order to boost chances of their financial performance.

Due to the finding that revenue management and expense management practices contributed positively to good financial performance of the non financial firms listed with NSE, this study recommends that the firms' management, investors and stakeholders to come up with appropriate rules and guidelines to facilitate good revenue and expense management for the benefit of spurring the firms' financial performance.

Since this study found that assets and liability management practice by listed non financial firms negatively affected financial performance of the firms, there is greater need for the firms' management to come up with appropriate measures that would guarantee proper management of inventories, accrued payable expenses and accounts payable in order to promote profitability performance of the firms.

Further, by virtue the flexibilities of accounting was found to provide non financial firms with opportunity to engage in inappropriate earnings management practices, this study recommends that the accounting oversight body, ICPAK need to develop appropriate

measures that would enable them address the loopholes that arise out of the flexibilities for the benefit of enhanced financial performance of the firms.

### **5.6 Limitations of the Study**

The researcher encountered hesitant respondents who were not willing to cooperate in the study; however, the researcher reassured the respondents of their confidentiality and that the information will be used for academic research purpose only.

The researcher was also faced with bureaucracy and other organizational procedures making it difficult to access the firms; however, prior request was made to the firms' management. Further, the researcher produced an authorization letter from Kenyatta University and research permit from National Commission for Science, Technology and Innovation [NACOSTI] to facilitate access and data collection from the sampled firms.

### **5.7 Suggestions for Further Research**

The study recommends further empirical investigation to be carried out to address the unique findings. First, there is need for further studies to confirm or refute the findings of this study and whether assets and liability management do not enhance financial performance of firms.

Second, it was found that other earnings management practices outside the scope of this study accounted for 46.1% of the effects on financial performance by listed firms; hence there is need for another study to document these other factors and to find out their effects on financial performance of firms.

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## APPENDICES

### APPENDIX I: UNIVERSITY AUTHORIZATION LETTER



**KENYATTA UNIVERSITY  
GRADUATE SCHOOL**

E-mail: [dean-graduate@ku.ac.ke](mailto:dean-graduate@ku.ac.ke)

P.O. Box 43844, 00100  
NAIROBI, KENYA  
Tel. 810901 Ext. 57530

Website: [www.ku.ac.ke](http://www.ku.ac.ke)

Internal Memo

**FROM:** Dean, Graduate School

**DATE:** 13<sup>th</sup> June 2016

**TO:** Maureen Wangui Ndungu  
C/o Accounting & Finance Department,

**REF:** D53/CTY/PT/29022/13

**SUBJECT:** APPROVAL OF RESEARCH PROJECT PROPOSAL

-----  
This is to inform you that Graduate School Board, at its meeting of 8<sup>th</sup> June 2016, approved your Research Project Proposal for the M.B.A. Degree Entitled, "Earnings Management and Financial Performance of Listed Non Financial Firms in Nairobi County".

You may now proceed with data collection, subject to clearance with the Director General, National Commission for Science, Technology and Innovation.

As you embark on your data collection, please note that you will be required to submit to Graduate School completed Supervision Tracking forms per semester. The form has been developed to replace the progress report forms. The supervision Tracking Forms are available at the University's website under Graduate School webpage downloads.

Thank you.


EDWIN OCHIENG  
FOR: DEAN, GRADUATE SCHOOL

c.c. Chairman, Department of Accounting & Finance

Supervisors:

1. Dr. Eddie Simiyu  
C/o Department of Accounting & Finance  
Kenyatta University

## APPENDIX II: NACOSTI RESEARCH AUTHORIZATION LETTER



### NATIONAL COMMISSION FOR SCIENCE, TECHNOLOGY AND INNOVATION

Telephone: +254-20-2213471,  
2241349,3310571,2219420  
Fax: +254-20-318245,318249  
Email: [dgg@nacosti.go.ke](mailto:dgg@nacosti.go.ke)  
Website: [www.nacosti.go.ke](http://www.nacosti.go.ke)  
when replying please quote

9<sup>th</sup> Floor, Utalii House  
Uhuru Highway  
P.O. Box 30623-00100  
NAIROBI-KENYA

Ref. No:

Date:

**NACOSTI/P/16/54426/13735**

**27<sup>th</sup> October, 2016**

Maureen Wangui Ndungu  
Kenyatta University  
P.O. Box 43844-00100  
**NAIROBI.**

#### **RE: RESEARCH AUTHORIZATION**

Following your application for authority to carry out research on "*Earnings management and financial performance of listed non financial firms in Nairobi County.*" I am pleased to inform you that you have been authorized to undertake research in **Nairobi County** for the period ending **24<sup>th</sup> October, 2017.**

You are advised to report to **the County Commissioner and the County Director of Education, Nairobi County** before embarking on the research project.

On completion of the research, you are expected to submit **two hard copies and one soft copy in pdf** of the research report/thesis to our office.



**BONIFACE WANYAMA  
FOR: DIRECTOR-GENERAL/CEO**

Copy to:

The County Commissioner  
Nairobi County.

The County Director of Education  
Nairobi County.

National Commission for Science, Technology and Innovation is ISO 9001:2008 Certified

**APPENDIX III: RESEARCH QUESTIONNAIRE**

**SECTION A: DEMOGRAPHICS PROFILE**

Kindly respond to the questions by ticking as appropriate or where applicable

1. Gender:

Male  Female

2. Your age bracket?

20-25 years  26-35 years  36-45 years  46 and above

3. How long have you worked in your organization?

1 - 5 years  6 -10 years  11 -15 years  16 years and above

4. What is your designation?

Accountant  Auditor

Chief Accountant  Finance Manager

5. What is your highest level of education/qualifications? Tick as appropriate

Secondary  Diploma  Degree

CPA/ACCA  Masters Degree  Others

If others, specify.....



**SECTION B: REVENUE MANAGEMENT**

On a scale of 1-5, kindly indicate by ticking where appropriate the extent to which you agree with the statements below on the influence of revenue management on the profitability performance of firms. Key: 1 = Not at all; 2 = Strongly Disagree; 3 = Disagree; 4= Agree; 5=Strongly Agree

No.	Questions on Revenue Management	1	2	3	4	5
i.	Do you embrace revenue management as one of the earnings management practices in the firm?					
ii.	If you agree to question (i) above, then, does revenue management affect financial performance of the firm?					
iii.	Do revenue timings enable firms to detect fictitious revenues that may result to losses?					
iv.	Does revenue projections aimed at creating positive impression in accounts influence good financial performance?					
v.	Does shifting of earnings influence profitability earning power and success of firms?					
vi.	Does revenue recognition influence market capitalization, creates positive expectations of future sales growth and consequently, future profitability of firms?					

### SECTION C: EXPENSE MANAGEMENT

On a scale of 1-5, kindly indicate by ticking where appropriate your level of agreement with the following questions on the influence of expense management practices on the financial performance of firms. Key: 1 = Not at all; 2 = Strongly Disagree; 3 = Disagree; 4= Agree; 5=Strongly Agree

No.	Questions on Expense Management	1	2	3	4	5
i.	Does the firm embrace expense management as one of the earning management practices?					
ii.	If you agree to question (i) above, then, does expense management influence profitability performance of the firm?					
iii.	Do companies engaging in expense management do so out of the need to remain profitable?					
iv.	Does inadequate provision, aggressive capitalization and extended amortization poses risks to financial performance of the firm?					
v.	Does recognition of expenses, reserves and inventory helps project future sales; hence promoting profitability performance of firms?					
vi.	Does reduction in discretionary expenditures help promote profitability performance of firms?					

## SECTION D: ASSETS AND LIABILITY MANAGEMENT

On a scale of 1-5, kindly indicate by ticking where appropriate your level of agreement with the following questions on the influence of Assets and Liability Management on profitability performance of firms. Key: 1 = Not at all; 2 = Strongly Disagree; 3 = Disagree; 4= Agree; 5=Strongly Agree

No.	Questions on Assets and Liability	1	2	3	4	5
i.	Does the firm embrace assets and liability management as one of the earnings management practices?					
ii.	If you agree to question (i) above, then, does assets and liability management affect financial performance of the firm?					
iii.	Are there instances when the firm overstated assets and understated liabilities to influence financial performance?					
iv.	Does concealment of liabilities by the firm negatively impacts on financial performance?					
v.	Do you agree that the firm practices proper inventory management practices to promote profitability performance?					
vi.	Do you agree that the firm properly manages accrued payable expenses and accounts payable promotes profitability performance?					

**SECTION E: THE MEDIATING EFFECT OF ACCOUNTING REGULATIONS ON  
THE RELATIONSHIP BETWEEN EARNING MANAGEMENT PRACTICES AND  
FINANCIAL PERFORMANCE OF FIRMS.**

This subsection seeks to obtain participants opinions with statements on the mediating effect of Accounting Regulations on the relations between earning management practices and financial performance of firms. On a scale of 1-5, kindly indicate by ticking where appropriate your level of agreement with the following questions. Key: 1 = Not at all; 2 = Strongly Disagree; 3 = Disagree; 4= Agree; 5=Strongly Agree

No.	Questions on Accounting Regulations	1	2	3	4	5
i.	Do you agree that the firm abides by the existing accounting regulations?					
ii.	If you agree to the above (question i), then, do the accounting regulations influence earnings management practices adopted by the firm to promote its financial performance?					
iii.	Do accounting policies aim to enhance transparency in financial reporting hence promoting financial performance of firm?					
iv.	Do you agree the flexibilities of accounting policies encourage earnings management practices by the firm?					
v.	Has the adoption of IFRS helped minimize unethical earnings management practices and enhanced profitability performance of firm?					
vi.	Do you agree that accounting laws do not make it difficult for firms to create potentially misleading impressions of their financial performance?					

## SECTION F: FINANCIAL PERFORMANCE

This subsection seeks to obtain participants opinions with statements on financial performance of the firms. On a scale of 1-5, kindly indicate by ticking where appropriate the extent of agreement with questions on financial performance of firms. Key: 1 = Not at all; 2 = Strongly Disagree; 3 = Disagree; 4= Agree; 5=Strongly Agree

No.	Questions on Financial Performance	1	2	3	4	5
i.	Do you agree that the firm has recorded improvement in its financial performance in the recent past?					
ii.	Do you agree that the firm has recorded improvement in profitability ratios?					
iii.	Do agree that the firm has recorded improved sales volume due to proper earnings management practices?					
iv.	Do you agree that the firm maximizes on shareholders wealth and that the firm regularly pays out dividends to its share holders?					
v.	Do you agree that the total assets of the firm have increased in the recent past?					
vi.	Do you agree that the amount of shares bought or held in stock at the NSE has increased in the recent past?					

**APPENDIX IV: LIST OF LISTED NON FINANCIAL COMPANIES IN KENYA**

- |                                  |                               |
|----------------------------------|-------------------------------|
| 1. A.BAUMANN & CO LIMITED        | 22. KENYA AIRWAYS             |
| 2. ARM CEMENT LTD                | 23. KENYA ORCHARDS            |
| 3. ATLAS DEVELOPMENT AGENCIES    | 24. KENYA POWER               |
| 4. BAMBURI CEMENT                | 25. LIMURU TEA                |
| 5. BAT KENYA                     | 26. LONGHORN PUBLISHERS       |
| 6. BOC GASES                     | 27. MARSHALLS                 |
| 7. CAR & GENERAL                 | 28. MUMIAS SUGAR              |
| 8. CARBACID                      | 29. NAIROBI BUSINESS VENTURES |
| 9. CROWN PAINT KENYA LTD         | 30. NATION MEDIA              |
| 10. EAAGADS                      | 31. SAFARICOM                 |
| 11. E.A CABLES                   | 32. SAMEER                    |
| 12. EAST AFRICAN BREWERIES LTD   | 33. SASINI                    |
| 13. EAST AFRICAN PORTLAND CEMENT | 34. STARNDARD GROUP           |
| 14. EVEREADY EAST AFRICA         | 35. TOTAL KENYA               |
| 15. EXPRESS KENYA                | 36. TPS E.A                   |
| 16. FLAME TREE                   | 37. UCHUMI SUPERMARKETS       |
| 17. HUTCHINGS BIEMER             | 38. UMEME                     |
| 18. KAKUZI                       | 39. UNGA GROUP                |
| 19. KAPCHORUA TEA                | 40. WILLIAMSON TEA            |
| 20. KENGEN                       | 41. WPP SCANGROUP             |
| 21. KENOLKOBIL                   |                               |