

Corporate Governance, Earnings Management and Performance of Firm: Evidence from Firms Listed at the Nairobi Securities Exchange, Kenya

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Abstract:

Background: The performance of firms listed on the Nairobi Securities Exchange remains an important area of interest to scholars, practitioners, and policymakers because of its implications for economic growth, investor confidence, and capital market stability. Although many studies have examined the relationship between corporate governance and firm performance, the findings remain inconclusive, particularly regarding the mediating role of earnings management. This study examined the effect of corporate governance on firm performance and assessed the mediating role of earnings management.

Materials and Methods: Guided by a positivist research philosophy and an explanatory research design, the study analyzed panel secondary data from 63 firms listed on the Nairobi Securities Exchange between 2014 and 2023, obtained from published annual reports and reputable financial databases. Firm performance was measured using Tobin's *Q*, corporate governance through board size and board independence, and earnings management using the Modified Jones Model. Panel regression techniques, including pooled ordinary least squares and hierarchical regression, were used to test the hypotheses at the 5% significance level.

Results: The findings showed that corporate governance had a positive and statistically significant effect on performance of firm. Earnings management partially mediated this relationship. These findings support agency and stewardship theories by revealing the importance of effective governance structures while highlighting the influence of earnings management practices on firm performance.

Conclusion: The study recommends that listed firms strengthen governance mechanisms and enhance transparency in financial reporting. Policymakers and regulators are advised to enforce stricter disclosure requirements and promote governance reforms that curb opportunistic managerial behavior. This study extends the literature by integrating governance and earnings management dynamics in explaining firm performance in emerging capital markets.

Keywords: Corporate Governance, Board Size, Board Independence, Earnings Management, Firm Performance, Tobin's *Q*.

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I. Introduction

Corporate governance is vital in driving firm performance and achieving profit maximization as it establishes a system that guides the firm in line with best practices. The benefit associated with good corporate governance in improving performance of firms can be compromised by earnings management, which represents a significant risk to performance of firms. Such manipulations of earnings can severely misrepresent the actual performance (Etiang et al., 2026).

Stewardship theory, proposed by Donaldson and Davis (1991, 1993), is the anchor theory for this study. This theory emphasizes that managers serve for the benefit of shareholders as stewards, reducing the need for extensive corporate governance controls. It posits that effective stewardship by management leads to better firm performance due to their intrinsic motivation to maximize organizational success, reinforcing the positive link between corporate governance and performance of firm. Agency theory, proposed by Ross (1973) and Jensen and Meckling (1976), highlights the conflicting interests between stakeholders, increasing oversight costs and affecting firm performance, thereby supporting the importance of earnings management as an intervening variable.

Firms listed on the Nairobi Securities Exchange (NSE) face persistent performance and sustainability hurdles associated with weak corporate governance and earnings management. Corporate governance assessments revealed persistent compliance weaknesses (Kamau, 2023), including the misclassification of board directors as independent non-executives and delays in submitting audited financial statements beyond the statutory four-month deadline (NSE, 2024). Furthermore, the number of listed firms declined from 67 in 2016 to 63 in 2024 (CMA, 2024). Globally, cases of corporate mismanagement prompt scholars to explore similar issues across different regions. For instance, Brimah et al. (2024) explored the relationship between corporate governance and performance of listed firms in Nigeria, while Al-Saidi (2021) studied non-financial firms listed in Kuwait. This study enhances the understanding of the relationships among corporate governance, earnings management, and performance of firms.

1.1 Corporate Governance

Corporate governance is the overall leadership of a company, specifically how the owners and managers control and direct the company (Gherghina, 2021). It is the mechanism concerned with putting in place procedures for the governance and regulations of companies, guiding their activities to assure capital owners that their invested fund is safeguarded and managed to yield profitability (Garzón, 2021). The core aim of corporate governance is to increase and grow shareholder's return and guard the interest of other stakeholders of the community. Measurement of corporate governance varies among scholars, with some developing a quality index while others consider individual practices (Dao et al., 2024). In this study, board size and board independence are the indicators. Total members of the board are used to measure board size, while independence of the board is measured by a ratio of the number of independent directors to all directors. These measures were chosen due to their measurable nature across all firms and their impact on oversight, performance, and earnings management, consistent with Utama et al. (2020).

1.2 Earnings Management

Earnings management is the intentional action in the reporting procedure for the purpose of gaining personal benefit (Nguyen & Duong, 2022). This self-interested modification of earnings undermines the value of earnings, as well as financial reports reliability (Bansal, 2024). If the company is desirous to remain operational and needs to avoid losing its status, it may become essential to adjust its financial statements (Dao & Le, 2022). The existence of financial information asymmetry between corporations' staff and third parties could be utilized as a tool for providing comparative advantages based on each party's goals (Gajdosikova et al., 2022). Earnings management scenarios are often noted when there is an issuance of equity, such as when a share is floated via an IPO (Nickel et al., 2025). There are several methods for measuring earnings management which focus on distinguishing between the discretionary and non-discretionary elements of accruals (Gošnik et al., 2023). Commonly used models focus on the Jones Model (1991) to separate routine operations from interventions (Utama et al., 2020). This study uses the Modified Jones Model, because it includes changes in receivables which the original Jones model lacked (Liu, 2024).

1.3 Performance of Firm

Performance of a firm is the profitability, growth trend, capital base, shareholder returns, customer satisfaction, and stakeholder perceptions. It is the indicator of how effectively a firm utilizes its resources to generate revenue and achieve sustainable profitability (Nguyen & Pham, 2026). As postulated by Kiymaz et al. (2024), a firm's performance is the mirror of its financial fitness. There are diverse ways of measuring performance of firms including return on sales (ROS) and return on assets (ROA) (Younas, 2022). In this study, firm performance is calculated using Tobin's Q. This measure is chosen because it combines both market value and asset data, offering a reliable indicator, (Bhatia & Kumari, 2026).

1.4 Firms Listed at Nairobi Securities Exchange

There are 63 firms on the Nairobi Securities Exchange, representing a range of sectors. The corporate governance of these firms features diverse board compositions and structures, incorporating executive, non-executive, foreign, and women directors (Kapkarich & Laiboni, 2026). Effective corporate governance is vital for the success of these firms; however, larger boards or those with dual CEO-chair roles often encounter governance challenges that can lead to excessive control, undermining oversight (Nzuki & Njoka, 2021). Between 2014 and 2023, the exchange experienced a net contraction as existing firms exited due to financial distress or acquisition, including KenolKobil in 2019, National Bank of Kenya in 2021, and Kurwitu Ventures in 2023 (Kapkarich & Laiboni, 2026). By 2020, regulators had flagged over a dozen companies, among them Uchumi and Kenya Power, as potential delisting candidates.

1.5 Problem Statement

The concept of corporate governance has been linked to performance of firms, but the relationship remains complex and contested, particularly in emerging markets such as Kenya. Further complicating this relationship is the role of earnings management, which can obscure true performance by manipulating financial statements. In Kenya, firms listed on the Nairobi Securities Exchange operate under stringent governance regulations enforced by the Capital Markets Authority; yet despite these frameworks, evidence shows persistent failures (Oino & Kithandi, 2025). Express Kenya's accumulated losses reached KSh 606.5 million, Sanlam Kenya posted cumulative losses of KSh 2.28 billion over four years, and Uchumi Supermarkets faces a governance probe over audits delayed for seven years (Nyatichi et al., 2020). Investor confidence has eroded sharply, with the NSE's market capitalization falling by 28 percent between January and September 2022, driven partly by poor performance of listed firms (Ndirangu & Mwenda, 2025).

There are conflicting theoretical perspectives. Stewardship Theory, proposed by Donaldson and Davis (1991, 1993), posits a positive correlation between corporate governance and firm performance by emphasizing trust and intrinsic motivation (Omura, 2026). However, this view is contested by Positive Accounting Theory, which argues that management behavior is often driven by self-interest. Regionally, Brimah et al. (2024) studied listed Nigerian firms and noted a considerable positive association between board size, earnings management, and corporate governance. Lindawati et al. (2025) found that duality of CEO influenced performance negatively. Based on the reviewed studies, this research sets out to fill the gaps as summarized in the research question: What is the interrelationship among corporate governance and earnings management on performance of firm at the Nairobi Securities Exchange?

II. Literature Review

2.1 Theoretical Literature

2.1.1 Stewardship Theory

Stewardship Theory was advanced by Donaldson and Davis (1991) and further refined in 1993. The theory focuses on the concepts of trust and the intrinsic motivation of managers (Capella et al., 2025). It views managers as stewards of the organization who are inherently predisposed to conduct activities that focus on benefiting the shareholders (Saxena et al., 2024). Managers are dedicated individuals whose success is tied to the organization as a whole (Watanabe, 2026). They derive gratification from giving their best to the accomplishment of the firm (Jasir et al., 2023).

Stewardship Theory explains the positive association between corporate governance and firm performance (Hussein & Mwangi, 2026). According to the theory, effective corporate governance contributes immensely to a firm's success because it is not undermined by the self-serving interests of management (Watanabe, 2026). This perspective encourages a collaborative dynamic founded on mutual trust and common objectives (Haider & Raza, 2026).

The theory has several weaknesses. It assumes that managers are inherently trustworthy and selfless, an assumption that Jensen and Meckling (1976) challenged by arguing that managers often have conflicting interests with shareholders (Naeem, 2026). While placing significant trust in managers, it does not provide accountability measures, which encourages complacency among boards, potentially resulting in insufficient oversight (Tröger, 2026). The theory contributes to the study as it suggests that effective governance practices are positively correlated with improved organizational outcomes (Muswere & Dube, 2022). It challenges the effect of intervening variables since managers avoid earnings management to serve shareholders (Londhe, 2026; Kejriwal, 2022).

2.1.2 Positive Accounting Theory

Positive Accounting Theory, advanced by Watts and Zimmerman (1978) through its political cost and bonus plan hypotheses, explains how manipulative management chooses accounting standards that serve their interests. Management behavior driven by self-serving motives erodes the intended benefits of corporate governance and subsequently impedes the general performance of the firm (Utari et al., 2023). This manipulative approach stems from incentives such as minimizing tax obligations, presenting favorable reports to regulators, or fulfilling personal interests like enhancing salaries and bonuses (Ananta et al., 2023).

Watts and Zimmerman (1978) postulated that good corporate governance does not always translate to better firm performance due to management behavior, which can backfire and negate governance efforts (Gujarathi, 2025). While these self-interested actions might benefit management in the short term, they lead to a misalignment with shareholder welfare, compromising long-term firm performance (Ardiansyah, 2022; Amantara & Utomo, 2025).

The weakness of Positive Accounting Theory (PAT) is that it portrays managers' actions as purely out of self-interest, contradicting Donaldson and Davis (1991, 1993). It also primarily addresses shareholders and managers, disregarding other key stakeholders like personnel, clients, and vendors (Kavrar, 2020; Firmansyah,

2020). Furthermore, it overlooks how varying legal, regulatory, and cultural environments shape accounting practices (Setyanto et al., 2024). The theory contributes to the study by supporting the influence of the intervening variable on the association between corporate governance and firm performance (Abbas et al., 2026), echoing prior applications by Kejriwal (2022) and Younas (2022).

2.2 Empirical Literature

2.2.1 Corporate Governance and Firm Performance

The effect of corporate governance on performance was examined by Brimah et al. (2024) using listed deposit-taking banks in Nigeria and applying the System Generalized Method of Moments (System GMM) approach. Corporate governance was primarily measured using board size and audit committee characteristics, while firm performance was evaluated within the banking sector context. The findings indicated that corporate governance has a significant influence on firm performance, particularly through board structure and audit oversight mechanisms. However, the study focused on a single sector without broader cross-industry analysis. Also, the target population covers only deposit money banks, excluding non-financial firms. It also focused on the Nigerian banking sector, which may differ from other emerging markets. The current study addresses these gaps by analyzing all firms listed at the Nairobi Securities Exchange across all industries using a 10-year census-based panel dataset (2014–2023).

A research conducted by (Etiang et al., 2026) examined the variables using a positivist approach and a descriptive explanatory design based on data from 61 firms through questionnaires, secondary data checklists, and logistic regression. The study observed that governance factors significantly influence firm performance, accounting for 60.2% of performance variation and improving both monetary and non-monetary outcomes. The current study applies a census-based panel design covering all NSE-listed firms over the 2014–2023 period and examining the combined effect of corporate governance, earnings management, and economic environment on firm performance.

The relationship between corporate governance and firm performance was investigated by Bhatia and Kumari (2026) who found that board size had a significant positive effect on performance, whereas CEO duality negatively affected firm performance. Firm performance was measured using Tobin's Q, while corporate governance was assessed using board size, promoter ownership, foreign ownership, and family ownership. This study extends that work by examining the mediating role of earnings management and the moderating influence of the economic environment in the relationship between corporate governance and firm performance, in order to replicate and build on the previous study.

2.2.2 Corporate Governance, Earnings Management and Firm Performance

A study conducted by Ogundele and Nzama-Sithole (2026) examined the relationship between corporate governance and earnings management in the financial reporting of listed firms in Nigeria. The study used data from non-financial firms for the year 2018. The Modified Jones Model was applied to estimate accrual-based earnings management. The results indicated a significant positive relationship between board size, earnings management, and return on assets (ROA). The study period for the research was limited to one year. Also, the research focused on non-financial firms, excluding financial firms which may result in biased conclusions. In this study the data period used spanned for 10 years and it includes all the firms listed at NSE including financial institutions.

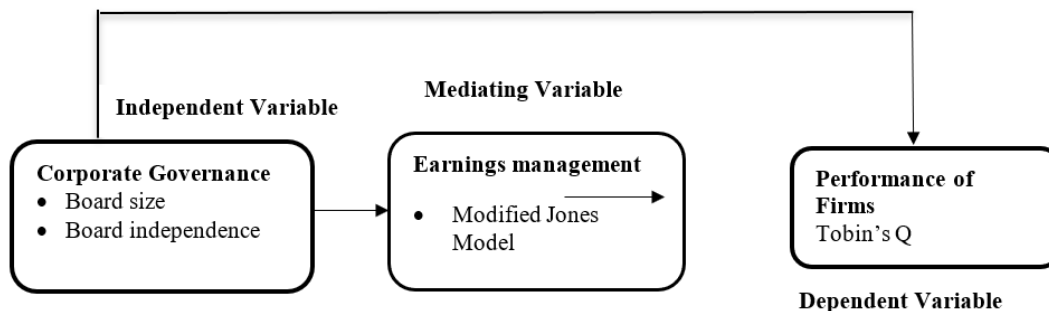
A study by Yeboah et al. (2026) investigated the mediating effect of earnings management and corporate governance in the relationship among small-scale community banks in rural Ghana. The study adopted a quantitative cross-sectional design and utilized both primary and secondary data, which were analyzed using regression analysis and the PROCESS macro. The findings revealed a significant association between corporate governance and earnings management, underscoring the interaction between governance structures and financial reporting practices. The study focused exclusively on rural community banks, excluding larger banks and non-financial firms which limits generalizability to more developed and diverse capital markets. This study addresses these limitations by examining all firms listed at the Nairobi Securities Exchange across all industries using a census-based approach over the 2014–2023 period.

A review of the relationships among corporate governance, earnings management, and firm performance was conducted by Manan and Amin (2023) using 191 non-financial firms listed on the Pakistan Stock Exchange for the period 2010–2019. The study applied diagnostic tests and ordinary least squares (OLS) regression for data analysis. Corporate governance was measured using ownership concentration, board independence, board size, and audit committee size, while firm performance was proxied by return on assets, and earnings management was measured through discretionary accruals. The findings revealed that earnings management did not have a significant effect on the relationship between corporate governance and firm performance. However, the study excluded financial firms and focused only on non-financial listed companies, the Pakistani market setting differs from emerging African markets. The current study reexamines the variables in the African Capital Market setup.

2.3 Conceptual Framework

The conceptual framework illustrates the relationship among corporate governance, earnings management, and firm performance. In this framework, corporate governance serves as the independent variable, proxied by board size and board independence. Board size is measured as the total number of board members, while board independence is operationalized as the ratio of independent directors to the total number of directors. Earnings management serves as the mediating variable, measured via discretionary accruals using the Modified Jones Model to capture its transmission role within the framework. Firm performance constitutes the dependent variable, measured using Tobin's Q to reflect market-based corporate valuation. This conceptual configuration allows for the empirical validation of both the direct impact of governance on the performance of firm and the indirect transmission channel through earnings management.

Figure1: Conceptual Framework



Source: Author (2024)

2.3.1 Operationalization of Study Variables

Corporate Governance: Operationalized using two structural indicators. Board size is defined as the total number of sitting directors serving on the board. Board independence is computed as a ratio of independent non-executive directors relative to the total board headcount (Utama et al., 2020).

Earnings Management: Measured via discretionary accruals derived from the Modified Jones Model (Jones, 1991; Liu, 2024). It isolates routine business adjustments from opportunistic reporting modifications using the fundamental accounting balance equation: Total Accruals = Net Income - Operating Cash Flows.

Firm Performance: Evaluated through Tobin's Q ratio, a hybrid market-and-accounting metric reflecting market valuation against physical asset replacement costs (Bhatia & Kumari, 2026). It is modeled as: $Q = [\text{Market Capitalization} + (\text{Total Assets} - \text{Equity})] / \text{Total Assets}$.

III. Research Methodology

This study adopted a descriptive research design within a quantitative research approach. The descriptive component enabled a systematic presentation of the characteristics of the study variables based on secondary data, while the correlational aspect focused on examining statistical relationships (Juliana et al., 2025). The study concentrated on 63 listed companies on the Nairobi Securities Exchange (NSE) with complete financial and governance records for the ten-year period 2014–2023.

Information on corporate governance variables, including board size and board independence, was obtained from company published annual reports via the NSE and Capital Markets Authority (CMA) databases. Financial data required to compute total accruals and Tobin's Q were extracted from audited financial statements and market records. Prior to analysis, a data cleaning process was undertaken, and descriptive statistics (mean, standard deviation, coefficient of variation) were generated (Durugkar & Jondhale, 2026). Inferential panel regression analysis was then utilized to model the paths through a sequential mediation framework.

IV. Research Findings and Discussions

Table 1: Descriptive Statistics

Variable	Indicator	N	Mean	Std. Dev.	CV (%)	Skewness	Kurtosis
Corporate Governance	Board Size	587	8.540	2.516	29.47	0.21	2.89
	Board Independence	587	0.783	0.433	55.29	0.63	3.12
	Composite CG Score	587	4.662	1.475	31.63	0.18	2.94
Earnings Management	Total accruals	587	-6.70×10^9	3.29×10^{10}	490.30	8.41	94.30
Firm Performance	Tobin Q	587	1.607	0.078	4.83	-0.11	2.97

Source: Research Data (2025)

The descriptive results indicate that, on average, firms had a board size of 8.54 members ($SD = 2.52$), reflecting moderate variability. Board independence averaged 0.78 (78.3% independent directors), with a relatively high CV of 55.29%, showing substantial variations in compliance with best practice guidelines. For earnings management, measured using total accruals from the Modified Jones Model, the mean value was -6.70×10^9 , with a large SD of 3.29×10^{10} and a CV of 490.30%. The negative mean suggests a general tendency towards income-decreasing accruals during the study period. In terms of firm performance, the mean Tobin's Q ratio was 1.61 ($SD = 0.08$, $CV = 4.83\%$), indicating that listed firms were valued above their book value.

5.1 Overview of Trend Analysis

Trend analysis was employed to examine longitudinal shifts and directional movements of the key constructs over the ten-year period from 2014 to 2023. Evaluating these temporal patterns highlights systemic developments, anomalies, and turning points influencing the corporate landscape.

5.1.1 Trends in Corporate Governance

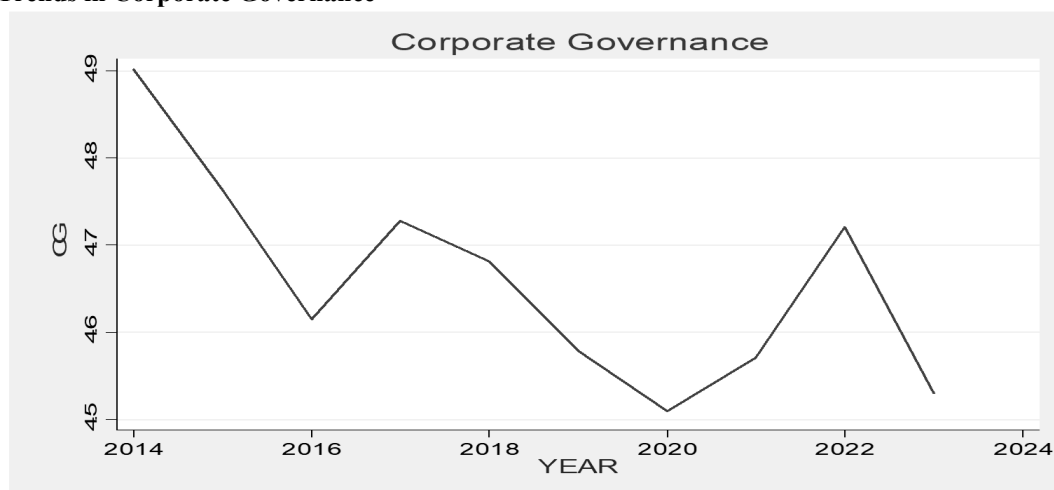


Figure 1: Trend in Corporate Governance among Firms Listed at the NSE

The mean corporate governance score commenced at a study period high of 4.9 in 2014, reflecting robust compliance fueled by early Capital Markets Authority (CMA) governance interventions. However, a steady downward trajectory materialized from 2015 (4.8) through 2020, bottoming out at 4.5. This compression indicates a gradual weakening in independent board composition, a pattern exacerbated in 2020 by severe COVID-19 operational disruptions that shifted firm resources from compliance monitoring toward operational survival.

5.1.2 Trends in Earnings Management



Figure 2: Trend in Earnings Management among Firms Listed at the Nairobi Securities Exchange

Analysis of financial reporting trends demonstrates a continuous reliance on downward accrual-based configurations across the entire 10-year horizon. Total discretionary accruals hovered around a baseline mean of -2.30 billion between 2014 and 2016, followed by an aggressive contraction to -6.26 billion in 2017 due to rising financial distress and performance-smoothing incentives. This defensive reporting behavior accelerated through the pandemic drop in 2020 (-8.95 billion) and reached an ultimate historical low of -18.70 billion in 2023. The compounding magnitude implies strategic managerial efforts to defer revenue recognition, mitigate taxation burdens, and flatten earnings volatility amid a tightening capital environment.

5.1.3 Trends in Firm Performance

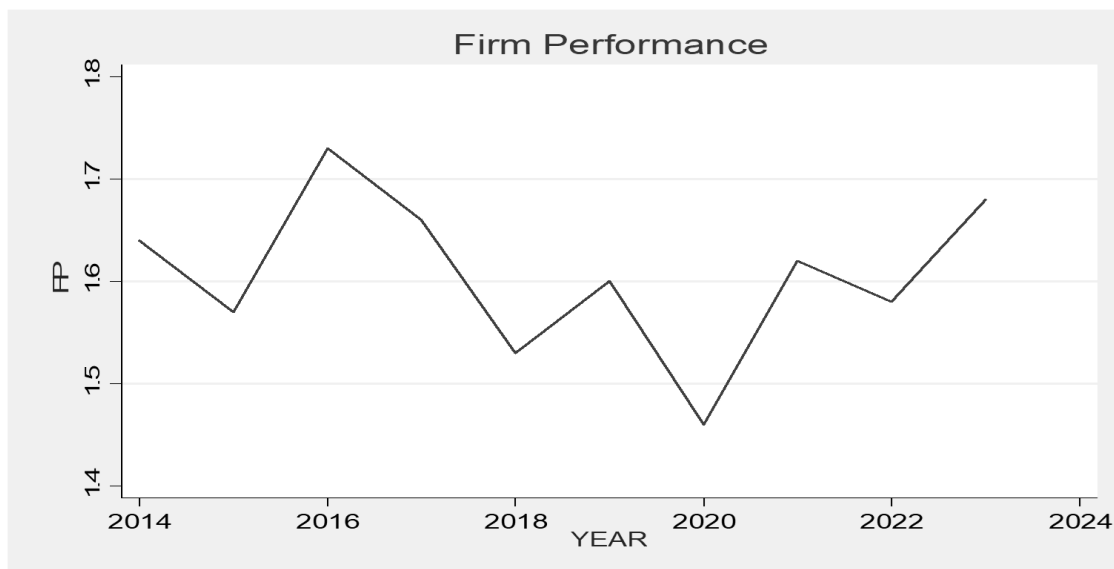


Figure 3: Trend in Firm performance among Firms Listed at the Nairobi Securities Exchange

Firm performance, captured via Tobin's Q, exhibited a fluctuating yet resilient trajectory over the review period. Initial investor optimism positioned the mean ratio at 1.64 in 2014 before a minor softening to 1.57 in 2015. Valuations staged a steady recovery to 1.62 by 2021, supported by digital integration and post-pandemic economic reopening strategies. Following a temporary dip to 1.58 in 2022 due to lingering global supply chain strains, Tobin's Q rebounded sharply to a study peak of 1.68 in 2023, signaling a major restoration of investor confidence regarding the long-term profitability and asset-utilization capacity of listed firms.

5.2 Correlation Analysis

Table 2: Pearson Correlation Matrix

Variable	CG	EM	FP
CG	1.0000		
EM	0.6371*	1.0000	
FP	0.8062*	0.8039*	1.0000

Note. CG = Corporate Governance; EM = Earnings Management; FP = Firm Performance. *Correlation is significant at the 0.05 level.

The correlation results revealed that corporate governance was strongly and positively correlated with financial performance, $r = 0.81$, $p < 0.05$, indicating that firms with stronger governance structures achieved higher performance results. CG also showed a significant positive correlation with earnings management ($r = 0.64$, $p < 0.05$). More importantly, none of the correlation coefficients exceeded the threshold of 0.85, indicating that serious multicollinearity concerns are unlikely to distort the regression analysis (Gujarati & Porter, 2009).

5.3 Regression Models and Mediation Analysis

Table 3: Mediation Analysis Results

Step	Effect Type	Path	β	SE	t	p	R ²	F-statistic
1	Total Effect path c	CG $\rightarrow$ FP	0.673	0.0204	32.96	0.000	0.650	1086.61, $p < 0.05$
2	Indirect effect path a	CG $\rightarrow$ EM	0.334	0.0167	19.99	0.000	0.406	399.62, $p < 0.05$
3	Indirect effect path b	EM $\rightarrow$ FP (ctrl CG)	0.779	0.0390	19.95	0.000	0.792	1111.08, $p < 0.05$
4	Direct Effect path c'	CG $\rightarrow$ FP (ctrl EM)	0.413	0.0204	20.21	0.000	0.792	1111.08, $p < 0.05$

Source: Research Data (2025)

Step 1 shows that corporate governance has a positive and significant total effect on performance ($\beta = 0.673$, $t = 32.96$, $p < 0.05$), with corporate governance accounting for 65.0% of the single-variable variance. Step 2 indicates that corporate governance positively predicts earnings management ($\beta = 0.334$, $t = 19.99$, $p < 0.05$). Step 3 and 4 evaluate the integrated models. Net of governance influences, earnings management exerts a strong positive effect on performance ($\beta = 0.779$, $t = 19.95$, $p < 0.05$). Importantly, when earnings management is explicitly controlled, the direct coefficient for corporate governance drops from 0.673 to 0.413 but remains highly significant ($t = 20.21$, $p < 0.05$). This specific reduction in magnitude without full attenuation confirms a state of partial mediation. The final model's combined R^2 of 0.792 indicates that 79.2% of the variance in performance is explained by these joint pathways. Consequently, the second null hypothesis is rejected.

VI. Summary, Conclusions and Recommendations

6.1 Summary of Findings

The results showed that the relationship between corporate governance and firm performance is positive and statistically significant, indicating that stronger governance mechanisms directly enhance firm performance. In addition, earnings management was found to partially mediate this relationship, suggesting that managerial reporting behaviors influence the transmission of governance effects on performance, while corporate governance also maintains a strong direct impact.

6.2 Conclusions

Corporate governance constitutes a fundamental driver of performance among companies listed at the NSE. The demonstrated positive and statistically significant relationship between governance quality and Tobin's Q reflects the critical role that well-structured governance mechanisms play in fostering firm value.

Furthermore, the revelation that earnings management partially mediates the governance-performance linkage adds a sophisticated layer of understanding. Rather than portraying earnings management purely as a manipulative practice detrimental to firm value, the partial mediation effect suggests a more complex reality whereby managerial discretion in financial reporting can complement governance objectives under effective governance regimes.

6.3 Recommendations

Managers and boards of directors must prioritize the composition and functioning of their boards by ensuring an optimal size that balances diverse expertise and decision-making efficiency, and by maintaining a high proportion of independent directors who can provide impartial oversight. Strong governance mechanisms are a strategic asset that fosters investor confidence, strategic agility, and ultimately superior market valuation as evidenced by the significant positive link with Tobin's Q. Listed firms must strengthen governance mechanisms and enhance transparency in financial reporting to ensure market integrity.

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