

The Role of Ownership Structure and Real Earnings Management on the Firm Performance of Non-Financial Firms Listed in Nairobi Securities Exchange, Kenya

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ABSTRACT: This study investigates the impact of real earnings management (REM) on firm performance and the moderating role of ownership structure among non-financial firms listed on the Nairobi Securities Exchange (NSE). Grounded in agency and stakeholder theories, the research examines how different forms of ownership specifically managerial and institutional shape the relationship between REM and firm profitability, measured through Return on Assets (ROA). Using panel data from 2008 to 2023, the study employs a dynamic panel regression model to control for firm-specific effects and potential endogeneity. The findings reveal that REM positively influences short-term profitability, but its effect is significantly moderated by ownership structure. Managerial ownership enhances overall firm performance but intensifies the negative impact of REM on ROA, suggesting potential overuse or ineffective application of REM strategies when managers hold significant equity stakes. Conversely, institutional ownership not only directly improves profitability but also weakens the positive impact of REM, reflecting its governance role in constraining opportunistic managerial behavior. These results highlight the dual influence of ownership structure in both enhancing firm performance and regulating earnings management practices. The study offers valuable insights for corporate managers, investors, and policymakers on the importance of tailoring governance mechanisms to mitigate REM risks and ensure sustainable financial performance.

KEYWORDS: Real Earnings Management, Ownership Structure, Firm Profitability

BACKGROUND INFORMATION

Earnings Management (EM) has emerged as a significant global issue, drawing increasing attention in financial literature (Ahmad et al., 2023; Alves, 2023). It is commonly employed by managers to influence firm valuation, enhance market perception, and maintain favorable share prices. Numerous studies indicate that managers may exploit EM during the financial reporting process to serve personal interests, often distorting the company's actual financial position (Mensah & Boachie, 2023).

Real Earnings Management (REM) specifically refers to managerial interventions in operational activities such as altering sales timing, production costs, or discretionary spending to achieve financial goals like meeting earnings benchmarks, stabilizing stock prices, or securing funding (Huong et al., 2023). In essence, REM involves real business decisions that influence reported earnings, distinguishing it from purely accounting-based manipulations. While such actions may help firms achieve short-term targets, they can either enhance or undermine long-term profitability.

Firm profitability, which represents a company's capacity to sustain earnings over time, is a vital metric of financial well-being. It reflects how effectively a firm generates income and is shaped by multiple elements such as sales growth, efficient cost control, and strategic capital investment (Aburishah et al., 2022). REM also plays a critical role in corporate transparency. When executed ethically, it reflects actual business operations and enhances managerial accountability. Through emphasizing authentic financial practices, REM can improve stakeholder confidence and the accuracy of performance evaluations (Mahmood et al., 2023).

Scholars like Nuanpradit (2019) and Alhmood et al. (2023) highlight that REM increases information asymmetry, investor risk premiums, auditor discomfort, and ultimately undermines firm value and post-SEO performance. REM is widely considered unethical and can severely harm a firm's profitability, productivity, and earnings quality (Fariha et al., 2022; Le & Nguyen, 2023). In extreme cases, it has been linked to firm collapse (Baskaran et al., 2020; Tohang et al., 2024). Moreover, because such

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manipulation can occur within the boundaries of generally accepted accounting principles (GAAP), detecting and addressing it remains a challenge (Kothari et al., 2016; Järvinen & Myllymäki, 2016).

Globally and locally, numerous corporate failures have been attributed to poor governance and earnings manipulation. In South Africa, MacMed collapsed due to fraudulent financial reporting and audit failures (Maroun & Cerbone, 2020). In Kenya, firms like Uchumi Supermarket, Mumias Sugar, and CMC Motors have faced financial distress linked to governance lapses and mismanagement (Madiavale, 2011; NSE, 2010). These cases reinforce the view that weak governance structures are associated with high levels of REM.

However, firms in sub-Saharan Africa, including those in Kenya, often face structural challenges such as limited access to capital, which constrains their ability to invest in growth initiatives. Coupled with political instability, these factors may adversely impact firm profitability and hinder the sustainability of earnings in the region. Ghaleb et al., (2021) opined that Real earnings management (REM) has increasingly drawn attention in both academic and practical contexts due to its impact on stakeholders and firm value.

Moderating Role of Ownership Structure

Ownership structure plays a crucial governance role by aligning the interests of managers (agents) and shareholders (principals). However, the separation of ownership and control often gives rise to agency problems, where managers may pursue personal gains at the expense of shareholders. Weak governance structures can facilitate REM (Mardny et al., 2018; Outa et al., 2017; Sirtaj, 2016).

Prior research shows mixed results on the relationship between ownership structure and REM. Some studies report a negative association, suggesting strong ownership curbs manipulation (Klein, 2002; Ali et al., 2008), while others find positive or no significant relationships (Abubakar et al., 2021; Alves, 2012). Alves (2012) concluded that different ownership types managerial, institutional, or foreign have varying effects on REM.

For example, Pham and Dang (2021) in the UK found that concentrated ownership increased REM, while institutional ownership reduced it. In contrast, family ownership showed no significant relationship. In Africa, Ayob and Mohammed (2020) found that higher operational cash flows were associated with better earnings quality, and Diaby and Douso (2020) reported that lower discretionary accruals correlated with higher earnings quality in Nigeria.

Ownership structure and debt financing play key roles in shaping real earnings management practices. Effective governance mechanisms especially audit committee oversight and creditor scrutiny are essential to curb managerial opportunism. Agency theory supports this view, arguing that principals must implement robust monitoring systems to align interests and reduce information asymmetry (Eisenhardt, 1989; Fama & Jensen, 1983). This study will therefore examine the moderating role of ownership structure on the relationship between real earnings management and Financial performance.

Empirical Literature Reviews

Firm profitability and real earnings management (REM) are key topics in finance and accounting, and have been widely studied in both developed and developing economies. For example, in Asia, Ghaleb et al. (2020) reported a negative and significant relationship between return on assets (ROA) and REM. Conversely, a study by Khuong et al. (2019) in Vietnam found a positive and significant association between ROA and REM. Reflecting these inconsistent findings, research by Darmawan et al. (2019) and Laurencia and Mulyana (2022) in Indonesia found no significant link between REM and profitability. In Europe, Owusu et al. (2020) observed a negative but significant effect of firm profitability on REM in a sample of 224 UK firms. Meanwhile, in Africa, studies such as that of Okoro and Ihenyen (2020) identified a positive and significant relationship between firm profitability and accrual-based earnings management. Similarly, Elkalla (2017), in a study of MENA region firms, found that profitability positively influences REM.

In South Africa, several studies (Mokwena & Gwangwava (2018); Nyamwanza & Mhaka (2019); Chinyamurindi & Mapuranga (2020)) supported a positive link between REM and firm profitability. However, Mutodi and Muzvidziwa (2020) reported a negative impact of REM on profitability among South African firms. In Tanzania, Ntim and Agyei-Boapeah (2019) documented a positive and significant relationship between REM and firm profitability. Conversely, Ahmad and Mghashi (2021) found that audit quality has a significantly negative influence on the relationship between REM and profitability.

In the Kenyan context, Shittu, S. A., & Oladipo, O. A. (2025) reported a positive impact of real earnings management (REM) on firm profitability within the manufacturing sector. Similarly, Mbatia and Waweru (2019) identified a significant positive association between REM and profitability. In contrast, Waweru and Karanja (2019) found a negative relationship between REM and profitability in the insurance industry. Supporting this, Shittu, S. A., & Oladipo, O. A. (2025). Karanja and Waweru (2020) also observed a negative effect of REM on firm profitability in the telecommunications sector. Furthermore, corporate governance

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significantly moderates the relationship between firm profitability and REM in Kenya's banking sector. Likewise, Karanja and Waweru (2020) demonstrated that audit quality has a significant negative moderating effect on the REM–profitability relationship.

Problem Statement

In Kenya, the literature on the relationship between real earnings management (REM) and firm profitability reveals mixed and inconclusive results across sectors. While some studies, such as those by Muriuki and Gikiri (2022), report a positive influence of REM on firm profitability, others, including Waweru and Karanja (2021), have documented negative effects in sectors such as insurance and telecommunications. This inconsistency signals a complex and context-dependent relationship that warrants deeper investigation.

One potentially critical, yet understudied, factor in this relationship is ownership structure, which may significantly moderate how REM practices affect firm performance. For instance, firms with strong institutional or foreign ownership may experience tighter financial oversight and improved transparency, thereby reducing the adverse effects of REM. Conversely, high managerial or concentrated family ownership might create room for opportunistic behavior, allowing managers to use REM to distort financial performance to meet short-term goals or preserve control, potentially harming long-term profitability.

Despite its theoretical importance, the moderating role of ownership structure including institutional, managerial, state, family, and foreign ownership has not been adequately explored in Kenya. This creates a significant gap in the accounting and finance literature, especially in the context of emerging markets where governance frameworks vary widely and may influence both REM practices and their outcomes. Therefore, further research is needed to disentangle the direction and strength of the relationship between REM and firm profitability in Kenya. Further to examine how ownership structure moderates this relationship across different types of ownership. This article provides empirical insights that inform policymakers, investors, and corporate managers on how to design effective ownership and governance structures to mitigate REM risks and enhance financial performance of non-financial firms listed in Nairobi Security Exchange.

Objectives of the Study

This article aimed to;

1. To disentangle the direction and strength of the relationship between real earnings management and firm profitability of non-financial firms listed in Nairobi Security Exchange.
2. To examine how ownership structure moderates this relationship across different types of ownership specifically institution and managerial.

CONCEPTUAL FRAMEWORK

The conceptual framework for this article is grounded in agency theory and stakeholder theory, which suggest that ownership structures influence managerial behavior, including earnings management practices, and ultimately impact firm performance. The framework proposes that Real Earnings Management (REM) directly affects firm performance, and that this relationship is moderated by ownership structure.

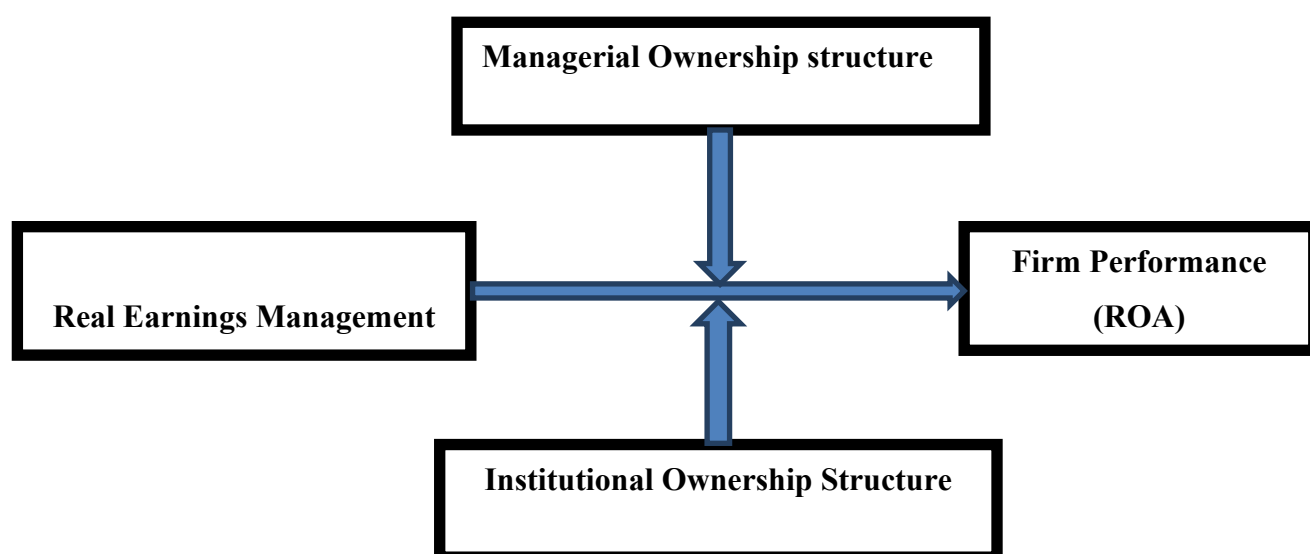


Figure 1: Conceptual Framework

Source: Author, 2025

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RESEARCH METHODOLOGY

Research Design: This study adopts a quantitative explanatory research design to empirically examine the causal relationship between real earnings management (REM) and firm performance, and how ownership structure moderates this relationship. The design enables the researcher to generalize findings to the population of Kenyan listed firms.

Target Population: The population comprised non-financial firms listed on the Nairobi Securities Exchange (NSE) between 2008 and 2023. Financial firms were excluded due to their unique regulatory and financial reporting frameworks, which may distort REM practices.

Sampling Technique and Sample Size: A purposive sampling technique was used to select firms that have consistent data on financial performance and have q detailed ownership structure information and also have operated throughout the study period (2008–2023).

Data Sources and Collection: The study used secondary panel data obtained from annual audited financial reports of the selected firms, NSE Handbook, Capital Markets Authority (CMA) and NSE websites and Firm websites for ownership structure disclosures.

Measurement of variables

Variables	Type	Measurements
Firm performance	Dependent	Accounting-based (ROA, ROE)
Real Earnings Management (REM)	Independent	Roychowdhury (2006) model: abnormal discretionary expenses, abnormal CFO, production costs
Ownership Structure	Moderating	% of shares held by: Institutional investors, Managerial insiders.

Model: The study employed panel model. The model considers a multiple linear regression for individual $i = 1 \dots N$ which is observed at several time periods $t = 1 \dots T$

$$y_{it} = \alpha + x'_{it}\beta + z'_i\gamma + c_i + u_{it} \dots \dots \dots 1$$

Where y_{it} is the firm financial performance(ROA), x'_{it} is a K -dimensional row vector of time – varying explanatory variables (real earnings management and ownership structure including the control variables)and z'_i is a M -dimensional row vector of time-invariant explanatory variables excluding the constant, α is the intercept, β is a K -dimensional column vector of parameters, γ is an M -dimensional column vector of parameters, c_i is an individual-specific effect (on each specific firm) and u_{it} is an idiosyncratic error term. It is assumed that each individual i is observed in all time periods t .

Specification of the Model: The study specifically used a dynamic panel model to evaluate the impacts of real earnings management moderated with and ownership structure on the firm performance of non-financial listed firms in NSE. This model allows for the analysis of both cross-sectional and time-series data, capturing the dynamics of change over time. The model is suitable for the study because, Dynamic panel models are used to analyse panel data where the dependent variable is affected by its own past values. This allows researchers to account for temporal dynamics, unobserved heterogeneity, and the potential endogeneity of explanatory variables (Greene, 2012). The model is given as;

$$Y_{it} = \alpha Y_{i(t-1)} + \beta_1 X_{it} + \gamma_i + \delta_t + \varepsilon_{it} \dots \dots \dots 2$$

Where;

Y_{it} = firm performance for firm i at time t

$Y_{i(t-1)}$ = Lagged dependent variable (previous period's firm performance)

X_{it} = Vector of independent variables (e.g. REM and ownership structure)

α = Coefficient for the lagged dependent variable

$\beta_1 - \beta_2$ = Coefficients for the independent and control variables

γ_i = firm-specific effects (unobserved heterogeneity)

δ_t = Time-specific effects (common shocks across firms)

ε_{it} = Error term.

For moderation analysis, the study used Barron and Kenny (2012) where the moderating variable (ownership structure) will be integrated into the model through interactions. The model used was;

$$Y_{it} = \alpha + \beta_1 X_{it} + \beta_2 Z_{it} + \beta_3 X_{1t} * Z_{it} + \gamma_i + \delta_t + \varepsilon_{it} \dots \dots \dots 3$$

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where $\beta_3 X_{1t} * Z_{it}$ measures the moderating role of ownership structure. The significance of β_3 at 5% significance level indicates the moderation effects.

FINDINGS

Managerial ownership structure has a strong, positive, and highly significant effect on ROA. This reflects the alignment of interests' hypothesis when managers are also owners, they are more incentivized to improve firm performance, reduce agency problems, and drive profitability.

Table 1: Moderation Effects of Managerial Ownership Structure

Firm Performance (ROA)	Coefficients(β)	95% CI	
Real Earnings Management (REM)	-0.071(0.012)***	-0.095	-0.046
Managerial Ownership Structure (MOS)	6.970(0.048)***	6.874	7.064
Interaction Effects (REM*MOS)	-7.130(0.093)***	-7.313	-6.947
Constant	0.004(0.001)***	0.001	0.006
F	8453.00		
P>F	0.000		
R-square	0.9840		
Adj. R-square	0.9839		

The interaction between REM and managerial ownership is negative and significant, suggesting that managerial ownership moderates the effect of REM on profitability negatively. This means that as managerial ownership increases, the negative impact of REM on ROA becomes even more pronounced. Managers are also owners, they may either be less dependent on REM to influence earnings, or use REM more aggressively, which backfires, reducing firm profitability further due to over manipulation or detection by stakeholders.

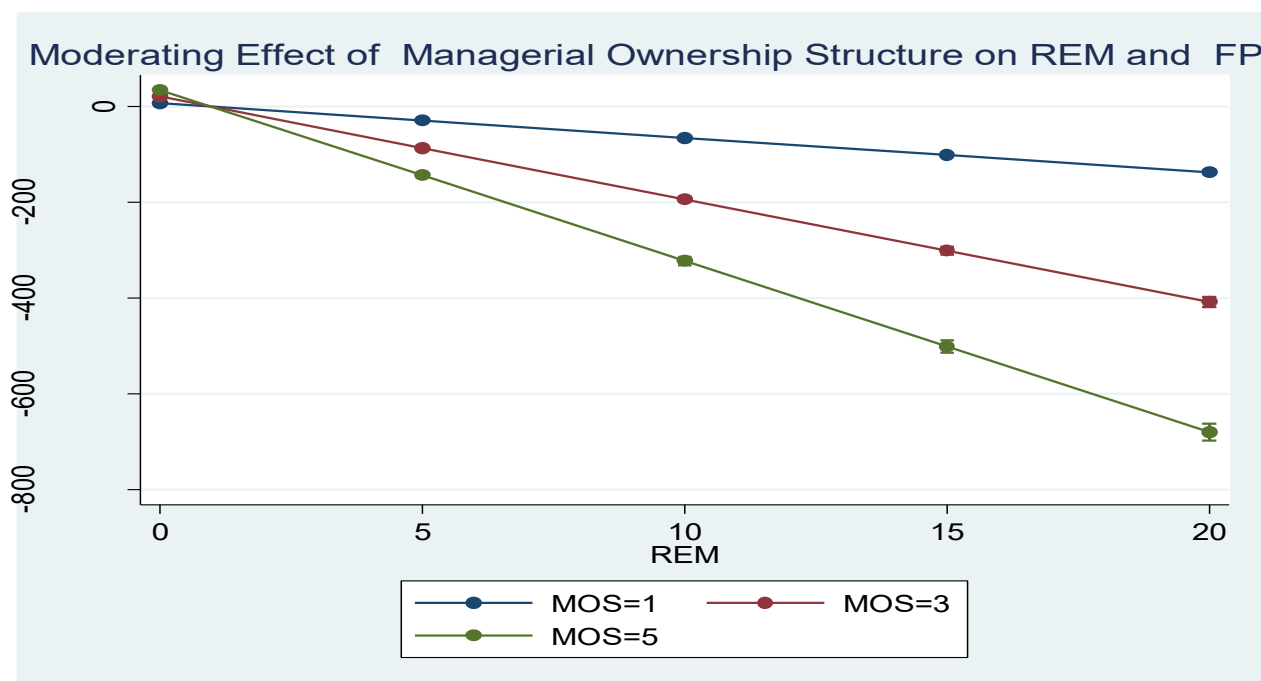


Figure 2: Graphical Representation of the Moderating Role of Managerial Ownership Structure;

Source: Study Findings

Real Earnings Management (REM) has a positive and statistically significant effect on firm profitability (ROA) among non-financial firms on the NSE. This suggests that such firms may use REM practices like managing production costs or discretionary expenses to temporarily enhance reported earnings. However, this may improve short-term profitability, the long-term implications may

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vary depending on the firm's governance structure. Firms with higher levels of institutional ownership tend to report significantly higher profitability. This suggests that institutional investors (e.g., pension funds, mutual funds, or investment firms) play a positive role in enhancing firm performance, likely through improved governance, pressure for efficiency, and oversight on managerial decisions.

On the other hand, the positive effect of REM on profitability is significantly reduced in firms with high institutional ownership. This suggests that institutional investors in non-financial firms listed on the NSE dampen the impact of earnings management practices, likely due to: Increased transparency requirements, Pressure for long-term performance rather than short-term earnings boosts, and Closer monitoring of financial reporting. Institutional ownership also has a strong, positive effect on ROA, suggesting that institutional investors bring better oversight, governance, and expectations for profitability.

Table 2: Moderation Effects of Institutional Ownership Structure

Firm Performance (ROA)	Coefficients(β)	95% CI	
Real Earnings Management (REM)	0.132(0.012)***	0.108	0.156
Institutional Ownership Structure (IOS)	1.154(0.014)***	1.128	1.181
Interaction Effects (REM*MOS)	-0.538(0.064)***	-0.663	-0.413
Constant	-0.0003(0.001)	-0.002	0.002
F	8274.95		
P>F	0.000		
R-square	0.9837		
Adj. R-square	0.9836		

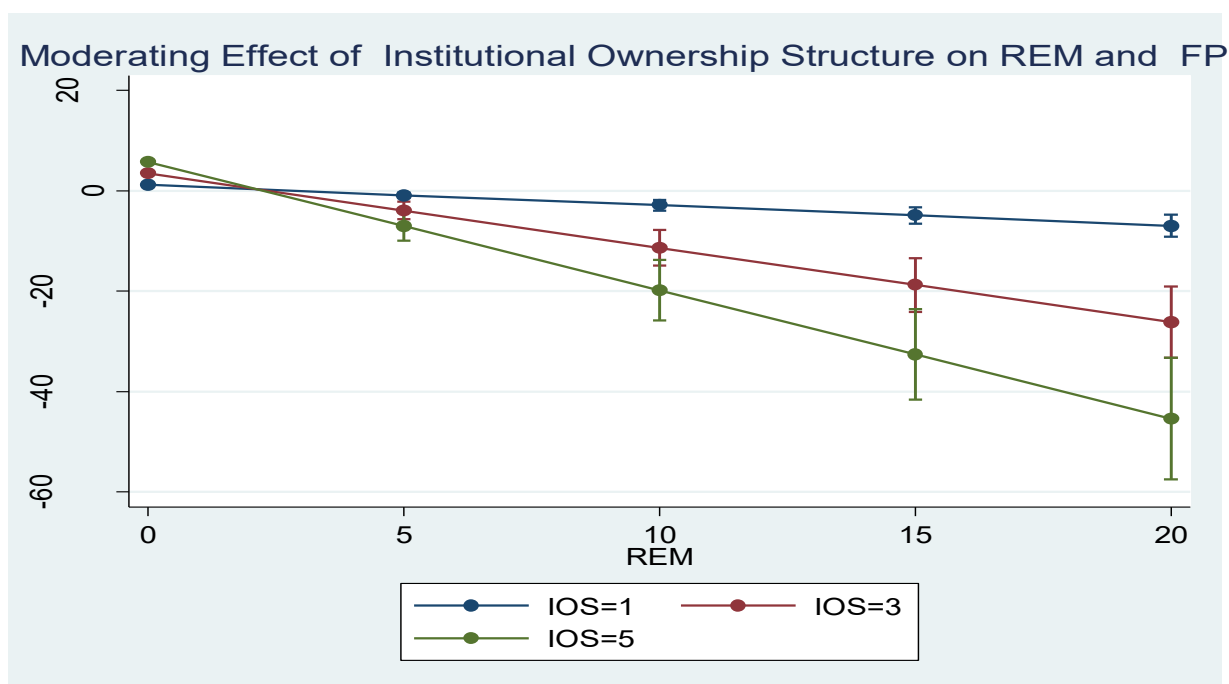


Figure 3: Graphical Representation of the Moderating Role of Institutional Ownership Structure;

Source: Study Findings

Institutional investors often closely monitor firm management and discourage opportunistic behavior, including aggressive REM. This reduces managers' freedom to engage in earnings manipulation, making REM less effective (or even detrimental) in improving reported profitability.

CONCLUSION

The regression results show that real earnings management (REM) has a significant negative effect on profitability (ROA) among non-financial firms listed on the Nairobi Securities Exchange (NSE). Conversely, managerial ownership structure (MOS) strongly and positively influences firm profitability, supporting the view that aligning ownership with control enhances performance.

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However, the significant and negative interaction between REM and MOS reveals that managerial ownership amplifies the negative impact of REM on profitability. This suggests that when managers have greater ownership, reliance on REM becomes more detrimental possibly due to excessive manipulation or reduced effectiveness of such practices under heightened internal control.

Furthermore, the findings reveal that Real Earnings Management (REM) significantly and positively affects profitability among non-financial firms listed on the Nairobi Securities Exchange (NSE). Institutional ownership structure (IOS) also exerts a strong positive impact on profitability, reinforcing the governance role played by institutional investors. However, the significant negative interaction between REM and IOS suggests that institutional ownership mitigates the influence of REM on firm profitability. This implies that institutional investors play a moderating role by limiting the extent to which managers can use REM to boost short-term performance, thereby promoting earnings quality and long-term value creation.

RECOMMENDATIONS

Managers of non-financial firms listed on the Nairobi Securities Exchange (NSE) should exercise caution in relying on REM strategies, particularly in firms with substantial institutional ownership, as such practices may be scrutinized or even penalized. Institutional investors play a crucial role in promoting sustainable firm profitability. Their presence as shareholders helps curb excessive earnings management, thereby encouraging more reliable and long-term performance outcomes. As a result of holding management accountable and insisting on high standards of corporate governance, institutional investors contribute to the overall health and transparency of the capital market.

Regulatory bodies such as the Capital Markets Authority (CMA) in Kenya, should promote increased institutional participation in firm ownership. Doing so would not only improve the quality of financial reporting but also serve as a mechanism to enhance earnings quality and corporate governance across the NSE. Institutional oversight can act as a deterrent to aggressive and potentially harmful financial manipulation practices.

Finally, investors both institutional and retail should be mindful of the interplay between ownership structure and accounting practices when assessing firm performance. Understanding how governance mechanisms influence managerial behavior is essential for making informed investment decisions and evaluating the sustainability of reported earnings.

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