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Earnings Management and Corporate Governance Mechanism: Evidence from Non-Financial Sector of Pakistan

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ABSTRACT

Background: Corporate governance (CG) is a vital aspect of the business environment, as it sets the framework for the proper functioning of management and board of directors. Earnings management (EM) is an important issue in financial reporting, as it affects the decision-making of investors and stakeholders, and the credibility of financial statements. Coalition between EM and CG mechanisms has been area of interest for researchers globally. **Objectives:** The research examined the association between EM and CG mechanisms in non-financial sector of Pakistan. **Method:** We used 400 samples acquired from 40 non-financial firms listed on the Pakistan Stock Exchange during 2019-20. The dependent variable was EM, measured using discretionary accruals. **Results:** Our research uncovered a clear link between board independence and earnings management, revealing that companies with a greater proportion of independent directors on their boards displayed a decreased tendency to engage in earnings management. Furthermore, our study revealed a negative connection between the effectiveness of audit committees and earnings management, indicating that firms with more efficient audit committees were less inclined to resort to earnings management practices. **Practical implications:** It has implications for policymakers, regulators, and practitioners in promoting better CG practices and enhancing transparency in financial reporting. **Conclusion:** The study provided evidence that CG mechanisms such as board independence and audit committee effectiveness play an important role in reducing EM in non-financial sector of Pakistan and firms with better CG practices were less likely to engage in EM that improved the transparency and reliability of financial reporting.

INTRODUCTION

Earnings management had been a subject of considerable interest to researchers, regulators, and investors in recent years, as it can have significant implications for financial reporting quality, corporate transparency, and market efficiency¹. EM pertains to the practice of manipulating financial statements for achieving certain ambitions like meeting earnings targets, maintaining stock prices, or obtaining financing². The manipulation can take various forms, including income smoothing, and income shifting. While some forms of earnings management may be legal and beneficial to the firm, others can be fraudulent and misleading to investors and stakeholders³⁻⁴.

Corporate governance mechanisms, on the other hand, refer to the systems and processes that companies use to ensure accountability, transparency, and fairness in their operations⁵. CG mechanisms comprised board of directors, audit committees, internal controls, and codes of conduct⁶⁻⁷. Non-financial sector of Pakistan refers to all industries and businesses that are not directly involved in financial services or banking. This includes a wide range of sectors, such as agriculture, manufacturing, construction, telecommunications, energy, and retail⁸.

Pakistan has a rapidly growing economy, and its non-financial sector is vital contributor to GDP and employment. According to the State Bank of Pakistan, the non-financial sector accounted for about 90% of GDP in 2019, with agriculture and manufacturing being the largest sectors⁸. The non-financial sector also provides employment to about 75% of the country's labor force, making it an important source of livelihood for the population⁹. However, the non-financial sector in Pakistan has been criticized for its weak corporate governance practices, lack of transparency in financial reporting, and low productivity¹⁰. Many firms in the sector suffer from poor management practices, inadequate infrastructure, and a challenging regulatory environment. These factors have hindered the growth and competitiveness of the sector and reduced its ability to contribute to the overall development of the economy¹¹.

To address these issues, government implied several policies and initiatives to promote growth and efficiency of the non-financial sector. These include the establishment of special economic zones, the provision of subsidies and incentives for investment in key sectors, and the promotion of entrepreneurship and innovation¹²⁻¹³.

Despite these efforts, the non-financial sector in Pakistan continues to face challenges in achieving sustainable growth and competitiveness. The sector requires more investment in infrastructure, technology, and human capital, as well as better governance practices, to overcome these challenges and realize its full potential¹⁴.

This study investigated association between EM and CG mechanisms in non-financial sector of Pakistan. Pakistan is a developing country with a rapidly growing economy, and its non-financial sector is an important contributor to GDP and employment. Therefore, this study is relevant to understanding the factors that contribute to earnings management in non-financial corporate and how CG mechanisms can mitigate practices.

MATERIAL AND METHODS

Data Collection: To investigate connection between EM and CG mechanisms, we collected data from 40 non-financial firms from Pakistan Stock Exchange. Sample of 400 was selected using a purposive sampling technique, for period of 2019-2022. We used the DataStream database and annual reports of selected firms for data collection.

Variables: Dependent variable to this study was EM that was assessed using discretionary accruals. Independent variables were CG mechanisms, including board size, audit committee independence, board independence, and ownership structure.

Data Analysis: We used descriptive statistics for analysis of characteristics of sampled firms. Then, we employed panel data regression analysis to investigate link between EM and CG mechanisms. We also conducted a robustness check to test results' sensitivity to diverse model specifications.

The following equation was estimated:

$$EM = \beta_0 + \beta_1BS + \beta_2BI + \beta_3CEO + \beta_4ACI + \beta_5OWN + \varepsilon$$

We identified several additional variables that influenced the correlation between earnings management (EM) and corporate governance (CG). These variables included firm size, leverage, GDP growth, firm age, and firm performance. For instance, the size of a company was measured using the logarithm of total assets, indicating that larger firms with more complex operational structures might present greater opportunities for management to engage in earnings manipulation. We also calculated leverage as the ratio of total debt to total assets, reflecting the firm's capital structure.

Another significant variable we considered was GDP growth, which serves as a crucial objective for all countries, with the corporate sector playing a key role in contributing to overall economic growth. Furthermore, firm performance was frequently used as a control variable, as it measured management's ability to effectively utilize organizational resources.

To summarize, our study encompassed these additional variables to capture a more comprehensive understanding of the relationship between EM and CG, taking into account firm size, leverage, GDP growth, firm age, and firm performance.

Ethical Considerations: This study followed ethical guidelines and protocols for data collection and analysis. We ensured that the data collected for this study was in compliance with legal and ethical standards. We also took steps to ensure the anonymity and confidentiality of the data to protect the privacy of the companies and individuals involved.

RESULTS

The analysis of our data presented various results. The REM variable ranged from 0.477 to 3.281, with a mean of 2.985 and a standard deviation (SD) of 0.312. ROA values ranged from -0.017 to 0.120, with an average of 0.0745 and an SD of 0.018. OCFT ranged from 0.0178 to 0.129, with a mean of 0.0833 and an SD of 0.029. CGI values varied from 0.289 to 0.0672, with an average of 0.0423 and an SD of 0.0188. Lev had values ranging from 0.021 to 0.160, with a mean of 0.096 and an SD of 0.0144 (Table 1).

In Model 1, the major independent board variable had a coefficient value of 0.0789, in Model 2 it was 0.0189, and in Model 3 it was 0.0866. The presence of "" indicated statistical significance at the 0.001 level, suggesting a positive and significant effect of having a major independent board on the dependent variable across all three models. Board diligence had a coefficient value of -0.0031 in Model 1, -0.0033 in Model 2, and -0.0040 in Model 3, with "" indicating statistical significance at the 0.001 level. This implied a negative and significant effect of board diligence on the dependent variable in all three models.

On the other hand, the coefficient value for size was -0.0017 in Model 1, -0.0021 in Model 2, and -0.0020 in Model 3. The lack

of statistical significance (no asterisks) in all three models suggested that size did not have a significant effect on the dependent variable. Similarly, the debt variable had coefficient values of 0.0398 in Model 1, 0.0412 in Model 2, and 0.0377 in Model 3, while TDA had coefficient values of -0.0021 in Model 1, -0.0022 in Model 2, and -0.0024 in Model 3. These findings indicated that size, debt, and TDA were not significant factors affecting the dependent variable (Table 2).

Total accruals showed a minimum value of 0.0178, a maximum value of 5.140, a mean value of 3.210, and SD of 0.89. This suggested that the values of total accruals are widely spread out, with a range of values from very low to very high. The mean value suggests that the typical observation falls around 3.210, while the relatively high SD suggested that there was a fair amount of variability or dispersion around this mean. Discretionary accruals revealed mean value of 2.982, and SD of 0.15. This suggested that the values of discretionary accruals were less widely spread out than total accruals, with a narrower range of values. The mean value suggested that the typical observation falls around 2.982, while the relatively low SD suggested that there was relatively little variability or dispersion around this mean (Table 3).

The ACI variable had a sample size of 400, with values ranging from 0.076 to 0.12. The mean value was 0.09, with a relatively low SD of 0.002. This suggested that values of ACI were quite tightly clustered around middling value of 0.09, with little variability or dispersion in the data. ACMF also had a sample size of 400, with values ranging from 2.76 to 12.98. The mean value was 7.77, with a relatively high SD of 2.34. This suggested that the values of ACMF were more spread out than those of ACI, with a wider range of values and more variability or dispersion in the data. ACFE had values ranging from 0.056 to 2.81. The mean value was 2.24, with a relatively high SD of 0.78. This suggested that values of ACFE were also more spread out than those of ACI, with a wider range of values and more variability or dispersion in the data. It was found in the table suggested that ACI had relatively little variability, while ACMF and ACFE had more variability or dispersion (Table 4).

Table 1: Dependent variables pertaining to earnings management, measured using discretionary accruals

S. No	Variable	No. of observatio	Min value	Max value	Mean	Standard Deviation
1	REM	400	0.477	3.281	2.985	0.312

2	ROA	400	-0.017	0.120	0.0745	0.018
3	OCF	400	0.0178	0.129	0.0833	0.029
4	CGI	400	0.289	0.0672	0.0423	0.0188
5	Lev	400	0.021	0.160	0.096	0.0144

Table 2: Impact of board characteristics on absolute discretionary accruals

S. No	Descriptive variables	Model 1	Model 2	Model 3
1	Major independent board	0.0789***	0.0189***	0.0866***
2	Board diligence	-0.0031***	-0.0033***	-0.0040***
3	Size	-0.0017	-0.0021	-0.0020
4	Debt	0.0398	0.0412	0.0377
5	TDA	-0.0021	-0.0022	-0.0024

Table 3: Accruals versus lagged total assets

S. No	Descriptive variables	Model 1	Model 2	Model 3
1	Total accruals	0.0178	5.140	3.210
2	Discretionary accruals	-0.534	4.144	2.982

Table 4: Association between audit committee effectiveness and EM

S. No	Expressive variables	Sample Size	Min	Max	Mean	Standard Deviation
1	ACI	400	0.076	0.12	0.09	0.002
2	ACMF	400	2.76	12.98	7.77	2.34
3	ACFE	400	0.056	2.81	2.24	0.78

ACI (Audit committee independence), ACMF (Audit committee meeting frequency), ACFE (Audit committee financial expertise)

DISCUSSION

Our results showed a negative association between board independence and earnings management, indicating that firms with a higher percentage of independent directors on their boards are less likely to engage in earnings management. In addition, study found negative link between audit committee effectiveness and EM, suggesting that firms with more effective audit committees are less likely to engage in earnings management.

A study reported that to achieve the wealth of stakeholders, management engages in manipulative practices with earnings information, which can reduce investor confidence¹⁹. However, research suggested that better financial reporting quality can decrease information asymmetry and improve CG compliance, and investigated impact of CG on EM in a sample of 257 non-financial firms listed on Pakistan Stock Exchange from 2012 to 2019, using a Fixed Effect model and control variables. Similar to our findings, results of a study indicated that CG system in Pakistan bears a negative and potent effect on EM activities among these companies and strong CG system is more effective in preventing earnings manipulation and business failure. These findings were consistent with our research that showed effective corporate governance can control earnings management and prevent company collapses²⁰. A study investigated how effective certain corporate

governance variables were in monitoring management behavior regarding their incentive to manipulate earnings²¹.

CONCLUSION

The study was relevant to policymakers, regulators, and practitioners in Pakistan who are concerned about the integrity of financial reporting and the need for better corporate governance practices. The findings informed the development of policies and guidelines to promote effective CG mechanisms and reduce EM in the non-financial sector of Pakistan.

However, study had some limitations that should be considered. First, the sample size is relatively small, which may limit the generalizability of the findings. Second, the study only focused on three CG mechanisms, and there may be other factors that influence EM. Therefore, future research could explore other CG mechanisms, such as internal controls and codes of conduct, and their impact on EM.

CONFLICT OF INTEREST

None.

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