The Impact of Corporate Governance on Earnings Management: Empirical Evidence from Pakistan

Muhammad Ilyas
Lecturer in Finance (PhD Scholar), Abdul Wali Khan University Mardan

Dr. Adnan Ahmad
Assistant Professor, Abdul Wali Khan University Mardan

Muhammad Tahir Khan
Lecturer, Abdul Wali Khan University Mardan

Ihtesham Khan
Assistant Professor, Abdul Wali Khan University Mardan

Abstract

To achieve their objective, firms may mask their true picture of financial positon. Moreover, firms' management may also be interested in hiding their private benefits of control, which is referred to Earnings Management (EM). They do so in order to avoid litigation from stakeholders due to non-performance. The extant literature offers solutions to this problem. For example, managements' interests need to be aligned with those of shareholders for undertaking profitable investment projects. Moreover, an efficient investor protection (IP) system also works as a controlling mechanism for such activities. Such regulatory and IP systems are called Corporate Governance (CG) that act as an important monitoring tool to mitigate the practices of EM. This study analyzing a panel data sample of 144 firms listed on Pakistan Stock Exchange (PSX) for the period 2007-16 through random effect model, the results suggests that such practices of EM can be lowered through a strong CG system. The results conclude that a strong monitoring system helps develop investors' confidence on the Capital Markets (CM) ultimately leading to strong economy.

Key Words: Corporate Governance; Corporate Governance Index; Earnings Management.

Introduction

Corporate scandals such as Enron, WorldCom, Parmalat, and Xerox in the late 20th and early 21st centuries again emphasized on the financial reporting quality of firms (Gul & Tsui, 2001). Such scandals led researchers to conclude that the disclosed firm financial information (FFI) needs to be accurate and reliable. Firms may disclose such FFI that may not reflect the true and economic value of the firm. Thus, management may indulge in masking the true picture of the financial performance of the firm or may hide their private benefits of control through such activities. The extant literature concludes that such activities lead to expropriation of the investors' funds resulting in an imbalance in the financial system resulting in corporate collapses (Habbash, 2010). Khan (2016) reports that EM practices in the world's capital markets (CM) shook the investors' confidence. However, these collapses not only affected the developed countries but also had a strong influence on the developing economies. For example, the Asian Financial Crisis (AFC) that started in 1997, many investors lost their investments in these Asian economies. Johnson et al. (2000) report that these economies were not only weak in their macroeconomic indicators but a major cause of the AFC was their weak regulatory system. Thus, in order to restore the confidence of the investors, different countries revisited their regulatory environment to protect their investors. Hence, Pakistan started its code of corporate governance in 2002. Other international aid agencies such as ***OECD*** and World Bank also helped in the strengthening of the regulatory environment in the developing economies (OECD, 1999).

Prior literature reports that the revised regulatory systems enhance the financial reporting quality. Firms started following a set of the finest rules and regulation to provide the best quality of FFIs to their stakeholders. For example, La Porta et al. (1997) report that a strong IP (hereinafter will be used as a synonym to CG) system not only regulate the CM of a country but also help understand improve the quality of FFI. Moreover, Bartov (2001) reports that strong IP system helps improve the quality of FFI through timely disclosure. Thus, a strong IP system and a detailed disclosure of FFIs help reduce the EM practices.

Since Pakistan is a Common Law country but possesses the characteristics of Code Law countries where CM are weak and IP is low. Pakistani firms have a strong concentrated ownership that may compel the managers to take such investment projects that are only beneficial to these owners. Since a weak IP system may weaken the disclosure of FFIs and

giving mangers the opportunity to manipulate the firm performance, thus an investigation to the level of EM practices in a weak IP system requires attention. Therefore, this paper empirically investigates the effect of IP systems on the EM practices of firms listed on PSX. The objective of this paper is to examine the impact of CG on the EM practices of companies listed on PSX for the period 2007-16.

Taking a sample of 144 firms from PSX for the period 2007-16, the panel-data techniques are used. The study controls for operating cash flow, leverage, capital expenditure and size of the firm. The results reveal that the association of CG and EM is negative and significant and hence implies that CG improves accounting quality by lowering EM practices. These results are in line with the extant literature on the association of CG and accounting quality. Corporate governance improves disclosures of FFIs through following accounting standards and other regulatory environment and thus reducing information asymmetry thus investors make informed decisions on these FFIs.

Review of Literature

Corporate governance (CG) and Earnings Management (EM) received much attention in recent years from academicians and regulators (Uadiale, 2012). This attention from researchers and regulators is due to the failure of large businesses around the world. Studies conclude that manipulation in the accounting information is one of the major causes of such accounting scandals. Thus, investors objected to the weak CG systems of not only these firms but also about these regions and reported an inefficient monitoring mechanism. For example, Johnson et al. (2000) report that one of the main reasons of the AFC was the inefficient CG system of these countries that not only led to AFC but also shattered the confidence of local and international investors.

Others report that these failures were either the result of accounting manipulation or due to the ineffective mechanisms of CG (Khalil, 2010). Such scandals led to an emphasis on the revision of CG system. These studies suggest that a more stringent CG system needs to be implemented to reduce the discretion of the management. For example, Bartov et al. (2001) report that revising and fine-tuning the accounting standards would not work without the implementation of rules and regulations. Such revision in the regulatory environment would lead to low levels of manipulation of earnings (Luez et al., 2003). They study 31 countries for EM and IP and find that countries with strong IP show low EM. The

premise is that strong CG system improves the FFI and enhances the monitoring system. Thus, management to avoid costly litigation abstains from manipulation of FFI (Bhattacharya et al., 2003). The results of these studies conclude that if CG is weak then management manipulates FFI for their own benefits (Alghamdi, 2012; Dechow, et al. 1996; Healy, 1985; Basiruddin, 2011).

CG is used as a safeguard against manipulation of accounting numbers, which is defined as;

> *"Structure whereby managers at the organization apex are controlled through the board of directors, its associated structures, executive initiative, and other schemes of monitoring and bonding" (Donaldson, 1990, p.376).*

Countries started revising their codes of CG and other relevant institutional arrangements in the wake of financial collapses such as Enron. Pakistan also followed suite and enacted code of CG in 2002. The premise behind the revision of these regulatory changes is to reduce the discretion of the management in reporting financial information and disclosures (Johnson et al., 2000). Managers in weak regulatory system do not report the actual performance rather they play with the accounting information (Luez et al., 2003).

The extant literature studies the association of EM with CG and report inconclusive results. For example, Ikechukwu (2013) examines the relationship of EM and CG practices in Nigeria. He reports that the internal mechanisms of concentrated ownership and smaller boards do not reduce EM. However, the external CG mechanism curtails EM practices. However, Epps and Ismail (2008) study EM and CG for US and find that smaller boards reduce EM. Others report negative results for EM and CG (Iraya, Mwangi, & Muchoki, 2015). The premise is that since CG helps improve the financial reporting quality reducing information asymmetry between the insiders and outsiders (Tanjung, Sucherly, Sutisna & Sudarsono, 2015).

Another strand of research investigates the association of CG with discretionary accruals for Bangladesh firms (Shamimul, Zabid & Rashidah, 2014). They report that dispersed ownership negatively affects EM since dispersed ownership elect independent directors that result in a strong monitoring system and thus managers avoid EM. Likewise, Patrick, Paulinus and Nympha (2015) examine the CG and EM in Nigerian listed firms during 2011-2014. The analysis show that CG negatively affects

the EM. Mulyadi and Anwar (2014) conclude that the impact of CG on EM is negative and significant.

Others report that sometimes instead of reducing or eliminating EM, CG encourages management to engage in such activities. For example, Tangjitprom (2013) finds that CG practices and EM are positively associated. They argue that though we report a positive association of EM with CG, the main role of CG is curtailing the management discretion of reporting earnings that does not portray the actual performance of the firm. They also report that not only CG is important but strong and efficient accounting standards are also important to avoid EM practices. Similar results of positive association of EM with board size, and board composition, are reported by Azzoz and Khamees (2015). However, duality of CEO, audit committee composition and activities are negatively related with EM.

Other studies argue that the existence of strong CG mechanisms in a firm can lead to improvements in professional conduct in business transactions limiting the opportunities for earnings manipulation (Clarke, 2007; Leventis & Dimitropoulos, 2012; Karamanou & Vafeas, 2005). In addition, Xiaoqi (2013) reports that EM practices are restricted through various factors such as quality of earnings as well as better disclosure of information becomes possible through implementations of good governance system.

The investigation of the association of CG and EM practices for Pakistan lacks research. However, some researchers have tried to investigate this association, but report contradictive results. For example, Kamran and Shah (2014) investigate the effect of CG and ownership concentration on EM. Their results show that EM increased in firms where directors and their family or relatives hold ownership. Their results also reveal no effect of CEO duality, audit firm size, board size and influence of ownership concentrations on EM. Shah et al. (2009) also study EM and CG for Pakistani listed firms. They report a positive relationship of these variables with EM. On the other hand, Latif and Abdullah (2015) study the association of EM with CG. Their results are also inconclusive. For example, they find that audit committee independence negatively affects EM while institutional shareholding and duality of CEO are positively related with EM.

Summing up, all these studies have used and mostly relied on using the standard proxies of CG such as board size, composition of the board,

number of independent directors in the board, audit committee, external and internal auditors. Moreover, these studies have used different companies and have used different time-periods and report contradictory results for this association. None of the studies used a comprehensive set of variables such as a CGI. The current study proposes to use a CGI that was initially developed by Javid and Iqbal (2010) but was used to investigate its effect on firm performance.

We believe that this index covers a whole range of different dimensions of an efficient CG system that are combined to measure a comprehensive score based on these three sub-indices. Moreover, the above reported studies have used different proxies for EM specifically many of them based their measurement on modified Jones model. Kothari et al. (2005) report that majority of these models have misspecification problems. This study uses a more recent model developed by Kothari et al. (2005) that takes care of the misspecification problems. In addition to this, the study is based on a more recent data set and CG system of PSX. Furthermore, the code of CG was also revised in 2012 that presents a stricter regulatory system of Pakistan. Summing up, this study investigates the association of EM practices with CG for Pakistani firms for the period 2007-16.

Research Methodology

This section presents the methods and methodology of the paper. It is reported that the population of this study includes all the non-financial firms listed on (PSX). The study period is from 2007 to 2016. This study period is selected since some of the data variables were not reported in the financial reports prior to 2007.

Sample and Sampling Technique

As stated above, the study uses data from all non-financial firms from PSX for the period 2007-16. The study uses panel data and is secondary in nature. A company is included in the sample if the data for that firm is available for the entire period of the study. Since the data prior to 2007 for some of the variables are not available, therefore the study is limited to the use of time-period from 2007-16. Once the bar for company inclusion in the sample is laid down, the sample size of the study is limited to only 144 companies. One of the reasons of the comparatively low number of companies is that annual reports of many companies are neither available on their respective websites nor with Securities and Exchange

Commission of Pakistan. However, since the time-period consists of 10 years, the total firm-year observations becomes 1440. The data for all variables is hand collected from the annual reports of the companies, which are downloaded from the companies' websites and Open Doors website. The CGI proposed by Javid and Iqbal (2010) is followed.

Data Analysis

The study uses univariate analysis and multivariate analysis techniques. Univariate analysis consists of descriptive statistics while multivariate analysis refers to correlational and regression analysis.

Panel Data Analysis Approaches

The data used in this research is panel in nature. Hence, used the approaches of panel data. Asteriou and Hall (2007) demonstrate that there are three different approaches of panel data estimations as; common, fixed and random effects methods.

Common Constant Method

Common constant or pooled OLS estimation method is based on the assumption that there are no differences among the data metrics of the cross-sectional dimension. However, this method of estimation having more restrictions. Therefore, fixed and random effects methods of estimations take into account (Asteriou & Hall, 2007).

The Fixed Effects Model

Greene (2000) for panel data use fixed and random effect approaches. Fixed model assumes that in regression model individual constant is group specific constant. However, to make a decision of model selection between common constant method and fixed effect method apply the F-test. If the F value is significant then pooled OLS applications are invalid for the model (Gujarati, 2003).

Random Effect Method

Greene (2000) random effect is the generalized least square approach, assume that individual constant is group specific disturbance.

Hausman Test

Asteriou and Hall (2007) report that to make choice between fixed and random effect model use Hausman (1978) test. Small value of

Hausman statistics decide to use random effect model instead of fixed effect model.

Regression Analysis

The study investigates the association of CGI with EM and control variables. Thus, the proposed model is.

$$EM_{it} = \beta_0 + \beta_1 CG_{it} + \beta_2 S_{it} + \beta_3 Lev_{it} + \beta_4 ROA_{it} + \beta_5 CFO_{it} + \beta_6 CE_{it} + \varepsilon_{it} \quad \textbf{(1)}$$

where EM is earnings management of firm i at time t; CG is the combined score of corporate governance index; S_{it} is Size of firm i at time t; Lev_{it} is leverage of firm i at time t; ROA_{it} is Return on Assets of firm i at time t; OCF_{it} is ratio of operating cash flow to total assets of firm i at time t; CE_{it} is Capital Expenditure of firm i at time t and ε_{it} is error term of firm i at time t.

Measurement of Variables

Earnings Management

The extant literature proposes different measurement techniques for EM. However, studies show that the proposed EM techniques has problem such as discretionary accruals of Jones Models and return on assets are positively and significantly associated (Dechow et al., 1995; Kasznik, 1999). Similarly, others such as Barth et al. (2001) and Dechow et al. (1995) demonstrate that due to correlation of normal accruals and firm past performance, a misspecification is experienced. Thus, a new model is developed that consists of an intercept and uses lag of return on assets to solve the problem of misspecification (Kothari et al., 2005), which is used in this study.

$$TA_{it} = \beta_o(1/Alag) + \beta_1(\Delta R_{it} - \Delta AR_{it})/Alag + \beta_2(PPE_{it}/Alag) + \beta_3(ROAlag) + \varepsilon_{it}$$

where TA_{it} is total accruals of firm i at time t; A_{lag} is lag of total assets; ΔR_{it} is the change of Revenue of firm i at time t; ΔAR_{it} is the change of Account receivable of firm i at time t; PPE_{it} is the property, plant and equipment of firm i at time t; ROAlag is lag of return on assets, and ε_{it} is error term of firm i at time t.

Corporate Governance Index

The CGI used in this study is adopted from the study of Javid and Iqbal (2010) who developed this index for non-financial firms listed on PSX. They develop the index using three different dimension of governance i.e., The Board of Directors (BoD), Ownership & Shareholdings (O&S) and Transparency, Disclosure, and auditing (Disc). They argue that these sub categories of the governance system comprehensively cover most of the fair disclosure determinants. For example, BoD covers the monitoring aspect of the firm's management; O&S refers to the shareholding and stake-holding aspect of the firm while Disc covers the financial reporting quality. This index is a combined score from the above three referred sub-indices that takes the score of 100 being the highest; 80 being the 75th percentile while 50 being partially observed otherwise takes the value of 0. Detailed description of CGI is given in Appendix A.

Control Variables

A number of control variables such as firm size measured as log of total assets (Llukani, 2013; Xiaoqi, 2013), leverage proxied by total debt over total assets (Cohen & Zarowin, 2010; Xiaoqi, 2013), CE taken as total capital expenditure over total assets (Conyon & He, 2011), RoA measure as net income over total assets (Cohen & Zarowin, 2010; Habbash, 2010), and operating cash flow (OCF) operating cash flows over total assets (Almasarwah, 2015; Habbash 2010) are used.

Results

It is reported that the study variables are not normally distributed. Moreover, correlational analysis reveal what is presumed in the study i.e. EM has a negative and statistically significant relation with CGI.

Descriptive Statistics of the Study

Table 1 *Descriptive Statistics*

Variables	Mean	Median	St. Dev	Minimum	Maximum
EM	-0.018	-0.012	0.841	-1.799	1.893
CG	78.114	78.571	7.812	57.143	100
LEV	0.551	0.559	0.222	0.007	0.999
Size	6.842	6.786	0.629	5.336	8.392
CE	0.708	0.716	0.335	0.000	1.476

ROA	0.063	0.057	0.112	-0.539	0.297
OCF	0.088	0.066	0.133	-0.193	0.39

Table 1 reports descriptive statistics summary of the study. It is reported EM does not have much variation across firms. For example, the mean and median values of the EM are almost similar suggesting that firms follow a similar pattern in reporting. It is reported EM does not have much variation across firms, suggesting that firms follow a similar pattern in reporting. Similarly, the code of CG is a mandatory requirement for each company listed on the PSX, thus a similar pattern is also visible in the summary statistics of the CGI variable. The variation reported for the CGI variable as shown by the standard deviation is because of the vast difference in the minimum and maximum values of the CGI. Furthermore, the adoption of this revised code of CG of Pakistan (2012) became mandatory for each company listed on PSX. The control variables summary statistics are similar in nature.

Correlations Results

Table 2 *Correlation Analysis*

	EM	CG	CE	LEV	ROA	OCF	Size
EM	1						
CG	-0.049	1					
CE	-0.175	-0.038	1				
LEV	0.065	0.025	0.265	1			
ROA	-0.071	0.082	-0.213	-0.483	1		
OCF	-0.034	0.034	0.037	-0.24	0.534	1	
Size	0.219	0.046	-0.217	0.037	0.049	-0.03	1

It is reported that EM is negatively associated with CGI. These findings suggest that due to good CG system, the activities of EM are reduced in listed firms in Pakistan. Thus, companies score high on the CGI as compared to the earlier years. CG code reduces EM and firms report a true economic picture. A theoretically expected result in the presumed directions are also evident for all the control variables.

Regression Analysis

Test for the OLS assumptions such as normality, autocorrelation and multi-collinearity, find that OLS is not a suitable regression technique for testing the relation of EM and CGI. OLS assumptions are reported in Appendix-B. Thus, this study analyzes the association of EM and CGI on panel data technique. Additionally, we test for the panel data techniques and find that random effect model (REM) is the suitable technique.

Table 3 *Random Effect Results of Corporate Governance and Earnings Management*

Dependent Variables: EM			
Variables	Coefficient	z-statistic	p-value
Constant	-1.033	-2.65	0.008
CG	-0.006	-2.09	0.036*
LEV	0.262	1.99	0.046*
CE	-0.451	-5.72	0.000**
ROA	-0.009	-3.44	0.001**
OCF	-0.743	-4.03	0.000**
Size	0.2498746	5.83	0.000**
Adj R-Square	0.0916		
Prob (F-statistic)	0.0000		

**p<.05. **p<.01 show the significant level of variables at 5% and 1% respectively.*

Table 3 shows that EM is negatively associated with CG as proxied by CGI. This result is significant with a p-value ≤ 0.05. These results suggest that CG acts as a monitoring tool to reduce the manipulation of the accounting information. These findings are in line with the stewardship theory that managers' act as agents of the principals and they take such decision, which are in line with the overall strategy of the firm. Others suggest that since CG reduces the problems that arise due to agency theory and that it assures that managers at on behalf of the shareholders, thus a strong CG system reduces the reporting discretion of the manger in reporting earnings.

Thus in summary, CG mechanism strengthens the monitoring base of the firms through BoD, ensures the efficient disclosure and accountability CG system and thus leads to low levels of earnings manipulation. Pakistan also have some form of concentrated ownership as well as some form of regulations exist, thus in the views of Shleifer and Vishney (1998), Pakistan must portray low levels of earnings management (Luez et al., 2003). These results are consistent with prior studies of (Amertha, Ulupui & Putri, 2014; Epps & Ismail, 2008; Habbash, 2010).

The results of control variables are also in line with the expected directions such as leverage is positively and significantly associated with EM since high leverage firms may engage in more manipulation of earnings as they need to show that such firms are making more profits. CE is negatively with EM and that this relation is significant. An increase in CE indicates that firms are expanding, which is a signal for the market. Similar results are reported for other control variables such as OCF negatively and significantly affect EM since OCF indicates that firms are generating enough cash.

Conclusion

We investigate the association of EM with CGI using a panel data from PSX for the period 2007-16 for 144 firms, the RE model results reveal that CG negatively affects the EM practices of Pakistani firms. These results suggest that Pakistan CM presents a strong CG system for its investors. Moreover, this strong CG system also ensures that financial reporting is in accordance with the adopted financial reporting standards and that Pakistani firms follow the same disclosure levels of accounting information. This financial reporting system not only improve the quality of financial information but also provide a conducive environment to its shareholders increasing their confidence and thus leads to more informed decisions.

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