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Does Corporate Governance And Corporate Social Responsibility Affect Earnings Management Practices?

Hasnain Manzoor*[1] , **Dr. Khuram Shafi**[2]

[1]*Ph.D Scholar, Department of Management Sciences, COMSATS University Islamabad Wah Cant, Pakistan. (Corresponding Author)* hasnain4343@gmail.com
[2]*Associate Professor, Department of Management Sciences, COMSATS University Islamabad Wah Cant, Pakistan.*shafikhuram@gmail.com
**Corresponding Author:* hasnain4343@gmail.com

Abstract

The study captures the impact of corporate governance characteristics and corporate social responsibility on the earnings management. Corporate governance mechanism in developing countries like Pakistan is not strong like that placed in the developed economies. To capture this unique context, the study collects data from the financial disclosures of the 196 non-financial firms. The results exhibit that having certain governance characteristics either good or bad do create a difference when finance managers decide to manage the earnings. It is found that the firms which have strong corporate governance mechanism and which perform CSR activities coupled with healthy financial status do not prefer managing their earnings.

Keywords: Earnings management, corporate governance, corporate social responsibility, Pakistan

Introduction

Effectiveness of corporate governance (CG) practices in developing and under developed countries has become a debatable issue from the last two decades. Extant literature poses that poor CG tends to lead not only the uncertain financing, inferior performance but also lead towards microeconomic downfall (Claessens et al., 2002). The existence of good corporate governance (GCG) reduces the conflict of interest which, if not addressed, may slow down the progress of firm's financial performance. Absence of GCG affects the information transparency negatively, which in turn declines the investors' confidence and lowers market liquidity ultimately. Relatively poor CG practices in the Asian markets, particularly in Pakistan, has caused the financial performance to grow with lower potential (Iqbal & Javed, 2017).

In developing economy like Pakistan there is a substantial lack of corporate social responsibility (CSR) activities. It is so because participation in CSR activities require more financial resources lowering ultimately the corporate profitability margin. Moreover, such firms focus on operational activities and utilizing the available resources fully to generate more profits. This business practice is largely followed in order to satisfy their shareholders rather than being socially responsible. Ownership structure in countries like Pakistan is characterized as concentrated in which majority shareholding is possessed by few members (Coffee, 2005; Rizwan, Obaid & Ashraf, 2018; Rizwan, 2019; Rizwan, Ahmed & Rasiah, 2018). In such scenario, preference of wealth maximization is evidenced over CSR activities when compared with the firms of developed countries where most of the firms contain dispersed ownership structure. However, absence of CSR reduces the financial performance of corporations in the long-run, particularly in a context where the entity is controlled by few shareholders (Saleh, Zulkifli & Muhamad, 2011).

Profit manipulations as unethical actions is observed more profound in the firms committing no CSR activities. It happens so because the firms preserve the long-run quality with the shareholders that applies the CSR activities in their business operations would not, therefore, indulge in earnings management practices (Gras-Gil, 2016).

Also, it is noticed in the literature that if the firms pursue CSR activities, the earning management is reduced. Interestingly earnings management actions are affected differently by CG and CSR considering different markets (Amiram et al., 2018; Chen & Lin, 2017). These two differing relationships with the earnings management and lack of consensus in the literature are another source of motivation studying them in a comprehensive model.

Literature Review

The established literature affirms that a significant but an adverse influence is generated by GCG mechanism on firm's earnings management. It is further added that in order to have more effectiveness of supervisory role of the BODs (board of directors), independence is required equally on high scale. According to the theme of agency theory, manager's think that independent directors are more watchful to agency issues. It is the primary responsibility of these independent directors on board to oversee the management's actions and conduct. GCG also explore the need of independent directors to strengthen their reputations as expert decision makers. Earning management can be avoided or limited by effective supervision. Effective supervision can encourage to management as an agent to act as good as possible in the best interest of the principal (Lee et al., 2012; Kamran & Shah, 2014).

It is, on the contrary, also observed that earnings management are not influenced by the firm's GCG mechanism. It is reasoned on the fact that merely the government rules and regulations are met in the shape of corporate compliance through enabling CG structure. It becomes ineffective and has less to do with supervising management actions (Hermiyetti & Manik, 2016).

Profit manipulation is considered as unethical actions and usually are rarely found in the firms practicing CSR activities. It may be reasoned possibly that they engage in long-term association with the investors. With the intention to build and sustain long-term quality relationships with investors, the firms intend not to indulge in earnings management (Gras-Gil, 2016). By focusing on transparency, CSR motivates the management to disclose the reports that outlay the actual results of the firms.

Earnings management can be driven through various factors such as personal gains of the Chief Executive Officer (CEO) (Ajina & Habib, 2017). Whereas in view of CSR, the CSR performance is determined by the personal values of the managers (Hemingway & Maclagan, 2004). Similarly, environmental and social practices are the results of beliefs and values of top management (Raymond et al., 2013).

Firms which are more socially tend to adopt long term relationships with its stakeholders rather than on focusing on increasing short term profitability (Choi et al., 2013). Stakeholders control resources which are compulsory for the survival of the firms. A manager who wants the continuous success of the firms, requires to pay attention to the requirements of the stockholders and satisfy them strategically (Choi et al., 2013). There are arguments given by the different authors which supports this empirical view and reveal that the firms that are more devoted to socially responsible activities engage less earnings management practices (Chih, Shen & Kang, 2008; Hong & Andersen, 2011; Choi et al., 2013).

The firms typically analyzed in the established literature mostly belong to Western countries and lacks the typical Asian perspectives.

Data and Methodology

This study undertakes listed firms in Pakistan Stock Exchange (PSX) with leading market capitalization. The study excludes financial, real estate and insurance firms from the sample because the rules and accounting principles of the said firms are different from the other sectors. Furthermore, the study does not include those firms whose data is not available. In order to draw the sample, the study applies Beneish M-Score model which resulted 196 firms.

Panel regression analysis is used to draw the analysis. Following is the mathematical form of the model applied.

$$\mathrm{EM_{it}} = \beta_0 + \beta_1\mathrm{IND_{it}} + \beta_2\mathrm{BGD_{it}} + \beta_3\mathrm{BS_{it}} + \beta_4\mathrm{ACM_{it}} + \beta_5\mathrm{ACF_{it}} + \beta_6\mathrm{INO_{it}} + \beta_7\mathrm{CEOD_{it}} + \beta_8\mathrm{DON_{it}} + \beta_9\mathrm{FP_{it}} + \beta_{10}\mathrm{CFO_{it}} + \beta_{11}\mathrm{LEV_{it}} + \beta_{12}\mathrm{DPS_{it}} + \beta_{13}\mathrm{FS_{it}} + \varepsilon_{\mathrm{it}} \ldots\ldots\ldots \text{Equation (1)}$$

Where: IND = Independent directors, BGD = Board gender diversity, BS = Board size, ACM = Audit committee meetings, ACF = Audit committee frequency, INO = Institutional ownership, CEOD = CEO duality, DON = Donations, FP = Financial performance, CFO = Cash flows from operations, LEV = Leverage, DPS = Dividends per share, and FS = Firm size

Descriptive Statistics

The study reports summary statistics in the form of mean, median, standard deviation, maximum and minimum values in the table 1 which are self-explanatory. The mean and median are measured to draw the central tendency of the model variables for 196 sampled firms. The standard deviation reflects the dispersion of each variable from the respective average value.

Table 1 Summary Statistics for Variables Characteristics

Variables	Mean	SD	Maximum	Minimum
Earnings management	.142	.015	.176	.095
Independent directors	.947	0.158	1	0.71
Board gender diversity	1.468	0.268	2	1
Board size	6.740	0.125	13	5
Audit committee members	2.611	0.421	5	1
Audit committee frequency	1.457	0.421	4	0
Institutional ownership	20.681%	4.535	36.45%	0
CEO duality	.279	.449	1	0
Donations	.031%	.014	.8%	0%
Firm performance	1.740%	.511	22.93%	-29.44%
Cash flow from operations	0.982%	.259	10.45%	-13.96%
Leverage	28.291%	0.215	57.68%	1.73%
Dividend per share	12.532%	1.925	23.19%	0%

Firm size	17.241	0.432	21.75	13.56

Correlation Matrix

The level of association between the pairs of variables is reported in table 2 along with the variance inflation factor (VIF). The results reflect that earnings management is associated negatively with the independent directors, board size, audit committee frequency, donations, firm performance, and cash flows from operations. However, it has a positive association with the audit committee members, institutional ownership, CEO duality, and leverage but at 5% level of significance. In addition, the VIF is reported in order to detect the presence of multicollinearity in between the explanatory variables. The results show a relative weak association among the explanatory variables and the VIF values are less than 10 which verifies the absence of multicollinearity.

Table 2 Correlation Matrix

		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
(1)	Earnings management	1													
(2)	Independent directors	-0.85**	1												
(3)	Board gender diversity	0.003	0.06	1											
(4)	Board size	-0.07**	0.06	0.04**	1										
(5)	Audit committee members	0.18*	-0.03***	0.05**	0.04**	1									
(6)	Audit committee frequency	-0.27**	0.02***	0.05	-0.04*	0.06**	1								

(7)	Institutional ownership	0.007*	0.04*	-0.02	-1.03**	-0.05*	-0.04	1							
(8)	CEO duality	0.06*	1.96***	0.15**	0.18**	0.07**	-0.03*	1.03***	1						
(9)	Donations	-0.03**	-0.04*	1.04**	0.02**	1.24**	0.07*	1.04***	0.02*	1					
(10)	Firm performance	-0.39**	0.02	0.32**	-0.02*	-0.41	1.03**	-0.04*	0.05***	0.00**	1				
(11)	Cash flow from operations	-0.22*	-0.31	-0.23	0.12**	0.04*	0.11	-0.35	0.22	0.56	-0.41	1			
(12)	Leverage	0.68*	0.39**	0.13*	0.03	0.65**	0.24*	0.65	0.24*	0.54*	0.32**	0.37***	1		
(13)	Dividend per share	-0.01	0.01*	-0.08	0.132	0.06	0.41*	0.01*	0.88	0.05	-0.37*	0.02	0.13*	1	
(14)	Firm size	-0.05*	0.07	0.14*	0.02*	0.10	0.04	0.03*	0.19	0.06*	0.24	0.11	-0.08	0.24*	1
	VIF		1.548	1.372	1.792	1.443	0.976	1.647	1.135	1.006	1.038	1.705	0.571	0.673	

Redundant Fixed Effect Test

The study applies redundant fixed effect test in order to determine the appropriateness of the model between panel least square (common effect) model and fixed effect model. The alternate hypothesis assumes the appropriateness of the latter model. Table 3 reports the findings obtained for redundant fixed effect test including significance of the cross-section effects only, period effects only and the significance of the both effects. As per findings, all the F score along with Chi-square in the aforementioned three scenarios are observed significant, thereby accepting the alternate hypothesis. In other words, the fixed effect model is noted to be appropriate. The results of panel least square model are reported in the appendix in table 6.

Table 3 Redundant Fixed Effect Test

Effects Test	Statistic	d.f.	Prob.
Cross-section F	4.080151	(16,137)	0.0000

Cross-section Chi-square	65.856573	16	0.0000
Period F	19.562778	(29,137)	0.0341
Period Chi-square	86.516249	6	0.0219
Cross-Section/Period F	3.207380	(25,137)	0.0000
Cross-Section/Period Chi-square	77.869513	25	0.0000

Hausman Test

The Hausman test is performed in order to evidence whether the random effect regression model and fixed effect regression model are different and that which model is more appropriate. The model assumes in its alternate hypothesis that the fixed effect regression model is appropriate.

The findings reported in table 4 reflect that Chi-square statistic is significant. This in turn verifies the appropriateness of fixed effect regression model by accepting the alternate hypothesis. The findings against random effect model are reported in the appendix in table 7.

Table 4 Hausman Test

Test Summary	**Chi-Sq. Statistic**	**Chi-Sq. d.f.**	**Prob.**
Cross-section random	94.825846	5	**.014**

Fixed Effect Model

The results of fixed effect regression model are reported in table 5. The fixed effect model here analyzes the causality of earnings management on corporate governance, corporate social responsibility and other control variables. The results in case of corporate governance all the characteristics except board gender diversity, audit committee members and institutional ownership do have a certain influence on the element of earnings management. Further, corporate social responsibility also determines the earnings management to some extent.

Table 5 Fixed Effect Test

Variable	**Coefficient**	**Std. Error**	**t-Statistics**	**Prob.**
Constant	11.841	2.820	4.191	**.000**
Independent directors	-.926	.459	-2.014	**.051**
Board gender diversity	-.794	.624	-1.272	.220
Board size	-.621	.281	-2.205	**.043**
Audit committee members	1.637	1.029	1.590	.132
Audit committee frequency	-1.065	.337	-3.154	**.006**
Institutional ownership	.723	.635	1.137	.273
CEO duality	.871	.416	2.093	**.053**
Donations	-.078	.038	-2.301	**.036**
Firm performance	-3.107	1.003	-3.096	**.007**
Cash flows from operations	-2.365	.855	-2.766	**.014**

Leverage	.481	.230	2.083	**.054**
Dividend per share	.054	.045	1.190	.252
Firm size	.003	.002	1.447	.168
Effects Specification				
Cross-section fixed (dummy variables)				
Period fixed (dummy variables)				
Adj. R^2	.402			
F-statistic	7.924			
Prob(F-statistic)	.000			

Dependent variable: Earnings management

Corporate Governance and Earnings Management

The independent directors do create a difference when the financial managers decide to manage their earnings in any form of the company's financial disclosure. It is noted that if the firms manage to enhance the proportion of these independent directors, the managers become less prone to manage their earnings. Similar findings are observed by Bansal, (2021). Although this discussion (including all the results) is not enough to simplify all the types of earnings management and the underlying financial & economic circumstances favoring earnings management, however it is negatively associated with the element of board independence.

In the same manner, if the firms possess larger board size, the earnings management is discouraged. The larger boards have more tendency to carry independence and a strong check on the policies of management, including the earnings management (Alareeni, 2018). The audit committees also play a vital role. Consistent to Sirait, Bukit & Kesuma, (2022), if the meetings are called frequently in a specific accounting period, the managers become less able to perform earnings management. Interestingly, if the CEO of a firm is also heading the board of directors, the firms undergo more earnings management. Possibly it can be explained as when the CEO plays a dual role, the management has more liberty to execute the policies they have planned in a way that getting approval of the same policies become more convenient. If the finance managers plan to do earnings management, it becomes smooth for them to do so (Nuanpradit, 2019; Rizwan & Chughtai, 2022).

Corporate Social Responsibility and Earnings Management

If the firms pour more funds in CSR activities, interestingly as per results they discourage to perform earnings management. What drives the finance managers to undertake such action? It can be justified in a way that those firms which decide to perform CSR activities are backed by healthy financial status. Such firms do not need to manage any item of the financial reporting. The study in case of control variables finds that if the firms are experiencing better financial performance, they are less prone to undergo earnings management as explained earlier in the CSR finding. The cash flows from operations reflect the cash performance of the firms in their operating activities. Both the indicators are consistent to Zimon et. al, (2021). At the end, if the firms are geared more with the debt source, they are more motivated to manage their earnings. Possibly it is so because when the firms experience more indebtedness their free cash flows face more pressure due to regular payments of interest. This eventually makes some of their financial indicators to have a declining trend. In order to overcome, the firms prefer managing such financial indicators to offer a better financial outlook to the key stakeholders (Nalarreason, Sutrisno & Mardiati, 2019).

Conclusion

The study aims to measure the impact of corporate governance characteristics and corporate social responsibility on the earnings management. Earnings management although is studied in different contexts with respect to its types, this study focuses on the one which is lawful. Corporate governance mechanism in developing countries like Pakistan is not strong like the developed economies. Also, the corporate ownership structure in developing countries is categorized majorly as concentrated. Under such ownership structure, the characteristics of corporate governance are different from the established literature in the context of dispersed ownership structure. In addition, the corporate culture of performing corporate social responsibility is not common when compared to the developed countries. The results suggest that having certain governance characteristics either good or bad do create a difference when finance managers decide to manage the earnings. Specifically, if the firms manage to enhance the proportion of their independent directors, the managers become less able to manage their earnings. If the firms have larger board size, the earnings management is discouraged. When the audit committee meetings are called frequently in a specific accounting period, the managers become less able to perform earnings management. Moreover, if the CEO of a firm is also heading the board of directors, the firms go through more earnings management. It is found that the firms which decide to perform CSR activities are backed by healthy financial status and they do not manage their earnings.

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Appendices

Appendix A:

Table 6 Panel Least Square (Common Effect) Test

Variable	Coefficient	Std. Error	t-Statistics	Prob.
Constant	15.441	4.263	3.622	**.002**
Independent directors	-.581	.267	-2.174	**.046**
Board gender diversity	-.654	.453	-1.443	.169
Board size	-.453	.176	-2.561	**.021**
Audit committee members	2.315	1.105	2.095	**.053**
Audit committee frequency	-.813	.248	-3.277	**.005**
Institutional ownership	1.044	.736	1.417	.006
CEO duality	1.587	.717	2.213	**.042**
Donations	-.045	.016	-2.731	**.015**
Firm performance	-2.432	.740	-3.284	**.005**
Cash flows from operations	-1.937	.658	-2.941	**.010**
Leverage	.839	.381	2.201	**.043**
Dividend per share	.134	.099	1.352	.196
Firm size	.017	.010	1.553	.141
Adj. R^2	.256			
F-statistic	9.297			
Prob(F-statistic)	.000			

Appendix B:

Table 7 Random Effect Test

Variable	Coefficient	Std. Error	t-Statistics	Prob.
Constant	12.870	3.097	4.155	**.000**
Independent directors	-.769	.340	-2.258	**.039**

Board gender diversity	-.717	.536	-1.336	.201
Board size	-.584	.256	-2.281	**.037**
Audit committee members	1.954	.924	2.113	**.051**
Audit committee frequency	-1.007	.338	-3.187	**.006**
Institutional ownership	.831	.689	1.205	.246
CEO duality	.944	.439	2.147	**.048**
Donations	-.069	.028	-2.455	**.026**
Firm performance	-2.835	.901	-3.144	**.006**
Cash flows from operations	-2.154	.762	-2.828	**.012**
Leverage	.603	.279	2.161	**.047**
Dividend per share	.085	.066	1.276	.221
Firm size	.007	.005	1.490	.156
Adj. R^2	.293			
F-statistic	12.637			
Prob(F-statistic)	.000			