# Corporate Governance And Earnings Management Evidence From Listed Non-Financial Firms

*by* Sri Utami Ady

# CORPORATE GOVERNANCE AND EARNINGS MANAGEMENT: EVIDENCE FROM LISTED NON-FINANCIAL FIRMS

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**Abstract:** The aim of the study is to investigate the influence of corporate governance on financial reporting quality in Pakistan and determine the role of political influences. The study uses a data sample of 260 publicly listed firms in the Pakistan stock exchange (PSX) during the period 2010 to 2019. For empirical analysis, correlation and multiple regression, the findings of the study suggest that corporate governance has positive and significant relation with the audit quality and political influences has negative significant relation with corporate governance. This implies that politically influenced firms have weaker corporate governance mechanisms. The results further suggest that corporate governance moderates the relationship of political influences with real earnings management. This means that politically influenced firms with stronger corporate governance mechanisms have better financial reporting quality as compared to politically influenced firms with weaker corporate governance. Since strong corporate governance curtails the negative impact of political influences on financial reporting quality, the onus is on the regulators to ensure a strong corporate governance mechanism in listed firms, particularly in politically influenced firms.

**Keywords:** Political Connections, Corporate Governance, Earnings Management.

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## Introduction

The following research paper is based on empirical investigation of the moderating influence of political influences and corporate governance on financial reporting quality in Pakistan, with a significant moderation effect identified. Political influences are established by firms through number of ways. For instance, firms establish links with politicians through political donations, cronies or major shareholders of firm(s) enter politics (Sadiq et al., 2019; Hashmi et al., 2018). Furthermore, firms appoint politicians and former civil/military bureaucrats on their boards of directors to accumulate political gains from their connections (Sadiq and Zaleha, 2017). However,

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this study considers a firm as politically influenced in existence of politicians or nearby associate of politician(s) in the organization; an existence of civil/military bureaucrat(s) in an organization; or an organization is mainly maintained by a politician(s). Prior research identified that politically influenced firms suffer fromseveral problems such as corruption, lack of investor protection, high risk and debts, poor organizational performance, operational inefficiencies, poor earnings quality, and high earnings management (Sadiq et al., 2019; Sadiq and Othman, 2017). In fact, political influences are commonly observed in countries where there is high level of corruption and less common in countries where strict regulations are enforced andthere is less occurrence of political conflicts with respect to its interests.
Politically influenced firms report poor financial reporting quality in comparison with the non-politically influenced organizations (Al-dhamari and Ismail, 2015). This is because; politically influenced firms obtain political gains through dubious legality, and then cover their gains through earnings management. Second, firms with political links are least bothered about detection by the authorities for poor financial reporting quality because they receive protection from politicians (Chaney et al., 2011). Third, firms report less taxable income because tax payments against managed earnings can only be possible with considerable political influence (Li et al., 2016). Moreover, politically influenced firms can gain strong benefits through other sources particularly from their easy access to finance and through lower taxation (Sadiq et al., 2019; Muposhi, 2019; Mokoena, 2019; Garidzirai et al., 2019), they are least bothered about reporting high earnings quality (Chaney et al., 2011).
Pakistan is also facing some of the above-mentioned issues. The financial reporting environment is less transparent and poor in Pakistan in comparison to the developed world. The poor quality of financial reporting has been linked to political influences and weak corporate governance structures (Arniati et al., 2020; Andayani and Daud, 2020; Szczepańska-Woszczyna, 2014). In addition to political influences, weak corporate governance is a reality in most emerging economies (Hashmi et al., 2018; Yarmoloyich & Chepel, 2019; Bae & Han, 2019; Peng & Chen, 2019; Meyer & Habanabakize, 2019), including Pakistan. Numerous studies have linked poor financialreporting quality with weak corporate governance, and this in turn has been linked to political influences. In contrast, some studies provide empirical evidence that strong corporate governance positively influences the quality of financial reporting (Lin and Hwang, 2010).
Sadiq and Othman (2017) found that corporate political connections influence the governance of firms which thereby enhances opportunities for manipulations of financial information. This research is based on agency theory, which highlights the lack of connection and association between corporate political influences, corporate

governance, and the quality of financial reporting. It is argued that any political influence is related to the effectiveness of governance mechanisms. The former facilitates the manipulation of financial information and poor financial reporting quality, and hence affects corporate wellbeing. Hence, the motivation for this study isto evaluate the relationship between earnings management and political influences after controlling for the corporate governance index. Further, we examined the role of corporate governance within the context of political associations and influences and their impact on earnings management.

This study extends prior research (Sadiq et al., 2019; Hashmi et al., 2018; and Chaney et al., 2011) in three ways. Firstly, this research is the first to use political influences as the moderating variable in corporate governance and earnings management with respect to Pakistan. This study which involved using the data of 260 non-financial organizations listed in the Pakistan Stock Exchange (PSE) from 2010 till 2019, found that implementation of good governance tends to prevent earnings management practices and hence improve quality of financial reporting while political influences tend to increase earnings management activities and have an adverse effect on financialreporting quality. Further, the findings of this study indicate that corporate governance moderates the impact of political influences on earnings management. Therefore, we provide deeper insights to policy makers and regulators in Pakistan and other developing economies, on the need to institute good governance practices.

## Literature Review

### *Political Influences and Earnings Management*

The fundamental objective of the managers is to maximize shareholders wealth. However, political influences divert managers from their fundamental objective because the presence of politically influential people on the board can lead to a major agency problem and therefore lead to a collapse as in case of Enron, hence the negativeimpact due to the presence of politically influential people. Further, the existence of politically influential people in organizations could increase window dressing activitiesin the annual reports and may not truly and faithfully represent value of firm and induce managers to selectively disclose the financial information. Prior studies (Sadiq et al., 2019; Hashmi et al., 2018) found that political influence within the organization weakens the internal control system which could worsen the situation and lead to inevitable losses. Consequently, cause agency problem and lead to poor disclosure and financial reporting quality (Sadiq & Othman, 2017; Al-Dhamari and Ismail, 2015; Isabirye & Moloi, 2019; Mokoena & Dhurup, 2019; Ortega-Toro et al., 2019; Portes etal., 2019; Kardas et al., 2019; Ozbasi, 2019; Munoz, 2019).

Some researchers (Belkaoui, 2004) argue that there is high tendency of income smoothing practices in firms with political connections and influence. They lack effective transparency and accountability mechanisms. Other researchers opine that political influences in state owned enterprises has also shown negative impact on transparency and quality of financial reports, as reflected by more income smoothing incidents in annual reports of state-owned enterprises (Sadiq & Othman, 2017). Numerous studies empirically show that political influences have positive relationship with earnings management, due to which the quality of financial reporting ultimately decrease (Sadiq et al., 2019; Al-Dhamari and Ismail, 2015). Hence, we hypothesize that:
H1. Political influences are related to poor financial reporting quality.

***Corporate Governance and Earnings Management***

The notion or construct of corporate is multifaceted and lacks a universally accepted consistent definition. Several researchers such as Lin and Hwang (2010) define corporate governance as a set of principles and mechanisms implemented to direct and control the decision-making processes in a firm in a way that managers always protect interest of the shareholders. Other researchers Liu and Lu (2017) opine that corporate governance provides directions to businesses and address the issues faced by different stakeholders.

The significance of corporate governance has been extensively discussed and explained in prior studies. There are studies that have employed multiple mechanisms of corporate governance and associated those mechanisms with earnings management as well as showed relationship with quality of financial reporting. Prior studies focused on relationship between audit committee characteristics, independent directors, and dominant individuals/groups in relation to the degree of earnings management in the firm. For example, Hamdan, et al., (2013) show that audit committee, independent directors increase financial reporting quality significantly. Whereas the presence of dominant individuals/groups tends to increase fraudulent practices including earnings management leading to low financial reporting quality. Further, Gul & Leung (2004) investigated the impact of CEO duality on quality of financial reports and suggested that CEO duality is negatively associated with transparency and financial reporting quality.

Moreover, extent literature investigated whether audit committee's characteristics affected earnings management and suggested that the former prevents earnings management and improve quality of the reporting. Rahman & Ali (2006) conducted an empirical investigation to evaluate the link between multiple corporate governance mechanisms such as board independence, board size, and CEO separation and earnings management practices. They reported that if there are effective mechanisms the tendency to use earnings management practices decrease.

In respect of corporate governance, previous investigations have discovered the interrelation existing between corporate governance and earnings management, but limited research is available measuring corporate governance via an index. An index encompasses numerous aspects of multifaceted corporate governance construct and provides better evaluation in the form of a score. Furthermore, in accordance with the agency theory, it can be assumed that if there is effective corporate governance in a business the degree of earnings management is likely to be low and limited or ideally eliminated.

H2. Financial reporting quality is interlinked with the Corporate Governance mechanisms.

H3. The relationship between Political influences and quality of financial reporting is moderated by Corporate Governance mechanisms

## Research Methodology

### *Data*

For this research paper, 260 firms that are listed in PSX have been selected as our sample for the years 2010-19. Thus, the total observations for the dataset are 2600. Only non-financial firms listed in PSX are included in the sample of this research in consideration to the requirements of the empirical data. Mainly the annual reports published by the companies were used to extract data from 142 non-politically influenced firms and 118 politically influenced firms. It covers the period of two elected governments which was formed after 9 years of military rule.

### *Measurement of Financial Reporting Quality (FRQ)*

REM measures of financial reporting quality has been used in this research in accordance with the earlier study conducted by Zandi, Sadiq, and Mohammad (2019). There is previous research that have also used this method where two proxies have been used. To capture the aggregate effects of REM, and to be congruent withprevious studies (Sadiq et al., 201[illegible]) we add the residuals of PRD and DIX.

First, managers manipulate earnings through reducing the discretionary expenditures, such as general and administration expenditures (SGA), and postponing research and development expenditures, which leads to abnormal level of discretionary expenditure (DIX) and the overstatement of reported income.

In order to determine the abnormal level of discretionary expenditures, the following equation has been estimated:

$$DIX_t = \beta_0 + \beta_1(1) + \beta_2(S_{t-1}) + \varepsilon_t \quad (1)$$

In the above equation $DIX_t$ represents abnormal level of discretionary expenditure recorded in year t and $S_{t-1}$ is sales revenue which is lagged as are the other variables.
Secondly, CoGS is reduced through the overproduction of goods by the managers to manipulate the earnings. This is because the fixed overhead is spread over larger number of products that results in abnormal level of production costs. It consequently leads to increase in the reported earnings. In order to capture the abnormal level of production costs, the following equation is presented by Roychowdhary (2006):

$$PRD_t = \beta_0 + \beta_1(1) + \beta_2(S_t) + \beta_3(\Delta S_t) + \beta_4(\Delta S_{t-1}) + \varepsilon_t \quad (2)$$

In the above equation, $PRD_1$ is the cost of abnormal level of production at the time t, St is sales recorded for the time period t, $\Delta S_t$ is the change in sales at the time t, $\Delta S_{t-1}$ is change occurred in the net sales which is lagged. All the variables in the above equation are lagged

***Measurement of Political Influences***

The presence of politician, bureaucrat, current or former military personnel or even a close relative of politician in a firm is considered a firm that is politically influenced in this research paper in accordance with prior research. In consideration to the studies conducted in past, this study measures political influences (PI) using an indicator variable, taking a binary number 1 for politically influenced firms through any aspect, and 0 for non-politicaly influenced firm. We add civil/military bureaucrat(s) as a new aspect in political influences to suit the context in Pakistan, because Pakistan was directly ruled by military dictators and bureaucrats for many years (Hashmi et al., 2018) Thus, an indicator variable (i.e., PI) is created to represent aggregate measure of political influences.

***Estimation model***

To analyse the impact of corporate governance on financial reporting quality by considering the moderating effect of political influences, other determinants that may influence the financial reporting quality should be monitored. Following previousstudies (Sadiq et al., 2019; Zandi et al., 2019), this study employed four controlvariables, which include financial leverage (LEV), return on equity (PERF), and audit quality (BIG4), and firm size (SIZE). Further, this study adds the baseline model to empirically examine whether financial reporting quality is impacted by political influence:

*Financial reporting quality = f (Political Influences; Firm Size; Firm Performance; Financial Leverage; Audit Quality).*

The above equation was empirically estimated, then the following regression model was developed from pooling together the sample firms:

$$FRQ_{i,t} = \beta 0 + \beta_1 PI_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 PERF_{i,t} + \beta_4 LEV_{i,t} + \beta_5 BIG4_{i,t} + \varepsilon_{i,t}$$

***Political influences, financial reporting quality, and Corporate Governance***

Corporate governance is found to have a positive impact over the quality of financial reporting by considering the moderating role of political influence, because good governance could curtail earnings management activities in a firm to a certain extent. Therefore, it is imperative to control corporate governance when assessing the association among financial reporting quality and political influences. Further, this study controls the regression model by including corporate governance as the moderating variable in the association between political influences and financial reporting quality.

This study then employed the aggregate corporate governance mechanisms to the baseline model:

*Financial reporting quality = f (Political Influences; Corporate Governance Mechanism; Firm Size; Firm Performance; Financial Leverage; Audit Quality).*

The econometric model specifications are as follows:

$$FRQ_{i,t} = \beta_0 + \beta_1 PI_{i,t} + \beta_2 CG_{i,t} + \beta_3 PI * CG_{i,t} + \beta_4 SIZE_{i,t} + \beta_5 PERF_{i,t}$$

$$+ \beta_6 LEV_{i,t} + \beta_7 BIG4_{i,t} + \varepsilon_{i,t}$$

## Results

### *Descriptive Statistics*

The statistical characteristics of different variables used in the research model are shown in Table 1. The mean values of the aggregate effect of REM are close to the mean value of Sadiq et al. (2019). The mean value for political influence is 0.45 which can be interpreted as that in the sample, 45% of the firms are politically influenced.The findings of this research are consistent with other researchers who have found that there is a large presence of politically influenced firms in Pakistan (Sadiq et al., 2019). For corporate governance mechanisms (CG), the mean value is 0.53, suggesting thaton average, firms in Pakistan only practice 53% of the items listed in the corporate governance index.

Moreover, the mean values for LEV, PERF, SIZE, and BIG4 of a Pakistani listed firm are 0.49, 4.36, 5.25, and 0.41, respectively. These mean values are close to the mean values reported in the existing literature (Sadiq & Othman, 2017). Overall, the descriptive statistics do not indicate any deviation from normality, thus there is no concern with the outliers.

**Table 1. Descriptive Statistics**

| Variable | Observations | Mean | Min | Max |
|---|---|---|---|---|
| REM | 2600 | 0.2082 | -2.8863 | 2.42 |
| PI | 2600 | 0.45 | 0 | 1 |
| CG | 2600 | 0.53 | 0.34 | 0.69 |
| LEV | 2600 | 0.49 | 0.01 | 0.78 |
| PERF | 2600 | 4.36 | -48.42 | 42.64 |
| SIZE | 2600 | 5.25 | 4.24 | 8.75 |
| BIG4 | 2600 | 0.41 | 0 | 1 |

## Correlations analysis

The correlation matrix is presented as Table 2 which shows the interrelationships and associations among the variables of the model. The negative correlation betweenpolitical influences (PI) and aggregate effects of corporate governance mechanisms (CG) suggest that politically influenced firms are unlikely to implement strong corporate governance mechanisms. The findings above show congruence with theagency theory and hence depict that there are more agency problems in firms influenced politically, an example of them is poor quality of financial reporting and ineffective governance system (Chaney et al., 2011).

LEV is positively correlated with PI, which reflects that firms with political influence can access loans easily. PERF is negatively correlated with PI, indicating that firm's performance tends to decrease with political influences. Further, BIG4 shows negative correlation with PI, which implies that firms with political influence are less likely to be audited by Big4 firms. Moreover, the results suggest that SIZE increases with PI. Previous studies (Sadiq et al., 2019) posited that large firms have better opportunities to gain political influence as compared to small firms.

**Table 2. Correlation Matrix**

| | REM | PI | CG | LEV | PERF | SIZE | BIG4 |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| REM | 1 | | | | | | |
| PI | 0.180* | 1 | | | | | |
| CG | -0.16* | -0.21* | 1 | | | | |
| LEV | 0.075 | 0.035 | -0.263* | 1 | | | |
| PERF | -0.252* | -0.224* | 0.084 | 0.0615 | 1 | | |
| SIZE | 0.179** | 0.155* | 0.266* | 0.183* | 0.164** | 1 | |
| BIG4 | 0.195* | -0.086** | 0.422* | 0.082 | 0.324* | 0.278* | 1 |

**Note:** *All variables are explained above.*

**Regression Results**

In table 3 regression analyses are presented which can be interpreted with the help of significance values and coefficient value. The p-value in the table below signifies that political influence of a firm tends to influence the quality of financial reporting in Pakistani firms. Moreover, as per the coefficient value of PI, it can be found that one unit of change in political influence can impact the financial reporting quality by 0.21 units. This finding suggests that the first hypothesis is accepted which means that the firms that are politically influenced report deteriorating financial reporting quality. On the other hand, there are certain researchers according to whom firms that are politically influenced are associated with higher earnings manipulation to escape regulatory requirements (Al-dhamari and Ismail, 2015).

The relationship between REM and corporate governance is found to be significant albeit negative. This result is in congruence with the second hypothesis of the study which states that companies that have improved and efficient corporate governance mechanisms have superior financial reporting quality. The findings can be related to the agency theory which implies that better financial reporting quality can be ensured if corporate governance mechanisms are strong. This is because companies with strong corporate governance do not engage in earnings management as it can tarnish their reputation.

Sadiq et al.'s (2019) results are similar to results in this research which also showed positive and significant influence of firm size on which mean that firms with larger size are more likely to be associated with REM. Similarly, as reported by Sadiq et al. (2019) the variable of leverage is also positively associated with REM because firms operating on high leverage have a stronger incentive to engage in REM. As reported by the study conducted by Zandi et al. (2019), the result of this paper also highlights a positive association of BIG4 with REM implying that if BIG4 are the external auditors of firms they are more involved in REM. Lastly, Table 3 indicate that PERF has a significant and positive impact on REM.

**Table 3. Linear regression results**

| | | Model 1 | | | Model 2 | |
|---|---|---|---|---|---|---|
| **REM** | **Coefficient** | **z** | **P>z** | **Coefficient** | **z** | **P>z** |
| **PI** | 0.2198 | 3.88 | 0.000 | 0.2442 | 4.11 | 0.000 |
| **CG** | | | | -0.3827 | 3.76 | 0.000 |
| **SIZE** | 0.0422 | 2.56 | 0.010 | 0.0431 | 2.57 | 0.009 |
| **LEV** | 0.2633 | 4.67 | 0.000 | 0.2974 | 4.82 | 0.000 |
| **PERF** | 0.0089 | 4.74 | 0.000 | 0.0096 | 4.76 | 0.000 |
| **BIG4** | 0.1848 | 3.59 | 0.000 | 0.2037 | 3.84 | 0.000 |

| | | | | | | |
|---|---|---|---|---|---|---|
| **Industry Effect** | | Yes | | | Yes | |
| **R-Square** | | 0.2912 | | | 0.3023 | |
| **Observations** | | 2600 | | | 2600 | |

***Political Influences and Financial Reporting Quality: The Moderating Effect of Corporate Governance***

In keeping with hypothesis 3, table 4 presents the results which indicate that corporate governance has a moderating impact on political influences (PI) and real earnings management (REM). Politically influenced firms with strong corporate governance demonstrate higher quality of financial reporting. The significant and negative coefficients of PI*CG indicate that strong corporate governance mechanisms reduce agency costs in politically influenced firms and improve the quality of financial reporting. In accordance with agency theory, the findings of this study suggest that strong corporate governance aligns the interests of managers (agents) and shareholders (principal) while reducing agency costs.

The findings of the current study are consistent with hypotheses and previous studies (Sadiq et al., 2020; Sadiq et al., 2019; Lin & Hwang, 2010; Liu & Lu, 2007) suggesting that implementation of good corporate governance curtail earnings management activities in firms, which leads to better financial reporting quality.

**Table 4. Linear regression results**

| | **REM** | | |
|---|---|---|---|
| | **Coefficient** | **z** | **P>z** |
| **PI** | 0.1949 | 3.65 | 0.000 |
| **CG** | 0.1098 | 1.15 | 0.188 |
| **PI*CG** | -0.4093 | -4.02 | 0.000 |
| **LEV** | 0.2135 | 3.89 | 0.000 |
| **SIZE** | 0.0669 | 3.67 | 0.000 |
| **PERF** | 0.0083 | 4.72 | 0.000 |
| **BIG4** | 0.1993 | 3.61 | 0.000 |
| **Industry Effect** | | Yes | |
| **R-Square** | | 0.3486 | |
| **Observations** | | 2030 | |

## Conclusion

The findings of this research have suggested that the firms that are politically influenced have poor financial reporting quality and standards as compared with firms that are not politically influenced. These findings are in accordance with agency theory

(Hashmi et al., 2018). Moreover, this research has also reported that improved quality of financial reporting is associated with strong corporate governance mechanisms. We also found from this research that corporate governance can significantly moderate the relationship of political influence and financial reporting quality. The results of this study have practical implications for regulatory bodies to increase both their monitoring and surveillance of politically influenced firms so that their reporting can be improved and there is no room for manipulation of earnings.

This research was focused on Pakistani firms that are listed in the Pakistan Stock Exchange. Considering the differing nature of various countries and their dynamics, the results of this paper cannot necessarily be generalized for other countries. Based onthese limitations, it is suggested that further research should be carried out based on cross-countries data in order to evaluate the differences in impact of political influence on the quality of financial reporting. It is also suggested that future researchers explore other variables such as earnings response coefficient, accruals earnings management, and earnings restatement.

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## ŁAD KORPORACYJNY I ZARZĄDZANIE ZYSKAMI: DOWODY Z WYMIENIONYCH FIRM NIEFINANSOWYCH

**Streszczenie:** Celem pracy jest zbadanie wpływu ładu korporacyjnego na jakość sprawozdawczości finansowej w Pakistanie oraz określenie roli wpływów politycznych. W badaniu wykorzystano próbę danych 260 spółek notowanych na giełdzie papierów wartościowych w Pakistanie (PSX) w latach 2010-2019. W przypadku analizy empirycznej, korelacji i regresji wielorakiej wyniki badania sugerują, że ład korporacyjny ma pozytywny i istotny związek z jakość audytu i wpływy polityczne mają istotny negatywny związek z ładem korporacyjnym. Oznacza to, że firmy podlegające wpływom politycznym mają słabsze mechanizmy ładu korporacyjnego. Wyniki sugerują ponadto, że ład korporacyjny łagodzi związek wpływów politycznych z zarządzaniem rzeczywistymi dochodami. Oznacza to, że firmy z wpływami politycznymi, posiadające silniejsze mechanizmy ładu korporacyjnego, mająlepszą jakość sprawozdawczości finansowej w porównaniu z firmami z wpływami politycznymi o słabszym ładzie korporacyjnym. Ponieważ silny ład korporacyjny ogranicza negatywny wpływ wpływów politycznych na jakość sprawozdawczości finansowej, na organach regulacyjnych spoczywa obowiązek zapewnienia silnego mechanizmu ładu korporacyjnego w firmach notowanych na giełdzie, zwłaszcza w firmach, na które wpływają polityki.

**Słowa kluczowe**: powiązania polityczne, ład korporacyjny, zarządzanie zyskami.

## 企业管治和盈余管理：来自所列非金融公司的证据

**摘要**：该研究的目的是调查公司治理对巴基斯坦财务报告质量的影响，并确定政治影响力 的作用。该研究使用了2010年至2019年期间在巴基斯坦证券交易所（PSX）的260家上市公司的数据样本。从实证分析，相关性和多元回归分析来看，研究结果表明公司治理与审计质量和政治影响与公司治理负相关。这意味着受政治影响的公司的公司治理机制较弱。结 果还表明，公司治理可以缓解政治影响与实际收益管理之间的关系。这意味着与具有较弱 公司治理的受政治影响的公司相比，具有较强公司治理机制的受政治影响的公司具有更好的财务报告质量。由于强有力的公司治理减少了政治影响对财务报告质量的负面影响， 因此监管机构有责任确保上市公司，尤其是受政治影响的公司具有强有力的公司治理机制。

**关键字：**政治关系，公司治理，盈余管理。

# Corporate Governance And Earnings Management Evidence From Listed Non-Financial Firms

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