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Financial Performance, Earning Management, and Corporate Governance: A Study of Selected Pakistani Non-Financial Firms

Quba Siddique[1]

*Ahmed Madi[2]

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Abstract

This paper investigates the impact of corporate governance and earning management has a direct effect on the performance of the financial performance of the firm. According to this paper, the sample data consist of 39 non-financial firms listed in Karachi Stock Exchange for the period 2011-2015, and 195 total firm year observations is used in this study. In this study, correlational research links the corporate governance instruments of board compositions, institutional shareholding, audit committee, audit score, and compensation of executives to the performance of the pre-managed firm. In order to achieve the objective of this study, the absolute discretionary accruals are used as the dependent variable and X1, X2, X3, X4, and D1 are used as explanatory variables. The results indicate that can examine that only firms' size significantly impacts the accruals and also, we analyze that there is a multicollinearity issue in the results. To resolve this issue, we use z-score values and again we run the test. The results again show that there is no multicollinearity issue and again only firm size has a significant impact on accruals. After it, we run the test a third time and here we can see that multicollinearity issue has been resolved. If we analyze the impact of variables on accruals again we can see that only the firm's size positively impacts on the accruals and the remaining variables do not impact the accruals.

Keywords: Earning management, Accruals, Firm Size BOD

1 Introduction

Investigations into the accuracy of financial reporting and an increase in the desire for improved governance procedures globally were triggered by the demise of once-respected businesses like

[1]Institute of Banking and Finance Bahauddin Zakariya University Multan
e-mail: qubasindhu@gmail.com
[2]CALCEE - Centro Árabe Latino de Cultura e Estudos Estratégicos
e-mail: corresponding author: akmadi@outlook.com

Enron and WorldCom (Abaalzamat et al. 2021; Al-Sulaiti 2022; Al-Sulaiti et al. 2021; Al-Sulaiti & Almwajeh 2007; Ismail et al. 2009; Sulaiti et al. 2006), which were involved in major corporate scandals (Akbarlou et al., 2021). Investigations into the accuracy of financial reporting and an increase in the desire for improved governance procedures globally were triggered by the demise of once-respected businesses like Enron and WorldCom (Park, 2022), which were involved in major corporate scandals (Babajee et al., 2022). The demise of once-respected businesses like Enron and WorldCom, who were implicated in major business scandals, led to investigations into the integrity of financial reporting and a rise in the desire for enhanced governance practices globally (Al-Sulaiti 2007; Al-Sulaiti & Baker 1998; Khalid & Baker 1997; Khalid & Fontenot 2004; Khalid et al. 2005). (Bowen et al. 2003, p.1) Most countries throughout the world have implemented new rules of best governance practices to match manager objectives with shareholders' goal of maximizing wealth (Al Halbusi et al. 2022; Jaffar et al. 2022; Jaffar et al. 2021; Mansourian et al. 2019; Zhuang et al. 2022) in order to prevent future business failures (Sharifirad et al., 2021). An efficient governance structure should link managerial choices (Balsalobre-Lorente et al. 2023; Jaffar 2020; Jaffar et al. 2019; Li et al. 2022; Shah et al. 2023), both operational and financial—to shareholder choices(Karimi Khorami & Farahmand, 2023). Best governance techniques have been introduced and modified in Pakistan, although little progress has been made (Ali et al. 2015; Jaffar 2020; Jaffar et al. 2019; Jawad et al. 2023; Jiakui et al. 2023). Many businesses in numerous economic sectors continue to face survival threats as a result of new instances of governance malfeasance (Lebni et al. 2021; Mohammadi et al. 2021; Mubeen et al. 2021; Shoib et al. 2022; Soroush et al. 2021). CG is a strategy used to reduce the agency cost caused by the conflict of interest between management and shareholders (Hafeez et al. 2023; Iorember et al. 2022; Local Burden of Disease 2021; Micah et al. 2023; Peter et al. 2017). Managers in modern businesses are in a privileged position where they can make decisions that may either align with or diverge from the firm's value maximization goal (Farzadfar et al. 2022; Liu et al. 2021; Moradi et al. 2021; Mubeen et al. 2020; Yu et al. 2022; Zafar et al. 2022).

Prior literature shows managers that have lack of professionalism just get to fulfill his goals exploit the company expenses that actually deceitfulness of the wealth of the shareholders (Aqeel et al. 2022; Ge et al. 2022; Hussain et al. 2017; Schmidt et al. 2022; Zhang et al. 2022). This is the fact accounting decisions are more relevant to the profitability, so, management are keener and more careful about this matter. According to the Bergstresser and Phillippon, 2006, most of the accountants use Accruals that is the instrument in accounting use for manipulating the transactions (Asad et al. 2017; Azadi et al. 2021; Li et al. 2022; Mubeen et al. 2021; Shuja et al. 2020). Benefits to use this is not any reflection in cash flows early.

The accuracy of a company's capacity to make investment decisions for investors and other stakeholders depends on the quality of its financial reports, which act as a mirror reflecting the success of the company (Aqeel et al. 2021; Azhar et al. 2018; Geng et al. 2022; Li et al. 2021; NeJhaddadgar et al. 2022; Zeidabadi et al. 2022). It is likely that managers will manipulate earnings within the regulatory framework to imply that they are competent managers because financial statements represent performance as well as managerial skill (Aman et al. 2022; Aqeel et al. 2021; Jaffar et al. 2019; Paulson et al. 2021; Toqeer et al. 2021). When managerial remuneration, such stock options and stock appreciation rights, is linked to company success (Jaffar et al. 2021; Rahmat et al. 2022; Wang et al. 2021; Yao et al. 2022; Zhou et al. 2021) , this aggressive accounting practice is much more obvious. (Bergstresser et al. 2006: Cornett et al. 2008). Management of earnings has the potential to harm a company's profitability and even the wealth of its shareholders (Aman et al. 2021; Khazaie et al. 2021; Mamirkulova et al. 2022; Pouresmaeil et al. 2019; Yoosefi Lebni et al. 2021). The conflict of interest between management and shareholders serves as the driving force behind misrepresenting the performance of a company (Aman et al. 2019; Aman et al. 2019; Fattahi et al. 2020). There have been some excellent studies examining the connection between CG and firm success in both developed and developing nations (Azizi et al. 2021; Hussain et al. 2021; Hussain et al. 2019; Lebni et al. 2020; Mamirkulova et al. 2020; Moradi et al. 2020). Several researches have examined the connection between opportunistic accounting or financial reporting quality and company governance structures (Anjum et al. 2017; Maqsood et al. 2021; NeJhaddadgar et al. 2020; Shuja et al. 2020; Yoosefi Lebni et al. 2020). The bulk of these research have demonstrated how strong governance frameworks can influence managers' discretionary conduct, leading to boards with more independent outside directors managing earnings less through irregular accruals. Independent directors, however, have been linked in several studies to excessive opportunistic accounting. Some studies have found a favorable correlation between audit committees and discretionary accruals, although the effects of audit committees on earnings management remain unclear. Institutional investors have also been studied, and it is believed that because of their power to supervise, correct, and influence managers, companies with significant institutional ownership are more likely to act in the interests of investors. Another crucial aspect of CG is executive compensation, as stock-based incentives have been linked to increased insider trading and earnings manipulation. It is widely acknowledged that CG significantly affects both company performance and earnings management, even if the direction and strength of the relationship between CG and corporate performance varies among studies. If earnings management isn't taken into account, the impact of CG systems on reported performance might just be marginal. Only a small number of studies have, to date, looked at how governance frameworks affect business performance after accounting for the impact of earnings management. (Cornett et al. 2008) discovered that accounting for the effect of earnings management greatly increases the relevance of governance characteristics and diminishes the significance of incentive-based compensation for company performance. Consequently, further research is needed to determine the true influence of CG on performance, both managed and unmanaged. According to earlier studies on CG and business performance, the CEO salary, audit committee, institutional ownership, and board composition all have an impact on corporate performance and earnings management. However, the majority of these studies were carried out in developing nations, which have different governance structures and regulatory frameworks than Pakistan. Additionally, there is a dearth of empirical data in the existing literature about how CG affects company performance in Pakistani firms. This study aims to investigate the relationship between CG and financial performance in Pakistani listed manufacturing firms, with a focus on board composition, institutional ownership, the audit committee, and CEO compensation. The study specifically hypothesizes that in Pakistani enterprises, pre-managed firm performance is not greatly impacted by CG. This study contributes to the body of existing literature by investigating the connection between CEO salary, CG, and firm performance when performance is modified to remove the discretionary component of accruals. It also includes growing economies like Pakistan in similar assessments done in developed nations. A review of pertinent literature, a discussion of methodological issues and the study model, a presentation and discussion of the results, and finally conclusions and recommendations based on the key findings make up the remaining sections of this essay.

2 Literature Review

According to Rashidah Abdul Rahman's 2003 research, the size of the board of directors is positively correlated with earnings management, showing that larger boards perform oversight functions less effectively than smaller boards. Using three definitions of earnings management and three estimation techniques, (Bhatt et al. 1996) evaluates the evidence for income-increasing and income-decreasing earnings management in distinct circumstances, such as financial organizations subject to regulatory restrictions. Last but not least, (Chang et al. 2008) looks into how company governance policies affect the caliber of financial information that is made available to the public.They discover that income increasing earnings management is adversely related to the presence of at least one member with financial expertise and a clear mandate for supervising both the financial statements and the external audit, while income decreasing earnings management is significantly related to specific governance practices by audit committees and boards of directors. 2013's (Ikechukwu) The author of this study looks into how CG practices and earnings management are related. Examined are two types of governance tools: internal (ownership concentration and board structure) and external (take-over pressure and institutional ownership). When other variables are taken into accountthe author finds that firms with stronger internal governance—such as greater ownership concentration and smaller boards—tend to engage in more earnings management, whereas firms with stronger external governance—such as larger institutional holdings and intense takeover pressure—tend to engage in less.

(2006) Hilary Better accounting data can lessen knowledge asymmetry between managers and outside capital sources, the author hypothesizes and shows, leading to more effective investment. Measures of accounting quality and investment-cash-flow sensitivity are found to be negatively correlated by (Bowen et al. 2003), indicating that enterprises with higher accounting quality are less affected by financing restrictions on investment. According (Hashim et al. 2008) research, both overinvestment and underinvestment are significantly and negatively correlated with accruals quality. (Dabor et al. 2009) Qiao Liu By introducing a tunneling viewpoint, this research investigates the connection between earnings management and CG in China. According to systematic differences in earnings management documented by the author between 1999 and 2005 among China's listed corporations, firms with greater degrees of CG had lower levels of earnings management. The author also points out two circumstances, both involving China, where companies have substantial incentives to manage earnings in order to reach predetermined return on equity (ROE) standards, and he provides proof of tunneling in each instance. The author's findings imply that agency conflicts between controlling owners and minority investors account for a sizable amount of profits management in China's listed corporations, though other explanations cannot be totally ruled out. 2009's Zhu and Tian. The authors discover that when business performance is modified to exclude discretionary accruals, the coefficient of CEO compensation considerably declines. Their data also suggest that, when actual performance is taken into account, board composition is more effective in enhancing company performance. (Cornett et al., 2008). The authors discover that controlling for the effect of earnings management dramatically raises the relevance of governance characteristics and significantly lowers the significance of incentive-based compensation for company performance..

3 Hypothesis

H0: Firm size has significant impact on discretionary accruals.

H1: Firm size has insignificant impact on discretionary accruals.

4 Methodology

The effectiveness of the pre-managed corporation is linked in this study by a correlational analysis to the CG tools of board memberships, institutional ownership, audit committee, audit score, and CEO remuneration. Absolute discretionary accruals are employed as the dependent variable in this study, and X1, X2, X3, X4, and D1 are used as the explanatory factors. In this study, 195 firm year observations total from 39 non-financial enterprises listed on the Karachi Stock Exchange between 2011 and 2015 comprise the sample data. Data is gathered from articles that have been published and the annual reports of the companies that have been chosen from the Karachi stock exchange website.

4.1 Model

$$Y_{1-3} = \alpha_0 + \alpha_1 X_{1it} + a_2 X_{2it} + \alpha_3 X_{3it} + a_4 X_{4it} + D_1 + \varepsilon_{it}$$

4.2 Explanation of Independent Variables

All the independent variables are explained as following below:

4.3 Board Composition (X1)

Board composition is used as independent variable and it is calculated as outside independent director over total board size (Hassan 2011).

4.4 Audit Committee (X3)

The audit committee is a further independent factor that the audit governance score takes into account. The audit committee's most often utilized governance features, such as its size, independence, and number of meetings, are added up to produce this score. To measure the strength of the board, this study follows the pattern of Shehu (2011) for calculating the governance score.

According to (Tehranian et al. 2006), Board of Director are considering a credible member of the organizations, that gives authority to the audit committee to increase organizational status in the market. As a result, sample companies with more than three directors on the audit committee are given a value of 1, and those without are given a value of 0.

Management, external auditors, and internal auditors are more likely to view an audit committee that is larger and has been given additional organizational status and authority by the board of directors as a reputable group, according to (Tehranian et al. 2006). As a result, sample organizations having more than three audit committee members are assigned a value of 1, while those without are assigned a value of 0.

The success of the board's oversight role, however, is reflected in how frequently the audit committee meets during the year. The frequency of meetings can be used to gauge the performance of an audit committee (Markchi et al. 2001). As a result, sample firms that met at least four times during the sample year are given a value of 1, while those that did not are given a value of 0.

4.5 Executive Compensation (X4)

Executive compensation is a second independent variable that is figured using the natural log of cash compensation. The primary focus of this study is total cash remuneration, which includes salaries and bonuses,

4.6 Firm Size (D1)

In order to limit the potential impact of firm size on the sample enterprises' discretionary accruals, the natural log of the total firm assets is employed to measure company size. The likelihood that a company will suffer an agency problem is typically higher for large firms. The large company has an edge since it has enormous assets and more opportunities to make enormous profits. They are more inclined to avoid management through discretionary accruals, according to Grey and Clarke (2004).

5 Results

The data is run on SPSS. First when we run the test we can examine that only firms' size is significantly impact on the accruals and also, we analyze that there is multicollinearity issue in the results. To resolve this issue, we use z-score values and again we run the test. The results again show that there is no multicollinearity issue and again only firm size has significant impact on accruals. After it we run the test third time and here we can see that multicollinearity issue has been resolved. If we analyze the impact of variables on accruals again we can see that only firm's size is positively impact on the accruals and remaining variables are not impact on the accruals.

Table 1

Variable	P value	Sig/insig.
Board size	.999	Insignificant
Audit committee size	.686	Insignificant
Audit committee meeting	.169	Insignificant
Board composition	.461	Insignificant
Firm size	.038	Significant
Ind BOD	.506	Insignificant

After analysis on the result, it can be seen that firm size is significantly impact on the accruals of the companies and it also indicates the positive relationship with the accruals. If we examine the Board size, Audit committee size, Audit committee meeting, Board composition and Independence of Board of directors, it shows that all that variables are insignificant.

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Appendix

Table 1

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.186[a]	.035	.030	341.59

a. Predictors: (Constant), Z-score (Firm Size)

b. Dependent Variable: Discretionary Accruals

Table 2

ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	803.00	1	803.000	6.898	.009[b]
	Residual	224.00	193	116.000		
	Total	230.00	194			

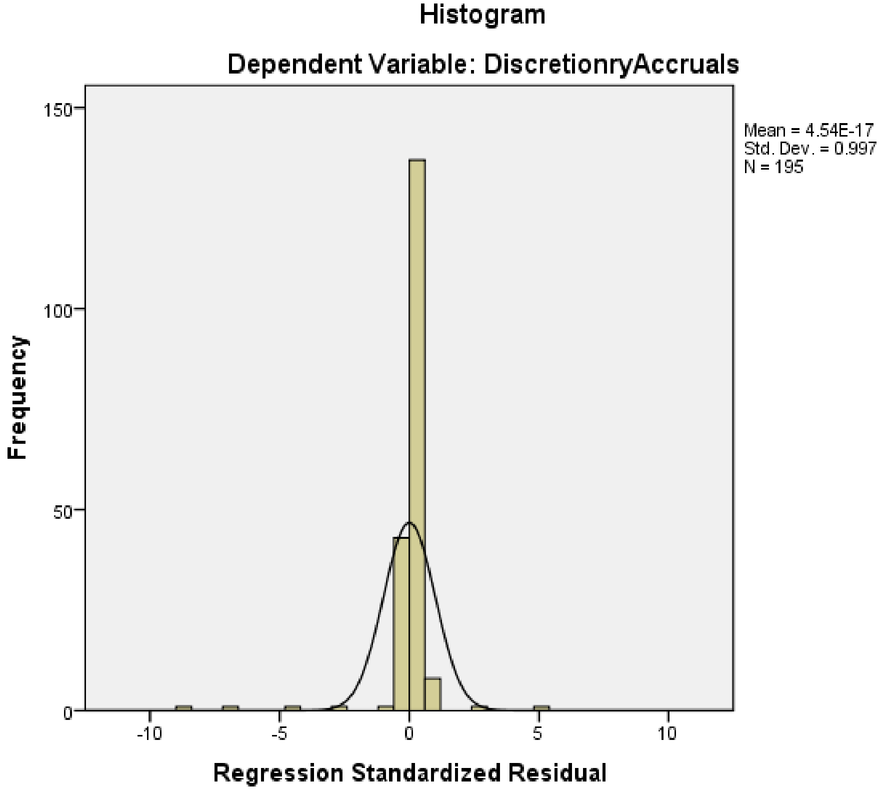
a. Dependent Variable: Discretionary... Accruals

b. Predictors: (Constant), Z-score (Firm Size)

Table 3

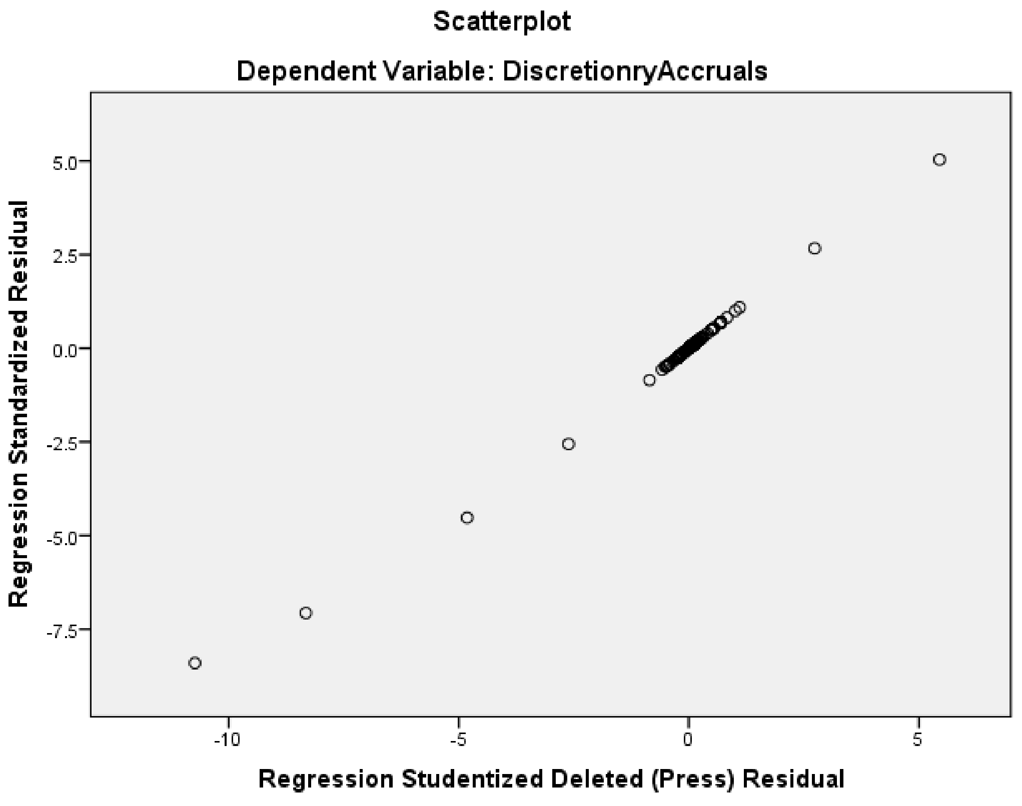
Coefficients									
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Correlations		
		B	Std. Error	Beta			Zero-order	Partial	Part
1	(Constant)	367.95	244.63		-1.502	.135			
	Zscore(FirmSize)	643.10	245.91	-.186	-2.626	.009	-.186	-.186	-.186

a. Dependent Variable: Discretionary Accruals



This histogram graph shows that our collect data is symmetric which means data is normal and does not have abnormality. But all though data is normal except firm size, not any other variables are significantly influence the discretionary accruals.

And scatter plot also shows that data does not have as much outlier only 5 outliers are present in the data and all other data is in a line. This indicates that our data does not have any issue.


Scatterplot
Dependent Variable: DiscretionryAccruals
Regression Standardized Residual
5.0
2.5
0.0
-2.5
-5.0
-7.5
-10
-5
0
5
Regression Studentized Deleted (Press) Residual