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Corporate Governance and Earnings Management: Does Family Matter?

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Abstract

This article examines the impact of corporate governance mechanism dimensions on earnings management in family and non-family firms listed in Pakistan from 2011 to 2019. Earnings management is proxied by accrual earnings management and measured by Performance Matched Jones Model. Two way clustered ordinary least square technique is used to estimate the coefficients of four corporate governance mechanism dimensions. Further, t-test is used to compare the coefficients of governance mechanism dimensions for family and non-family firms. Results of the study show that corporate governance mechanism dimensions play significant role in reducing earnings management. But in family firms the impact is insignificant, except for board size. Furthermore, results also suggest that the impact of corporate governance mechanism dimensions is significantly different on family and non-family firms.

Key words: Earnings management, corporate governance, family firms

Introduction

Many stakeholders consider earnings of a firm as an important factor while they are making decision regarding investment, financing and/or contracting with the firms (Kothari, Mizik & Roychowdhury, 2012; Cohen & Zarowin, 2010). Accounting rules provide space to management to manipulate earnings by utilizing different accounting methods (Healy & Wahlen, 1999; Dechow & Skinner, 2000). This manipulation of earnings is known as earnings management (Healy and Wahlen, 1999). After the introduction of earnings management (EM) in 1953 by Hepworth (Hepworth, 1953), it has received considerable attention of researchers (Assenso-Okofo et al., 2021; Nguyen et al., 2021; Pipatnarapong, 2020; Saeed et al., 2019; Shahzad et al., 2017; Zang, 2012; Cohen & Zarowin, 2010; Roychowdhury, 2006). Many models have been

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developed by researches to detect EM practices by the firms, including DeAngelo model (DeAngelo, 1986), Jones model (Jones, 1991), modified Jones model (Dechow et. al., 1995), performance matched Jones model (Kothari et. al., 2005) and some others. This shows the importance of EM in corporate finance literature. Management involves in earnings management to achieve their objectives like, to show reported profit (Duong, 2020), to decrease tax liability (Pipatnarapong, 2020), to attain forecasted earnings by analysts so that to influence the market price of shares (Das et al., 2011). Furthermore, researchers also document that management of firms involve in EM activities to get more compensation from firms in the form of increased salary and performance based bonus (Assenso-Okofo et al., 2021). EM practices may be considered lawful because accountants manage earnings by using the space provided by accounting rules. But, earnings management practice is considered unlawful, because management manipulate earnings by breaching the accounting as in the case of Enron scandal (Sterling, 2002), or by not complying the governance rules.

To control this unlawful or at least unethical conduct of management, corporate governance rules have been devised and implemented in maximum countries of the World. At one side, studies document that EM reduced after the implementation of corporate governance (Alzoubi, 2019; Al-Sraheen & Al-Daoud, 2018; Zalata, 2018), but on the other side, studies also document that corporate governance rules have no significant impact on EM (Inya et al., 2018; Katmon and Farooque, 2017; Fuzi et al, 2016). Studies also document that some dimensions of corporate governance mechanisms are significant to deter earnings management, not the whole governance mechanism (Yousuf & Aldamen, 2021; Alareeni, 2018; Luthan et al., 2016; Swai, 2016). At one side, studies document that gender diversity is helpful in deterring EM (Li et al., 2023; Orazalin, 2020; Alqatan, 2019; Saona, 2019), on the other side researchers also provide evidence that gender diversity failed to control EM (Mensah et al., 2023; Kuo et al.,2014). Researchers also document that board independence controls EM (Nguyen et al., 2024; Bello et al., 2024; Githaiga et al., 2022; Orazalin, 2020), on the other side researchers also claim that board independence is not helpful in controlling EM (Saleh et al., 2022).

Similarly, contradictory opinion exits on the role of audit committee independence (Almarayeh 2024; Khan & Kamal, 2024; Zadeh et al., 2023; Kaoje et al., 2023) and board size on EM (Saleh et al., 2023). These contradictory results advocate that there may be some other factors that influence the impact of governance mechanism on earnings management, e.g. rule of

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law and ownership structure (Saleh et al., 2023; Tikollah et al., 2022). Family ownership is one of the important ownership structures in the world, as 80% firms in US are owned by families (Prencipe et al., 2014), 76% in Taiwan (Yeh et al., 2001), and 60% in Pakistan (Hussain, 2018). According to Berrone et al., (2012) family firm (FF) consider their socio-emotional wealth in decision making while non-family (NFF) decisions are based on agency theory.

Based on socio-emotional wealth (SEW) theory, this study tries to explain the effectiveness of governance mechanism on EM for FF and NFF in Pakistan. WJP Rule of Law Index 2023, indicates that individual rights protection is low in Pakistan (WJP Rule of Law Index 2023), and mostly firms are owned by families (Hussain, 2018). Based on the gap discussed above, this study contributes in the existing literature by studying the relationship of EM and governance mechanism for two different group of firms, which have different objective based on SEW theory. Further, this research also contributes in literature by studying the governance mechanism in an institutional setting where individual right protection is week. Rest of the paper will continue in the following manner: section 2 presents literature review and hypotheses development, section three discusses data and methodology and section 4 discusses results and conclusion.

Literature Review and Hypotheses Development

Corporate Governance

OECD define corporate governance (CG) as "a set of relationships between a company's management, its board, its shareholders and other stakeholders". The most crucial agency relationship from above discussed relationships is between management and shareholders of a firm. Any conflict of interest in this relationship is known as agency problem which creates in corporations due to separation of ownership and control. To control the agency problem or align the interests of management and shareholders, different CG models are constructed (Brown et al., 2011). Extensive literature is available which discusses the role of CG mechanism in reducing agency problem (Huang et al., 2023; Bui & Krajcsák, 2023; Jiang & Kim, 2020 Belloc, 2012; Crutchley et al., 2007).

Earnings Management

Healy and Wahlen (1999) define earnings management in the following words:

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"Earning management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers. Existing literature discusses three different types of earnings management i.e. accrual earnings management (Attia et al., 2024; Khuong et al., 2023; Saeed et al., 2019; Shahzad et al., 2017), real earnings management (Musa et al., 2023; Habib, 2023; Saeed et al., 2019; Shahzad et al., 2017) and classification shifting (Malikov & Zalata, 2024; Anagnostopoulou & Malikov, 2024; Bansal, 2023; Liu et al., 2023; Ha & Thomas, 2020).

In accrual earnings management, management manipulates accruals based on their judgement or use space provided by the law to manipulate actual earnings of the firm (Kothari et al, 2005), which has no real effect on firm performance. On the other side, in real earnings management, management uses real activities to manipulate earnings of the firm, like, decrease in production cost due to abnormal production, increase in sales revenue by providing extra discount, decrease in R&D expenditure and other discretionary expenditures (Roychoudhry, 2006). Whereas in classification shifting management manipulate operating and non-operating income and expenses to show more operating income. It has no impact on net profit.

Management of the firms involve in earnings management activities to achieve their different objectives, which includes increase in salary and performance based bonus, to decrease tax liability, to show high reported profit, to attain forecasted earnings by analysts so that to influence the market price of shares (Assenso-Okofo et al., 2021; Pipatnarapong, 2020; Duong, 2020). Next section discusses corporate governance role in mitigating earnings management.

Corporate Governance and Earnings Management

Earnings management is considered as opportunistic behavior of management in which management misguides different stakeholders about the underlying performance of the firm. Extent literature discusses the role of governance mechanism in controlling earnings management behavior of management in public listed firms (Nguyen et al., 2024; Chuma & Yahaya, 2024; Mensah & Onumah, 2023; Fan et al., 2021; Alzoubi, 2019; Al-Sraheen & Al-Daoud, 2018; Zalata, 2018; Inya et al., 2018; Fuzi et al, 2016; Katmon and Farooque, 2015). At one side studies document that governance mechanism controls earnings management (Nguyen et al., 2024; Mensah & Onumah, 2023; Fan et al., 2021; Alzoubi, 2019; Al-Sraheen & Al-Daoud, 2018;

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Zalata, 2018), and on the flip side, studies also document that governance mechanism fails to control earnings management (Chuma & Yahaya, 2024; Saleh et al., 2023; Inya et al., 2016; Fuzi et al, 2016; Katmon and Farooque, 2015).

Scholars also documented that different dimension of governance mechanism are also helpful in curtailing earnings management in public listed firms, like, board size (Bello et al., 2024; Orazalin, 2020), board independence (Nguyen et al., 2024; Bello et al., 2024; Githaiga et al., 2022; Orazalin, 2020), audit committee independence (Githaiga et al., 2022) and gender diversity (Attia et al., 2024; Orazalin, 2020; Saona et al., 2019). Based on RBV theory, larger boards possess more experience, knowledge and skills to control managerial opportunism. Furthermore, women are more supportive in ethical conduct as compared to men in board's decisions (Krishnan & Parsons, 2008), hence curbing earnings management. On contrary, opposite empirical results of studies suggest that board size, board independence, audit committee independence and gender diversity are not helpful in controlling earnings management (Almarayeh et al, 2024; Chuma, N., & Yahaya, 2024 Enoidem et al., 2023; Amijaya & Prastiwi, 2013).

Based on above discussion this study hypothesizes tha:

H1: Governance mechanism dimensions i.e. board size, board independence, audit committee independence and gender diversity significantly influence earnings management

Corporate Governance, Earnings Management and Family Firms

These contradictory results of governance mechanism on earnings management suggest that there are some other factors which influence the relationship. Based on SEW theory, family involvement in business may be the reason of these contradictory results among other reasons. As Berrone et al. (2012) explain that FF prefer their socioemotional wealth over financial wealth in business related decisions. On the other side NFF decision are based on financial wealth, and agency theory explain these decisions. Furthermore, in countries where governance mechanisms are week, family block holders are so strong to influence the board decision (La Porta et al., 1999). In the light of above arguments, the behavior of FF may be different than the behavior of NFF.

Based on the above discussion, this study hypothesizes that:

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H: The effectiveness of governance mechanism dimensions i.e. board size, board independence, audit committee independence and gender diversity is not same to control earnings management in family and non-family firms.

Research Methodology

Data

The study utilized secondary data of 182 non-financial listed firms in Pakistan during 2011 to 2019. This study period is selected to ignore the impact of financial crises of 2007-08 and COVI-19. Based on available data, sample size consists of 1638 firm/years observation.

Dependent Variable

Earnings Management

The dependent variable of this study is EM. In literature mostly accrual EM is used as a proxy of EM (Saeed et al. 2019, Shahzad et al., 2017; Cohen & Zarowin, 2010). Different models are developed to measure accrual based EM i.e. Jones model, modified Jones model and performance based Jones model. Following the existing literature, this study utilizes performance based Jones model (Kothari et al., 2005) to measure accrual EM (Saeed et. al. 2019; Lazzem & Jilani, 2017; Baig & Khan 2016). Equation of the performance based Jones model is as follow:

$$TA_{i,t} = \alpha + \beta_1 \Delta S_{i,t} + \beta_2 PPE_{i,t} + \beta_3 PER_{i,t} + \varepsilon_{i,t} \text{ -------- } (1)$$

TA are total accruals, ΔS shows change in sale revenue from time t-1 to t, PPE is property plant and equipment, and PER represents performance of firm proxied by return on assets and ε represents error term. The difference between estimated total accrual and actual total accruals represent accrual earnings management.

Independent Variables

Four dimensions of governance mechanism are used in this study i.e. board size, board independence, audit committee independence and gender diversity. Following by existing literature, board size is proxied by natural log of no. of board members (Hassan et al., 2023; Abdou et al., 2021, Orazalin, 2019), while board independence is measured as the ratio of independent directors to total no. of directors (Abdou et al., 2021; Bansal, 2021; Orazalin, 2019). Whereas, audit committee independence is measured as the ratio of independent directors on audit committee to audit committee size (Zadeh et al., 2023; Kaoje et al., 2023), and gender diversity is quantified as the percentage of female board members (Mensah & Onumah, 2023; Orazalin, 2019).

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Moderating Variable

This study considers FF as a moderator. In literature different definitions of FF are available. La Porta et al., (1999) consider a firm as FF if individual shareholder holds 5% or more shares. García-Sánchez et al., (2018) consider a firm as FF if family members own 20% or more shares of a firm. Barontini and Caprio (2006) consider a firm as FF if family members hold 10% or more shares in a firm. Barontini and Caprio (2006) criteria has been considered for this study.

Control Variables

In EM literature, different variables are used as control variables as these variables significantly influence EM. Following existing literature, this study also used some controls i.e. leverage, firm performance, size of firm, listing age (Saleh et al., 2023; Saeed et al., 2019; Lisboa, 2016). leverage is measured as the ratio of debt to total assets and firm performance is measured through the ratio of net income to total assets. Moreover, firms size is measured as natural log of total assets and listing age is measured as natural log of listing no. of years.

Econometric Model and Technique

Two way clustered pooled-OLS regression technique is employed to estimate the following model, as this technique is realistic for the panel data which has the issue of heteroscedasticity and auto- correlation.

$EM_{i,t} = \beta_0 + \beta_1 BS_{i,t} + \beta_2 BI_{i,t} + \beta_3 AI_{i,t} + \beta_4 GD_{i,t} + \beta_5 LEV_{i,t} + \beta_6 Age_{i,t} + \beta_7 FS_{i,t} + \beta_8 PER_{i,t} + \varepsilon_{i,t}$ – (2)

Where EM, BS, BI, AI, GD, LEV, Age, FS, PER present earnings management, board size, board independence, audit committee independence, gender diversity, debt burden, listing age, firm size, and firm performance respectively. β_0 represents constant term, and β_1, β_2, ... , β_8 are coefficients of board size, board independence, audit committee independence, gender diversity, debt burden, listing age, firm size, and firm performance respectively.

Followed by Abbas and Saeed (2023), Saeed et al., (2019) and Shahzad et al., (2018), at first step equation (2) is estimated for full sample. After that firms are divided into two different groups i.e. FF and NFF, based on the definition of FF by Barontini and Caprio (2006), and then equation (2) is estimated for both samples. Furthermore, t-test is used to compare the coefficients of independent variables for both samples i.e. FF and NFF.

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Results and Discussion

Univariate Analysis

Table 1 represents the summary statistics of full sample, FF and NFF separately. Full sample consists of 1638 firm year observation, while size of FF sample is 738 firm year observations and 900 firm year observations for NFF. It is clear from the results presented in Table 1 that FF' involvement in EM is higher than NFF based on their mean values, as average EM of FF is 1.893 and for NFF is 1.796. Similarly, FF board are more gender diverse as average gender diversity in FF is 0.118 and for NFF it is 0.056. Table1 also depicts that average board size of NFF is 8.421 which is higher than average board size of FF (7.795). Similarly, average of board independence and audit committee independence is higher in NFF as compare to FF.

Table 1- Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max
Full Sample (N=1638)				
EM	1.773	0.437	0.599	2.899
BS	8.139	1.635	5	15
BI (%)	0.679	0.202	0	1
AI (%)	0.835	0.223	0	1
GD (%)	0.084	0.131	0	0.429
LEV (%)	0.628	0.391	0.049	0.978
Age	3.28	0.479	1.792	4.025
FS	8.391	1.549	4.274	12.758
PER (%)	0.046	0.115	-0.461	0.662
FF (N=738)				
EM	1.893	0.437	0.602	2.899
BS	7.795	1.333	5	14
BI (%)	0.613	0.205	0	1
AI (%)	0.802	0.251	0	1
GD (%)	0.118	0.147	0	0.429
LEV (%)	0.612	0.3	0.104	2.87
Age	3.296	0.417	1.946	4.025

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FS	8.09	1.434	4.274	12.758
PER (%)	0.04	0.103	-0.489	0.591
NFF (N=900)				
EM	1.796	0.418	0.599	2.529
BS	8.421	1.798	6	15
BI (%)	0.732	0.184	0	1
AI (%)	0.861	0.192	0	1
GD (%)	0.056	0.108	0	0.429
LEV (%)	0.642	0.452	.049	3.978
Age	3.267	0.524	1.792	4.025
FS	8.638	1.596	4.274	12.758
PER (%)	0.05	0.125	-0.461	0.662

Table 2 present the results of Pearson's correlation coefficient for FF and for NFF. Results of Table 2 reveal that there is no issue of multi-collinearity as no pairwise correlation is higher than 0.5. Results also posit that there exists significant correlation between governance mechanism dimensions and EM.

Table 2- Pairwise Correlations for FF

Family Firms					
Variables	(1)	(2)	(3)	(4)	(5)
(1) EM	1.000				
(2) BS	-0.019**	1.000			
(3) BI	-0.044*	0.263*	1.000		
(4) AI	-0.018*	0.107*	0.245*	1.000	
(5) GD	-0.080**	0.161**	-0.045	0.061	1.000
Non-Family Firms					
Variables	(1)	(2)	(3)	(4)	(5)
(1) EM	1.000				
(2) BS	-0.042**	1.000			
(3) BI	-0.034**	0.300**	1.000		
(4) AI	-0.037*	0.253**	0.306*	1.000	

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(5) GD	-0.070*	0.075*	-0.083	0.005	1.000

*,**,*** shows level of significance at 10%, 5% and 1*

Multivariate Analysis

To test the hypotheses of the study, we estimate the equation (2) by using two way clustered pooled OLS technique for all firms, FF and NFF. Table 3 presents the result of the estimated equation and also presents the results of Comparison of regression coefficients of FF and NFF based on t-test. Results of the study confirms that board size, board independence, audit committee independence and gender have significant negative impact on earnings management. These results of the study are in line with existing literature (Bello et al., 2024; Nguyen et al., 2024; Attia et al., 2024; Githaiga et al., 2022; Orazalin, 2020). Results of the estimated model show that effectiveness of board size in controlling EM is different for FF and NFF, as it is negative and significant for NFF (-0.311**), but positive in FF (0.209*) and just significant at 10% level of significance. Further t-test value (3.13***) also confirms that the effectiveness of board size is not same in FF and NFF. This result supports our hypothesis that the effectiveness of board size is not same in FF and NFF. Results further advocate that board independence has different impact on EM for both samples, as coefficient of BI for NFF is -0.201*, while coefficient of BI for FF is 0.285 and it is insignificant. T-test value (2.33**) also confirms that beta coefficients of BI for both samples are not same. This result confirms the acceptance of H2.

Table 3- Two Way Clustered Pooled OLS Regression & t-test

VARIABLES	(Full Sample) EM	(FF) EM	(NFF) EM	Comparison of beta coefficient Based on t-test	Decision
BS	-0.254*	0.209*	-0.311**	3.13***	Sig
	(0.118)	(0.108)	(0.126)		
BI	-0.329**	0.285	-0.201*	2.33**	Sig
	(0.144)	(0.174)	(0.114)		
AI	-0.88*	0.75	-0.812**	2.17**	Sig

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	(0.51)	(0.63)	(0.350)		
GD	-0.318**	-0.239	-0.803***	2.03**	Sig
	(0.108)	(0.262)	(0.092)		
LEV	0.428***	0.466***	0.406***	0.67	In-Sig
	(0.050)	(0.083)	(0.051)		
Age	-0.170*	0.210*	-0.155**	3.31***	Sig
	(0.076)	(0.093)	(0.059)		
FS	0.151***	0.0514	-0.216***	5.59***	Sig
	(0.019)	(0.043)	(0.021)		
PER	0.841***	-0.514**	0.936***	-4.37***	Sig
	(0.270)	(0.277)	(0.182)		
Constant	0.260***	0.525***	0.660***	-1.17	In-Sig
	(0.038)	(0.065)	(0.095)		
Observations	1,436	642	794		
R-squared	0.158	0.127	0.215		

*,**,*** shows level of significance at 10%, 5% and 1*

Furthermore, audit committee independence negatively and significantly influences EM for NFF (-0.812**), but has insignificant for FF (0.75). Result of t-test (2.17**) confirms that the impact of AI for both samples is significantly different, hence we accept our hypothesis that AI has different impact on EM for both samples. Moreover, results of the Table 3 also indicate that the impact of gender diversity is significant for NFF (-0.803***) and insignificant for FF (-0.239), and these coefficients are significantly different based on t-test result (2.03**).This result also supports our hypothesis that gender diversity has different impact on earnings management in FF and NFF. Results of control variables are also significantly different for FF and NFF.

Discussion and conclusion

This study examined the impact of four dimensions of governance mechanism on EM for family and NFF listed in Pakistan during the period 2011-2019. For testing the hypotheses of the study, equation (2) is estimated by employing two way clustered pooled OLS. Results of the study provide evidences that governance mechanism is more pronounced in controlling EM in NFF as compare to FF. These results support our hypotheses of the study that family influence the

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relationship between EM and governance mechanism. Independent board members, audit committee independence and gender diversity are not performing well in FF as compare to NFF. Result indicates that independent directors on board and in audit committee in FF are reluctant to take opposite position to the position of family in board meeting (Bansal et al., 2018). Furthermore, difference in the results of the study can also be explained by SEW theory, which describes that family firm's decisions are supported by socio-emotional wealth, while NFF's decisions are grounded on agency theory.

Garcia-Sanchez et al. (2015b) also documented that investor protection is low in FF as compare to NFF, so FF manage earnings more extensively as compare to NFF despite the presence of independent directors on board and on audit committee. Moreover, in Pakistan, it is easy for FF to expropriate the rights of minority shareholders, due to week individual rights protection and inefficient rule of law (WJP Rule of Law Index 2023). These two factors make governance mechanism inefficient. Similarly, gender diversity has no impact on EM in FF, the possible reason for this is that in Pakistan gender diversity on board was not compulsory till 2017, and Damak (2018) also accomplishes that gender diversity is supportive in limiting EM in countries where female presence is mandatory on board, and females are more influential in board meetings. Additionally, low female participation on board is another reason that females have now influence on board's decisions (Joecks et al., 2013)

Implications and Future Directions

Based on the results of the study, there is a need to make governance mechanism more strong in Pakistan, so that FF cannot influence independent directors in board meetings, and make female directors more powerful, so that they can effectively participate in board decisions.

The study opens several avenues for future research. As this study consider only pre covid-19 data, future studies may consider post covid-19 period to analyze the impact of governance mechanism on EM for FF, to check either there is change in behavior of FF on EM or not in pre and post covid-19 periods. Furthermore, other governance mechanism may also be analyzed like, separation of CEO and chairman, qualification of audit committee members, qualification of head of internal auditor and outsourcing of internal audit function.

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