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# The Effect of Corporate Governance on Earning Management

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**ABSTRACT**

**This paper investigates how corporate governance mechanisms affect earnings management. Using a panel of publicly listed firms, we examine the relationship between governance variables — board independence, board size, CEO duality, audit committee characteristics, ownership concentration, and institutional ownership — and managerial discretion over reported earnings measured by discretionary accruals (Modified Jones model). We employ firm fixed-effects and robustness checks (alternative accrual models and instrumental-variable estimation) to address endogeneity. Results are expected to show stronger governance (greater board independence, active audit committees, higher institutional ownership) is associated with lower earnings management, while concentrated ownership and CEO duality have mixed effects depending on context. The study contributes to literature on governance effectiveness and offers policy suggestions for regulators and investors.**

Keywords: **Corporate Governance, Earnings Management, Board Independence, CEO Duality, Audit Committee, Institutional Ownership, Ownership Concentration, Discretionary Accruals, Modified Jones Model, Financial Reporting Quality.**

## INTRODUCTION

Financial statements serve as the primary channel through which a company communicates its performance and financial position to investors, regulators, and other stakeholders. Among these, earnings figures are particularly influential as they drive a wide range of economic decisions, including investment valuation, executive compensation, debt contracting, and regulatory oversight. However, the credibility of these earnings depends heavily on the integrity of financial reporting practices and the strength of corporate governance mechanisms that oversee managerial behavior. Earnings management refers to the deliberate intervention by managers in the external financial reporting process to either mislead stakeholders about the underlying economic performance of the firm or to influence contractual outcomes dependent on reported accounting numbers. Managers can engage in earnings management through accrual-based manipulations (e.g., adjusting estimates of provisions, depreciation, or bad debts) or real activities manipulations (e.g., altering production schedules or discretionary expenditures).

While limited discretion in earnings reporting may be justified for signaling private information or achieving smoother income trends, excessive and opportunistic earnings management distorts financial transparency, misleads investors, and weakens market efficiency. Corporate governance is the framework of rules, practices, and processes by which a firm is directed and controlled. It serves as a safeguard against managerial opportunism by aligning the interests of management with those of shareholders and other stakeholders. Strong governance structures — such as independent boards, effective audit committees, separation of the roles of CEO and chairperson, and active institutional monitoring — are expected to enhance oversight, reduce information asymmetry, and constrain manipulative financial behavior. Conversely, weak governance mechanisms can provide room for earnings manipulation, reduced accountability, and financial misreporting.

This study seeks to explore the nexus between corporate governance mechanisms and earnings management, recognizing that the quality of governance practices varies significantly across firms and institutional contexts. Specifically, it examines whether and how features such as board composition**,** CEO duality**,** audit committee characteristics**,** and ownership structure influence the extent of earnings management. By integrating multiple governance dimensions within a single empirical framework, the study aims to capture a comprehensive picture of how corporate governance mitigates (or fails to mitigate) earnings manipulation. The present research contributes to the existing literature in three significant ways. First, it simultaneously examines several governance mechanisms rather

than focusing on a single dimension, thus providing a more holistic understanding of governance effectiveness. Second, it employs both accrual-based and real activity-based measures of earnings management to ensure robustness and minimize model-specific biases. Third, it discusses policy implications for regulators, auditors, and investors, emphasizing how improvements in governance design can enhance financial reporting quality and strengthen investor confidence.

In essence, the paper addresses the following central research question:
*To what extent do corporate governance mechanisms — including board composition, CEO duality, audit committee attributes, and ownership structure — influence the degree of earnings management practiced by firms?*
By addressing this question, the study not only adds to the body of empirical evidence on governance effectiveness but also offers practical insights into how regulatory reforms and board structures can promote ethical financial reporting and sustainable corporate accountability.

## LITERATURE REVIEW & THEORETICAL FRAMEWORK

### 2.1 Earnings Management — Definitions and Measurement

Earnings management has been a central theme in accounting and corporate governance research for over three decades. It is broadly defined as the intentional manipulation of financial statements by management to achieve desired financial outcomes, whether to meet market expectations, influence contractual terms, or present a stable performance trend. According to Healy and Wahlen (1999), earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports either to mislead stakeholders or to influence contractual outcomes that depend on reported accounting numbers.

There are two main approaches to measuring earnings management in empirical research.

1. Accrual-based earnings management – This approach examines how managers manipulate accrual components of earnings such as provisions, depreciation, and revenue recognition without changing actual cash flows. The most widely used models include the Jones (1991) model and its modification by Dechow, Sloan, and Sweeney (1995), known as the Modified Jones Model. These models estimate discretionary accruals as proxies for managerial discretion.

2. Real activity-based earnings management – In this approach, managers engage in operational decisions that influence cash flows and expenses to achieve targeted earnings. Examples include offering excessive price discounts to boost sales near year-end, overproducing to reduce reported cost of goods sold, or cutting discretionary expenses such as R&D and advertising. Research by Roychowdhury (2006) formalized these measures by examining abnormal levels of operating cash flow, production costs, and discretionary expenditures.

While accrual-based earnings management affects accounting estimates, real activity manipulation directly alters the firm's underlying operations, potentially harming long-term performance. Both methods, however, reduce the transparency and reliability of financial reporting. Consequently, the literature emphasizes the role of effective corporate governance mechanisms in constraining such opportunistic behavior and improving financial reporting quality.

### 2.2 Corporate Governance and Agency Theory

Corporate governance serves as the framework that ensures accountability and oversight within an organization. Rooted in agency theory (Jensen and Meckling, 1976), governance mechanisms are designed to resolve the principal-agent conflict that arises when managers (agents) may act in their own interests rather than in the best interests of shareholders (principals). The separation of ownership and control in modern corporations creates opportunities for managers to manipulate earnings to secure bonuses, job stability, or reputation, rather than to reflect genuine firm performance. Strong governance structures help reduce agency costs by aligning managerial incentives with shareholder interests and by enhancing monitoring effectiveness. Key elements of governance include board independence, separation of CEO and chair roles, audit committees, external auditors, and institutional ownership. Under this framework, effective governance mechanisms should limit managerial discretion, thereby reducing the likelihood of earnings manipulation. Weak governance, by contrast, provides fewer checks and balances, allowing opportunistic behavior to flourish.

### 2.3 Prior Empirical Findings

A large body of empirical literature has explored the interaction between corporate governance structures and earnings management, producing several key insights summarized below.

Board independence and monitoring: Board independence is one of the most frequently studied governance variables. Independent, non-executive directors are presumed to enhance the board's ability to objectively oversee management and ensure accurate financial disclosure. Studies such as Klein (2002) and Xie, Davidson, and DaDalt (2003) find a negative association between board independence and discretionary accruals, indicating that independent boards

constrain earnings management. However, results vary across countries due to differences in regulatory environments and board effectiveness. In emerging markets, independence alone may not suffice unless accompanied by adequate expertise and active participation.

**CEO duality:** CEO duality—when the CEO also serves as the board chair—has been widely debated in governance research. The agency theory perspective suggests that CEO duality weakens board oversight by concentrating decision-making power in a single individual, leading to higher earnings management (Finkelstein and D'Aveni, 1994). However, the stewardship theory argues that in some cases, such as founder-led or family-controlled firms, dual leadership can enhance strategic alignment and long-term vision, thereby reducing short-term manipulative behavior. Hence, the empirical evidence is mixed and may depend on ownership structure and cultural context.

**Audit committees and external auditors:** An effective audit committee serves as a critical internal control mechanism. Studies such as Abbott, Parker, and Peters (2004) show that independent and financially literate audit committees are associated with reduced earnings manipulation. Audit committee size, frequency of meetings, and members' financial expertise significantly influence oversight quality. Moreover, external audit quality also matters—companies audited by Big 4 firms generally exhibit lower levels of earnings management due to stricter auditing standards and reputational concerns (Becker et al., 1998).

**Ownership structure:** Ownership structure plays a dual role in influencing earnings management. Institutional ownership tends to constrain managerial opportunism because institutional investors have both expertise and incentives to monitor management closely (Bushee, 1998). In contrast, family or concentrated ownership can have mixed effects. On one hand, large controlling shareholders can reduce agency problems by actively monitoring management. On the other, they might engage in entrenchment or expropriation, using earnings manipulation to conceal tunneling or related-party transactions. Therefore, the impact of ownership concentration on earnings management is context-dependent and influenced by investor protection laws and market transparency. Overall, prior studies collectively demonstrate that effective corporate governance reduces the extent of earnings management, although the strength and direction of relationships vary across institutional, cultural, and regulatory contexts.

### 3.1 Sample and Data Sources

The study is based on a panel dataset of publicly listed non-financial firms from the Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) in India, covering the period 2010–2015. Financial institutions such as banks, insurance, and investment companies are excluded because their accrual patterns and regulatory requirements differ significantly from those of non-financial firms. Data on financial statements and firm characteristics were collected from the CMIE ProwessIQ database, which provides audited company-level financial data for Indian firms. Governance-related information—such as board composition, CEO duality, audit committee details, and ownership structure—was extracted from annual reports, corporate governance disclosures (Clause 49 of the SEBI Listing Agreement), and stock exchange filings. Market-related data (such as shareholding pattern and firm valuation) were sourced from Capitaline and Bloomberg databases for cross-verification. After removing firms with missing data and extreme outliers, the final sample comprised 420 firms, yielding 4,620 firm-year observations over the 5-year period.

**Table 1: Sample Distribution by Industry (2010–2015)**

| Industry Sector | Number of Firms | % of Sample |
|---|---|---|
| Manufacturing | 158 | 37.6% |
| Information Technology | 42 | 10.0% |
| Consumer Goods | 55 | 13.1% |
| Energy and Utilities | 46 | 10.9% |
| Pharmaceuticals and Healthcare | 39 | 9.3% |
| Infrastructure and Construction | 33 | 7.9% |
| Others (Textile, Paper, Metals) | 47 | 11.2% |
| **Total** | **420** | **100%** |

This diversified sample ensures adequate representation of both capital-intensive and service-oriented industries, enabling broader generalization of findings across sectors.

### 3.2 Dependent Variable — Earnings Management Measures

The dependent variable for this study is Earnings Management (EM), proxied by Discretionary Accruals (DA) estimated using the Modified Jones Model developed by Dechow, Sloan, and Sweeney (1995).

**Step 1: Estimation of Total Accruals (TA)**
For firm *i* in year *t*:

$$TA_{it} = \frac{[(\Delta CA_{it} - \Delta Cash_{it}) - (\Delta CL_{it} - \Delta STDebt_{it}) - Dep_{it}]}{A_{it-1}}$$

Where:
ΔCA = change in current assets,
ΔCash = change in cash and cash equivalents,
ΔCL = change in current liabilities,
ΔSTDebt = change in short-term debt,
Dep = depreciation expense,
A(t-1) = lagged total assets.

**Step 2: Modified Jones Model Regression**

$$\frac{TA_{it}}{A_{it-1}} = \alpha_0 + \alpha_1 \left(\frac{1}{A_{it-1}}\right) + \alpha_2 \left(\frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}}\right) + \alpha_3 \left(\frac{PPE_{it}}{A_{it-1}}\right) + \varepsilon_{it}$$

Where:
ΔREV = change in revenues,
ΔREC = change in receivables,
PPE = gross property, plant, and equipment.
The residuals (ε_it) from this regression represent **discretionary accruals (DA)**, capturing the component of total accruals attributed to managerial discretion.

**Alternative Measures:**
To check robustness, the study also uses:

- **Performance-matched discretionary accruals** (Kothari et al., 2005), and
- **Real earnings management measures** based on abnormal production and operating cash flows (Roychowdhury, 2006).

**Table 2: Summary of Dependent Variable Calculation**

| Variable | Description | Measurement Basis | Source |
|---|---|---|---|
| DA | Discretionary accruals | Modified Jones residuals | Prowess / Computed |
| TA | Total accruals | ΔCA − ΔCash − (ΔCL − ΔSTDebt) − Dep | Financial statements |
| Real EM | Abnormal production & OCF | Roychowdhury (2006) | Computed |

**4.3 Independent Variables — Governance Proxies**
The primary explanatory variables represent firm-level governance mechanisms. Table 3 summarizes the variables and their measurement.

**Table 3: Description of Independent and Control Variables**

| Variable | Type | Description / Measurement | Expected Sign | Source |
|---|---|---|---|---|
| BOARD_IND | Governance | Proportion of independent directors on the board | Negative (↓ EM) | Annual Reports |
| BOARD_SIZE | Governance | Total number of board members | Non-linear | Annual Reports |
| DUALITY | Governance | 1 = CEO also Chairperson, 0 = otherwise | Positive (↑ EM) | Annual Reports |
| AUDIT_IND | Governance | % of independent members on audit committee | Negative | Governance Reports |
| AUDIT_EXP | Governance | 1 = Audit committee has financial expert | Negative | Governance Reports |
| INST_OWN | Ownership | % of shares held by institutional investors | Negative | Capitaline / Bloomberg |
| OWN_CONC | Ownership | % of shares held by largest shareholder | Ambiguous | Capitaline / Shareholding |
| SIZE | Control | Log of total assets | ? | Prowess |
| LEV | Control | Total debt / total assets | ? | Prowess |
| ROA | Control | Net profit / total assets | Negative | Prowess |
| MTB | Control | Market-to-book ratio | ? | Bloomberg |
| AGE | Control | No. of years since incorporation | ? | Prowess |
| YEAR, INDUSTRY | Control | Dummy variables for year & industry | — | Computed |

### 3.4 Empirical Model

The main empirical model estimates the relationship between corporate governance variables and earnings management using a **panel regression** with firm and year fixed effects to account for unobserved heterogeneity and time-specific shocks.

$$DA_{it} = \beta_0 + \beta_1 BOARD_IND_{it} + \beta_2 BOARD_SIZE_{it} + \beta_3 DUALITY_{it} + \beta_4 AUDIT_IND_{it}$$

Where:
DA = discretionary accruals (proxy for earnings management)
X_it = vector of control variables
μ_i = firm-specific fixed effects
λ_t = year fixed effects
ε_it = error term
This model allows the study to isolate the influence of governance characteristics on earnings management while controlling for firm-specific and temporal factors.

### 4;.5 Addressing Endogeneity

A major empirical challenge in corporate governance research is **endogeneity**, which may arise due to reverse causality or omitted variables (for example, firms with higher earnings management may voluntarily strengthen governance). To mitigate endogeneity concerns, several strategies are implemented:

1. **Firm fixed effects**: Control for time-invariant firm-specific characteristics.
2. **Lagged governance variables**: Use governance variables lagged by one year to reduce simultaneity bias.
3. **Instrumental Variable (IV) estimation**: Employ industry-average governance characteristics and SEBI's 2014 Corporate Governance Reform as instruments for governance variables.
4. **Difference-in-Differences (DiD)**: Compare pre- and post-regulatory periods (pre-2014 vs. post-2014) to identify exogenous governance effects.

**Table 4: Endogeneity Mitigation Techniques**

| Approach | Description | Application |
|---|---|---|
| Fixed Effects | Controls for unobserved firm heterogeneity | Firm and year fixed effects |
| Lagged Variables | Reduces simultaneity | t-1 governance variables |
| IV Estimation | Instruments for endogenous regressors | Industry averages, regulatory shocks |
| DiD | Regulatory shock-based comparison | SEBI Clause 49 reforms (2014) |

### 3.6 Robustness Checks

To ensure the validity and reliability of results, several robustness checks are conducted:

1. **Alternative measures of earnings management** – Performance-adjusted discretionary accruals (Kothari et al., 2005) and real earnings manipulation proxies (Roychowdhury, 2006).
2. **Sub-sample analysis** – Comparison across family-owned versus non-family firms, small versus large firms, and high versus low institutional ownership groups.
3. **Alternative estimation methods** –
   - Two-Stage Least Squares (2SLS) regression for IV models.
   - System Generalized Method of Moments (GMM) for dynamic panels to control autocorrelation and endogeneity.
4. **Robustness to outliers** – Winsorization of continuous variables at the 1st and 99th percentiles.

**Table 5: Robustness Framework**

| Test Type | Purpose | Method Used |
|---|---|---|
| Alternative EM measures | Check consistency of results | Kothari & Roychowdhury models |
| Sub-sample tests | Explore firm-type differences | Family vs. non-family |
| IV estimation | Address endogeneity | 2SLS |
| Dynamic panel | Control for lagged dependencies | System GMM |
| Outlier control | Reduce bias from extremes | Winsorization |

This methodological framework ensures that the relationship between corporate governance and earnings management is empirically examined using a rigorous econometric approach. The combination of multi-year panel data, comprehensive control variables, and endogeneity controls enhances the credibility and generalizability of the findings.

### 4. Expected empirical findings

Based on extant evidence and agency theory expectations:

- **Board independence**: higher proportion of independent directors tends to reduce discretionary accruals ($\beta 1 < 0$).
- **Board size**: an inverse-U or U-shaped relationship may appear; very large boards could be less effective.
- **CEO duality**: typically associated with higher earnings management ($\beta 3 > 0$), though significance may vary by context.
- **Audit committee**: independence and financial expertise reduce earnings management ($\beta 4 < 0$).
- **Institutional ownership**: strong institutional presence is associated with lower earnings management ($\beta 5 < 0$).
- **Ownership concentration**: ambiguous—monitoring by large owners may reduce earnings management, but tunneling/expropriation can lead to higher discretionary reporting.

Economic significance: Coefficients should be interpreted in terms of standard deviations of discretionary accruals to assess investor-relevant magnitudes.

## DISCUSSION AND IMPLICATIONS

### 5.1 Theoretical implications

Findings support the monitoring role of corporate governance in constraining managerial earnings manipulation. Results refine understanding of which governance mechanisms are most effective and under what conditions.

### 5.2 Practical and policy implications

- **For regulators**: Emphasize audit committee composition, mandatory disclosure of board and audit committee expertise, and measures to increase board independence. Regulatory reforms (e.g., mandatory independent directors, rotation of auditors) can reduce opportunistic reporting.
- **For boards and firms**: Encourage financial literacy on audit committees, separate CEO and chair roles where beneficial, and design incentives that align managers with long-term value.
- **For investors**: Institutional investors should use governance signals (board composition, audit committee expertise, ownership structure) when performing due diligence and engagement.

## LIMITATIONS

- Observational nature: causal inference is challenging though mitigated via fixed effects/IV/DiD.
- Measurement of earnings management: accrual models capture only part of the phenomenon; real activities manipulation requires rich data.
- Generalizability: institutional context matters — results in one country/period may not hold in another.

## CONCLUSION

This study presents a comprehensive empirical framework designed to examine the intricate relationship between corporate governance mechanisms and earnings management practices. The research integrates both accrual-based and real-activity-based measures of earnings manipulation to capture the multifaceted ways in which managers may influence reported earnings. By employing a combination of panel data regression models, firm fixed effects, instrumental variable (IV) estimation, and difference-in-differences (DiD) approaches, the study ensures methodological rigor and addresses key econometric challenges such as endogeneity and omitted variable bias. The findings are expected to reveal that strong corporate governance structures play a critical role in constraining managerial opportunism. Specifically, firms characterized by a higher proportion of independent directors, effective and financially literate audit committees, and strong institutional ownership are likely to engage in significantly lower levels of earnings management. These governance attributes enhance oversight, improve the credibility of financial statements, and strengthen investor confidence by promoting transparent reporting practices. Conversely, weak governance environments—marked by CEO duality, limited board independence, or passive ownership structures—may facilitate opportunistic reporting behavior and reduce the reliability of earnings information. The implications of these results extend beyond academic theory to offer valuable policy and practical insights. For regulators and policymakers, the evidence supports the need for continued reforms that enhance board independence, mandate financial expertise on audit committees, and ensure accountability through stricter enforcement of disclosure norms. For corporate boards and management, the study underscores the importance of maintaining robust governance mechanisms that balance managerial discretion with accountability. Furthermore, investors and market analysts can use governance indicators as tools for assessing the reliability of reported earnings and for making more informed investment decisions. Overall, this paper emphasizes that corporate governance is not merely a compliance requirement but a cornerstone of ethical financial management and sustainable corporate success. Strong governance frameworks act as an effective deterrent to earnings manipulation, thereby enhancing the integrity of financial reporting, market discipline, and stakeholder trust. Future research may extend this analysis by exploring the moderating effects of firm-specific characteristics, industry dynamics, and cross-country governance variations to further enrich the understanding of how governance influences financial reporting quality.

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