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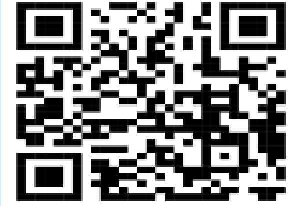

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Corporate Governance as a Constraint on Earnings Management: Evidence from Emerging Economies

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Abstract

This paper investigates the impact of corporate governance on the earnings management in the selected South Asian firms over the period of 2013 to 2024. Using panel data, the study analyzed how key governance indicators, such as board size, CEO duality, audit Committee, and Institutional Ownership effects the earnings management. The findings provide empirical evidence that corporate governance plays a significant role in shaping managerial reporting behavior. It offers useful insights for the policymakers and regulators aiming to strengthen the corporate governance mechanism so as to improve the transparency of the financial reporting.

Keywords: Earnings Management, Corporate Governance, South Asia

Introduction

Earnings management is when managers use accounting methods to make a company's financial statements look better than they really are. When making financial reports, managers have to use their judgment to apply different accounting rules and standards (Sidney & Liao, 2025). Financial reporting frameworks like GAAP and IFRS give managers some freedom by letting them pick from different accounting methods. This flexibility allows for professional judgment, but it may also give managers the freedom to choose how to report earnings. For the last thirty years, a lot of research has tried to find and measure earnings management using different models and empirical methods (Estébanez & Martín, 2025).

Financial accounts are manipulated by earnings management to inflate or "smooth" earnings. The act of improperly manipulating the earnings figure included in the company's income statement is known as earnings management. Earnings management can be said as a movement made by a person to alter the accounting numbers to portray a good performance of the company (Mohd et al.,2023). EM has two methods: the first is real earnings management, in which businesses manipulate their operating operations, and the second is accrual earnings management, in which businesses manipulate their accounting procedures to achieve desired results(Jain & Nissim, 2025).

According to Soyemi et al. (2020), accrual-based earnings management implies using judgment by making sound choices about the selection of accounting estimates. Earnings can be manipulated by management for a variety of reasons, including assessing performance, tax burden reduction, catering to analysts' profit forecasts, avoiding loss, and smoothing results (Li & Sun, 2023). "Earnings management hides true performance and sends the wrong message to stakeholders, making it harder for them to make wise decisions.

One important internal control mechanism that acts as a link between capital owners (shareholders) and managers who use that capital to generate value and increase shareholders' wealth is the BoDs. In order to ensure the accuracy of accounting information, the adherents also keep an eye on the company's accounting system by making sure managers follow relevant ASs and principles when creating financial reports. The board's oversight of financial reports is essential since shareholders may be misled by opportunistic managerial practices linked to earnings manipulation(Keil et al., 2025). The executive members are the most important aspect of CG, and how the board is organized affects how well it can keep an eye on the management. As a result, key elements that increase the board's efficacy in reducing profits manipulation include its size, independence, gender diversity, and financial expertise(Ali et al., 2022).

Even though there is more and more research on earnings management and corporate governance, there isn't much evidence from developing economies, and what there is, isn't always clear. Emerging markets often have institutional environments that are different from those in developed economies. The reasons for differences depend on the number of factors for instance, regulatory enforcement, lack or insufficient investor protection and varying governance mechanisms. These factor thus, impact the efficacy of the corporate governance procedures and ultimately influence the earning management by the firms. Therefore, it is critical to study the impact of corporate governance on the earning management. This paper explicitly analyzes the corporate governance in emerging economies using number of proxies which have been used in the literature to measure the impact of corporate governance. These include, board size, board independence, CEO duality and others. The inclusion of these essential proxies is critical to measure the effectiveness of mitigating managerial opportunism in the financial reporting.

This study adds to the existing literature by providing empirical evidence from the emerging economies. It also provides policy makers and regulators the meaningful insights as to the significance of enhancing governance structures so that the financial reporting could be improved and the stakeholder interests can be guarded.

Theoretical Foundation:

According to Agency theory, there can be difference in the objectives of the shareholders and the managers. There is a probability that managers may emphasize their personal interests over the wealth maximization goals of the shareholders. The theory highlights this conflict among the owners (principals) and the administrators i.e. managers (agents). Because of information asymmetry, managers have more access to internal financial data and may use this to their advantage by doing things like managing earnings. In this context, corporate governance mechanisms are meant to reduce agency conflicts by making it easier to keep an eye on and oversee what managers do. Good governance structures, like a board of directors that is independent and knowledgeable, can cut down on the freedom of managers and make it less likely that they will manipulate earnings.

Empirical Literature

Earnings management is a term that explains how leaders of a company inflate their financial reports. In such a way, they make it seem that the corporation is actually doing better than it really is. This practice uses accounting decisions that are at the discretion of the firm but obscure the reality of the company’s financial condition(Abed et al., 2022). A significant case of accounting fraud is the collapse of Enron. Here, executives made use of special purpose entities (SPEs). Further, SPEs were used to mislead investors and exclude debts from the consolidated financial statements(Fairchild & Marnet, 2022).

There are two basic types of EM- accrual and real . Accrual-based EM is the act of changing (accounting) entries (for example, by changing accruals) without changing the actual operations of the firm, but remaining in the limits of GAAP(Mawaali et al., 2024). Because this method is related to regulated accounting practices, it is likely to be detected by an audit or a regulatory review more easily. In contrast, actual earnings management means changing business decisions, like altering production levels or lowering discretionary spend, to influence reported earnings (Simamora et al., 2022). Because these activities are at the discretion of management (rather than a standardized accounting procedure), they are harder to detect and may impact the company’s long-term sustainability prominently (Asad et al., 2024).

On the other hand, CG has become a cornerstone of monetary transparency and accountability, particularly in the context of public companies (Dote-Pardo et al., 2025; Nguyen N.T.H. et al., 2025). Effective CG apparatuses, such as board size, AC oversight, and CD, are indispensable to certify the precision of balance sheet which mirrors a business’s performance(Efunniyi et al., 2024). In South Asian Countries, where CG practices are still evolving, the need for robust governance structures is particularly pressing (Hales et al., 2025).

CG encompasses decision-making structures, accountability, and behavior within organizations, aiming to strike a balance between management autonomy, accountability, and stakeholder interests (Mahdavi Parsa & Noor Ahmadi, 2018). It seeks to reduce agency problems, align the holders and executives’ targets, and secure the interests of all stakeholders(Schoenmaker & Schramade, 2023). Therefore, it is expected that the characteristics of a governance system will influence financial performance, as effective governance reduces the negative consequences of conflicts of interest, such as the abuse of power (Abdulwahid et al., 2021)

Agency Theory elucidates the conflicts of interest between shareholders (principals) and managers (agents), thereby enhancing the understanding of the relationship between earnings management and corporate governance. Because managers have more access to financial information than other people, they can use this power to change reported earnings for their own or their company's benefit. In these cases, good corporate governance systems work as monitoring tools that stop managers from being opportunistic and make financial reporting more trustworthy. Governance structures—particularly board characteristics such as size, independence, gender diversity, and financial acumen—

facilitate oversight of managerial choices and reduce the likelihood of misconduct will alter their income. In order to understand with clarity that how governance structures can enhance transparency and safeguard the interests of the stakeholders, it is critical to understand and investigate the impact of corporate governance procedures on earnings management. It is therefore, that the underlying study has taken into account the emerging economies so as to not only extend the literature by providing empirical evidence but also, due to the fact that governance frameworks in the emerging nations are still evolving.

Data and Methodology

This paper employs quantitative research design using panel data for the purpose of investigating the impact of corporate governance on the earnings management. This study utilizes a multi-stage sampling method to determine the final sample. Multi-stage sampling is a type of cluster sampling in which the sample is chosen in several steps instead of all at once from the whole population. This method works best when there are a lot of people spread out over a large area.

The first step was to look at countries in South Asia as the main groups. The sampling frame included eight countries: Afghanistan, Bhutan, Bangladesh, India, Nepal, Pakistan, Sri Lanka, and the Maldives. Three countries—India, Pakistan, and Bangladesh—were chosen from this group for the study. The second step was to find the manufacturing sector in the chosen countries. We chose textile, food processing, and chemical manufacturing sub-sectors to stand for important industrial activities in the area. In the third stage, companies from each country that worked in one of these chosen industries were chosen at random to make sure that all manufacturing sectors were represented. Then, data on financial and corporate governance were gathered from the sampled firms' annual reports and publicly available financial statements for the years 2013 to 2024.

The final sample comprises companies from specific South Asian nations engaged in the manufacturing industry. Table 1 shows how the sampled firms are spread out across countries and how many firm-year observations were used in the analysis for the years 2013 to 2024.

Table 1: Sample Selection

No.	Country	No. of Companies	No. of Observations
1	Pakistan	58	638
2	India	100	1100
3	Sri Lanka	10	110
4	Nepal	10	110
	Total	**178**	**1958**

Source: Author's Estimation

Measuring Instruments:

Following are the proxies which are used in the study.

Particular	Symbol	Formulation	Empirical evidence
		Dependent variables	
1.EM	EM		
Real Earning	REM	(DISC_PROD),(DISC_EXP), (DISC_CFO)	(Nuanpradit,2019)
Accrual's Earning Management	AEM	Modified Jones Model	Abdelghany et al. (2024)
		Independent variables	
1.CG			
a) Board Size	BS	Numbers of board directors	
b) AC	AC	The number of AC meetings held in financial years	
c) CD	CD	Dummy variable 1 if the ceo chairman and board of director if not taking 0	(Khalid et al., 2017)
d) IO	IO	Natural log of total assets	
		Control Variables	

1.Leverage	LEV	Total liabilities divided by total assets	(Nazeer, Saleem, & Amin, 2025)
2.Firm Size	FS	Log of total assets	(Karadeniz et al., 2011)
3.Return on Assets	ROA	Net income divided by average total assets	Sinurat et al. (2025)

Econometric Model:
Following panel regression model has been employed for the purpose of examining the relationship between the Earning Management and Corporate Governance.

$AEM = \propto +\beta_1 BS_{it} + \beta_2 AC_{it} + \beta_3 IO_{it} + \beta_4 CD_{it} + \beta_5 Controls_{it} + +\varepsilon_{it}$ -----------------------I
$REM = \propto +\beta_1 BS_{it} + \beta_2 AC_{it} + \beta_3 IO_{it} + \beta_4 CD_{it} + \beta_5 Controls_{it} + +\varepsilon_{it}$ ---------------------II

In equation I, AEM is the Accrual earnings management for firm I and time t, BS shows Board size, IO shows institutional ownership, CD is CEO duality. Control variables present, Firm size, leverage and Return on Assets. The study employs Panel Data Regression model with Fixed and Random effect model for the purpose of analysis. The method effectively facilitates in explaining the relationship between the IVs and DV. Further, Diagnostics such as Hausman test and Multicollinearity has also been tested.

Results and Discussion
Table 2 Descriptive Statistics

Descriptive Statistics					
Variables	**N**	**Minimum**	**Maximum**	**Mean**	**Std. Deviation**
	Statistic	Statistic	Statistic	Statistic	Statistic
REM	1958	-5.38	2.13	.0345	.49186
AEM	1958	-1.19	2.33	.0020	.15451
ROA	1958	-1.91	.52	.0926	.08916
Liquidity	1958	.00	16.41	1.7190	1.04301
Leverage	1958	.00	1.05	.1786	.16552
Firm Age	1958	2.00	149.00	49.9510	25.21682
FF	1958	-.10	2.15	.1132	.15758
Board Size	1958	5.00	15.00	9.1645	1.50201
CD	1958	.00	1.00	.0715	.25773
Audit Meetings	1958	3.00	7.00	4.9556	.72658
IO	1958	.00	84.48	1.5053	8.41540

Table 2 shows the descriptive statistics for the study's variables. The sample comprises 1,958 firm-year observations from 178 non-financial companies listed on South Asian stock markets during the study period. The table shows the number of observations, the lowest and highest values, the mean, and the standard deviation for each variable. This gives an idea of how the data is spread out and how much it varies.
Real Earnings Management (REM), one of the most important dependent variables for earnings management, has a mean value of 0.0345, a minimum value of −5.38, and a maximum value of 2.13. The value shows that real activity manipulation is moderately present across firms and years. The high level of standard deviation shows variation in how the managers act. On the other had AEM i.e. accrual earnings management's mean and standard deviation values are comparatively smaller, showing that the reduced variability within the sample taken for the purpose of this study. The ROA which is a firm specific metric, shows moderate profitability in the sample, however, the variability in profitability across firms is significant. The liquidity average shows that majority of the corporations, have sufficient funds to meet their short-term obligations. the table further shows that the board comprises of 9 directors on average, which is consistent with the operational practices in the emerging economies. The variable of CEO duality shows limited number of firms in the sample show CEO duality. The average number of the audit committee meetings is five annually. The frequence of audit committee meetings show that financial reporting processes are diligently reviewed by the audit committee. The variable of institutional ownership shows significant variability, highlighting that ownership structures vary among the firms in sample.

Table 3 : Regression results for REM

Variable	B	SE	T	p
(Constant)	-0.733	0.344	-2.129	0.033
Board Size	0.015	0.008	1.851	0.064
CEO Duality	0.175	0.042	4.149	< 0.001
Audit Meetings	-0.019	0.017	-1.100	0.272
Institutional Ownership	0.003	0.001	2.166	0.030

Source: Author's Estimation

Table 3 shows the impact of corporate governance on earnings management by taking into account the corporate governance proxies and the real earning management (REM) proxy for earning management variable. The findings shows that CEO duality has positive and significant impact on the earnings management. It highlights that the firms with a CEO who also holds the position of board chair, tend to participate in the real earnings management. The variable of audit committee shows non-significant p-value, meaning there is no impact of audit meetings on the earning management. It indicates that merely increasing the frequency of the audit meetings will not be sufficient to prevent the actual profit manipulations. The findings contradict to the notion and that increase in the number of audit committee meetings, means increase in the oversight of financial reporting of the firm. Finally, the institutional ownership shows significant positive impact on the earnings management. Although the percentage impact is very minimal yet it indicates short term performance pressures imposed by institutional investors.

Table 4 Regression Results for AEM

Variable	B	SE	T	P
(Constant)	-0.045	0.111	-0.407	0.684
Board Size	0.003	0.003	1.191	0.234
CEO Duality	0.041	0.014	3.005	0.003
Audit Meetings	0.007	0.006	1.305	0.192
Institutional Ownership	0.000	0.000	0.744	0.457

Source: Author's Estimation

Table 4 shows the impact of corporate governance on earnings management. It takes in to account the accrual earnings management proxy for the purpose of measuring the earnings management instead of real earnings management used in Table 3. The findings show that board size, institutional ownership and Audit meetings have no significant impact on the accrual earning management. However, only CEO duality has a significant impact on the earnings management measured by accrual earnings management proxy. It shows that merging the roles of CEO and board chair leads to a concentration of managerial power, which can cause decline in the board oversight and cause increase in the risk of earning management manipulation via accruals.

Conclusion:

To sum, this paper has examined the impact of corporate governance mechanisms on earnings management. The aim of this paper was to investigate whether corporate governance assists in preventing managers from manipulating company earnings or not. It argued that stronger corporate governance procedures act as monitoring tools and therefore, reduce the probability of managerial opportunism. To achieve these objectives, the study obtained data from the emerging economies for the period of 2013 to 2024. It employed corporate governance characteristics such as board size, CEO duality, audit committee meetings and institutional ownership and two proxies for earnings management i.e. real earnings management and accrual earnings management. The findings of the study show CEO duality is positively and significantly associated with both accruals and real earning management. It suggests that concentration of leadership authority reduces the oversight capacity and tend to increase the managerial discretion in the financial reporting, increasing the probability of manipulation. These findings are aligned with the agency theory as well, which asserts that the lack of sufficient monitoring mechanisms allow managers to involve in the opportunistic conduct that often contradicts with the interests of the shareholders.

Prior studies on the subject, also support the findings of this paper. For instance, a study by Ali et al (2022) and Abdul Wahid et al (2021) found that the separation of the roles of CEO and the board chair enhances the board independence and strengthen the oversight of the management operations. The findings further show that merely having larger boards and frequent audit committee meetings may not intrinsically improve the monitoring effectiveness. Prior studies such as of Efunniyi et al., (2024) and Nguyen et al., (2025) also highlight that governance quality if effected by the competence, independence and the involvement of the board members, which is confirmed by the findings of the underlying study with both the proxies of dependent variable. Moreover, institutional ownership shows a significant link with real earnings management, highlighting that institutional investor's role in prioritizing short term benefits above long term governance. These findings are also supported by studies of Dote-Pardo et al (2025); Hales et al (2025). the findings of these studies also highlight that the governance structure should be strengthened so as to increase the transparency and protect shareholder interest.

The findings of this paper are important for the policy makers, regulators and the corporate stakeholders. Firstly, their must be separation of roles to increase the board independence and reduce management dominance in decision making. Secondly, the effectiveness of the board is important in terms of diversity and not by increasing the board size. Finally, to increase the integrity in the financial reporting disclosure practices should be strengthened.

This study provides valuable insights yet it has few limitations providing avenues for the future research work. For instance, the inclusion of more corporate governance attributes such as gender diversity, board independence, audit quality. The data is limited to firms selected in selected South Asian countries. It may be increased for the comparative analysis.

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