CORPORATE GOVERNANCE MECHANISMS AND EARNINGS MANAGEMENT IN INDIA

A STUDY OF BSE-LISTED COMPANIES

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PURPOSE
THE present study contributes to the literature by investigating the impact of corporate governance practices on earnings management by companies.

Design/Methodology/Approach: *To achieve the objectives of this study, a sample of 36 large-capitalisation companies listed on BSE (Bombay Stock Exchange) for the period 2005-06 to 2014-15 has been analysed. This is the period which started just after SEBI introduced revised Clause 49 of the Listing Agreement. Annual reports of companies have been analysed for the purpose of this study. Corporate governance has been quantified through its different attributes, i.e., size of board of directors (board size), board and audit committee meeting frequency, board independence, role duality (CEO/chairman), and audit committee independence. These factors are considered to play an important role in constraining the propensity of managers to engage in earnings management. Earnings management is measured by discretionary accruals calculated using the modified Jones model developed by Dechow et al. (1995).*

Findings: *The empirical findings are quite in line with the philosophy of corporate governance. Board independence and earnings management are negatively correlated. Similarly, board size and audit committee independence are positively associated with earnings management. However, three of the corporate governance variables (i.e., board meeting frequency, audit committee meeting frequency, and role duality) are found insignificantly related to earnings management.*

Research Limitations: *This is a preliminary analysis investigating the impact of corporate governance practices on earning management of select companies in India. Limitations of the study includes: (i) More elaborate testing of time series properties is not done; (ii) More econometric techniques can be used; (iii) We have accounted only for ROA as the control variable whereas there are many other factors that may influence earnings management decisions of managers, namely, leverage, and firm growth; and (iv) Results can further be improved by increasing the sample size of the study.*

Practical Implications: *In general, the paper empirically demonstrates the relationship between corporate governance and earnings management, i.e., corporate governance is negatively associated with earnings management. The findings of this study have important policy implications as they encourage adopting corporate governance practices in firms in order to mitigate earnings management. This will help to reduce distortions in financial reporting and therefore, enhance the reliability and transparency of reported financial statements.*

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Originality/Value: *Our study is unique in the sense that very few studies have been done on the aspect of investigating the impact of corporate governance practices on earning management in India.*

Key Words: *Corporate Governance, Discretionary Accruals, Earnings Management.*

Introduction

The integrity of financial disclosure has been a subject of debate among regulators, financial analysts, and accounting practitioners; especially after the series of high-profile accounting scandals and frauds involving well-known firms such as Worldcom and Enron (US) (Levitt, 1998). Financial statements are seen as an important summary statistic of a firm's financial performance and are often used in firm valuation. But, earnings management by companies is widespread throughout the world. The existing literature reveals that it is actually a *pervasive phenomenon.* Earnings management defined as alteration of a firms' reported economic performance by insiders either to mislead stakeholders or to influence contractual outcomes (Leuz et al., 2003). The prime motive for earnings management may be private gains in the form of managerial compensation by meeting earnings targets**.** Secondly, earnings management occurs when managers use personal opinion in reporting financial information and in structuring accounting transactions to alter financial statements to either mislead stakeholders on the original economic performance of the firm or to manipulate contractual outcomes that depend on reported accounting numbers. Thus, the very nature of accounting accruals and information asymmetry between managers and owners give managers a great deal of discretion in determining the reported earnings of a firm in any given period. As a consequence, this practice of earnings management has adversely affected the quality of financial information disseminated by companies which has led to poor investor decision-making.

The need for corporate governance aroused with the separation of management and ownership that resulted in agency problems. Prior studies have shown that good corporate governance practices can help to control earnings management by companies. Good corporate governance is characterized by transparency of corporate operations, timely disclosure of credible information, accountability, active co-operation, and corporate responsibility of managers & board of directors towards all stakeholders.

Prior studies on corporate governance and earnings management came mostly from developed countries like the UK, Canada or the US (including Beasley, 1996; Klein, 2002; Park & Shin, 2004; Peasnell et al., 2005; Xie, Davidson et al., 2003) as compared to studies from developing countries like India.

The present study contributes to the literature by examining the impact of corporate governance practices in controlling the opportunistic behaviour by managers. To achieve the objectives of this study, we analysed a sample of 36 large-capitalisation companies listed on BSE (Bombay Stock Exchange) for the period 2005-06 to 2014-15. This is the period which started just after SEBI introduced revised Clause 49 of the Listing Agreement. Annual reports of companies for this period have been analysed for the study. Corporate governance has been quantified through its different attributes, i.e., board size, board committee meeting frequency, board independence, role duality (CEO/chairman), audit committee meeting frequency, and audit committee independence. These corporate governance mechanisms are considered to play an important role in constraining the propensity of managers to engage in earnings management. Discretionary accruals are used as proxy for Earnings management and are computed using the modified Jones model developed by Dechow et al. (1996).

In general, this paper empirically demonstrates the impact of corporate governance mechanisms on earnings management. Thus, the findings of this study have important policy implications as they encourage the adoption of corporate governance practices in firms in order to mitigate earnings management. This will help to reduce distortions in financial reporting and, therefore, enhance the reliability and transparency of reported financial statements.

Review of Literature

Both the areas of corporate governance and earnings management are of immense importance. Corporate governance revolves around the relationship among the corporation and its stakeholders such as shareholders, suppliers, management, employees, customers, financiers, government, and the society. It protects the interest of all these stakeholders and provides a set of mechanisms through which outside investors protect themselves against expropriation by the insiders (La Porta et al., 1997). The practice of earnings management, on the other hand, shows its kind nature only to managers and provides them the opportunity to alter financial information according to their own vested interests. Prior researches have shown that good quality corporate governance has a noteworthy influence in limiting earnings management practices.

Cadbury Committee (1992) stated that board independence is an important aspect of effective corporate governance. The emphasis on board independence is grounded in agency theory (Fama & Jensen, 1983; Shleifer & Vishny, 1997). Independent directors are generally considered to be better monitors as compared to other directors because they have the "ability to act with a view of the best interests of the corporation".

Beasley (1996) concluded that there is a negative relationship between the percentage of non-executive board members and the chances of fraud. Dechow et al. (1996) found that corporations with a large percentage of non-executive members are less likely to be subject to accounting enforcement actions by the SEC for alleged GAAP violations. So we need to test if this result holds good for earnings management or not and we expect a negative association between the proportion of independent directors on the board and the level of earnings management.

Blue Ribbon Committee (1999) considered audit committee independence as an essential quality for an audit committee to fulfil its oversight role. Several recent studies have documented a correlation between audit committee independence and a higher degree of active oversight as well as a lower incidence of financial statement fraud. So there is need to test whether audit committee independence will be associated with lower levels of earnings management or not.

TSE (1994) provided evidence that the number of directors is an important factor influencing the effectiveness of the board. But, unfortunately the literature provides no consensus about the direction of the relationship between board size and effectiveness. On the one hand, a larger board is less likely to function effectively and is easier for the CEO to control (Jensen, 1993). On the other hand, a larger board provides better environmental links and more expertise (Dalton et al., 1999). The evidence regarding financial statement reliability is also mixed. Beasley (1996) finds a positive association between board size and the likelihood of financial statement fraud whereas Abbott et al. (2000) find no relationship between the two. Because of this lack of consensus, there is a need to examine the association as well as its direction between earnings management and size of the board.

Liu & Lu (2007) suggested that corporate governance is significantly associated with earnings management, and also emphasized that agency problems may be overcome by good corporate governance practices. They examined the association between corporate governance and earnings management in China by introducing a tunnelling perspective to describe the transfer of resources away from firms for the benefits of their controlling shareholders.

Iqbal et al. (2015) studied the impact of corporate governance practices on earnings management by employing fixed effect estimators on a sample of 89 non-financial companies listed on the Karachi Stock Exchange. The empirical findings for the period 2003-2012 showed that there is negative correlation between audit committee independence and earnings management. CEO-chair duality was found to be positively associated with earnings management while two corporate governance variables (i.e., board size and managerial ownership) were insignificantly related to earnings management. On the whole, the study concluded that corporate governance is negatively associated with earnings management,

thus evidencing that in developing countries corporate governance is playing a major role in overcoming this problem.

Abbadi et al. (2016) investigated the impact of corporate governance quality on earnings management in Jordan by taking a panel data set of all industrial and service firms listed on the Amman Stock Exchange (ASE) during the period 2009-2013. Overall, the results showed that earnings management, measured by discretionary accruals, is negatively affected by corporate governance quality. Particularly, the empirical findings showed that earnings management is affected negatively by overall categories of corporate governance index represented by board of directors, board meetings, audit committee & nomination, and compensation committee. The results also indicated that compliance with corporate governance code by Jordanian companies has increased over time thereby, resulting in greater ability of corporate governance to control earnings management. Based on its findings, the paper strongly recommends Jordanian companies to enhance their compliance with corporate governance code to improve the reliability and integrity of financial reporting.

Agrawal & Chadha (2005) empirically examined whether there is a relation between the probability of a company restating its earnings and its corporate governance mechanisms. They found that several key governance characteristics like board and audit committee independence and provision of non audit services by outside auditors are essentially unrelated to the probability of restatement. The results also indicated that the probability of restatement is significantly lower in companies having an independent financial expert in the board or audit committees. On the other hand, it is higher in companies whose CEO belongs to the founding family. The findings of the paper throw light on the fact that independent directors with financial expertise are valuable in providing effective oversight of a firm's financial reporting process.

Bekiris & Doukakis (2011) studied the relationship between corporate governance and accruals earnings management. They focused on the multi-dimensional character of corporate governance by using a corporate governance index consisting of 55 individual corporate governance measures. Analysis of a sample of firms listed on the Milan, Athens and Madrid stock exchanges showed that there is an inverse relationship between earnings management and corporate governance. The findings of the paper further suggested that the inverse relationship holds for large and mid cap firms but not for the small cap sample. Moreover, corporate governance restricts upwards but not downwards earnings management. Overall, the paper highlighted the power of corporate governance mechanisms in constraining the tendency of managers to manage earnings of firms and thus, ensuring the integrity of the financial reporting process.

Abed, et al. (2012) investigated the relationship between earnings management and corporate governance characteristics like independence of board of directors, board size, the percentage of insider ownership, and CEO/ chairman duality. They examined a sample consisting of 329 firm-observations for the firms listed on the Amman Stock Exchange for the period 2006-2009. Discretionary accruals are used as a proxy for earnings management and are measured using the Jones model. The study also employed two control variables, namely, financial leverage and company size. The findings of the study show that board size is the only variable that has a significant negative relationship with earnings management. Roy (2014) examined the firm specific characteristics that drive companies in India to superior governance and sustainability performance. Goel & Mclver (2015) examined the impact of reforms of India's corporate governance standards on the capital structure of its listed corporations and concluded that stock market development is associated with lower gearing, while improvements in the quality of development of India's institutions are associated with higher gearing.

Objective of the Study

The prime aim of the study is to empirically investigate the impact of corporate governance mechanisms on earnings management of large capitalisation companies listed on the Bombay Stock Exchange (BSE).

Hypothesis Formulation

On the basis of a thorough review of literature, the following hypotheses were formulated:

H1: There is a relationship between board size and earnings management.

H2: There is negative association between board independence and earnings management.

H3: There is an association between board meeting frequency and earnings management.

H4: There is an association between audit committee meeting frequency and earnings management.

H5: There is a relationship between audit committee independence and earnings management.

H6:There is an association between chair and CEO duality and earnings management.

Data and Research Methodology

Data

The current study population covers all BSE listed large-cap companies. The sample for the study consists of 36 companies selected from 9 different sectors viz. automotive, oil and gas, pharmaceuticals, cement/construction, chemical, real estate/retail, food and beverage, technology, and metals and mining. Data of companies is taken from the year 2005-06 to 2014-15, the period which started just after SEBI introduced revised Clause 49 of the Listing Agreement. Annual reports of companies were analysed for the purpose of this study.

Corporate Governance

In this paper, corporate governance has been quantified through its six different attributes, i.e., size of board of directors (board size), board meeting frequency, board independence, role duality (CEO/chairman), audit committee independence, and audit committee meeting frequency. These factors are considered to play an important role in constraining the propensity of managers to engage in earnings management. These six individual practices of corporate governance have been taken as the independent variables in our study.

1. **Board size:** It refers to the total number of directors on the board of the company and is calculated by taking the natural logarithm of the total number of directors on the board.

2. **Board meeting frequency:** It refers to the number of board meetings held during the year and is calculated by taking the natural logarithm of the total number of board meetings.

3. **Board independence:** It refers to the presence of independent directors on the board and is calculated as a proportion of the number of independent directors on the board of directors i.e.,

$$Board\ independence = \frac{number\ of\ independent\ directors\ on\ the\ board}{total\ number\ of\ directors\ on\ the\ board} \times 100$$

   We take the natural logarithm of board independence.

4. **Role duality (CEO/chairman):** It refers to whether the two different roles are assigned to the same person or not. Role duality has been taken as a dummy variable and is assigned the value 1 if CEO and chairman are the same person, otherwise the value assigned is 0.

5. **Audit committee independence:** It refers to the presence of independent directors in the audit committee and is calculated as a proportion of the number of independent directors in the audit committee i.e.,

$$Audit\ committee\ independence = \frac{number\ of\ independent\ directors\ in\ audit\ committee}{total\ number\ of\ directors\ in\ the\ audit\ committee} \times 100$$

6. **Audit committee meeting frequency:** It refers to the number of audit committee meetings held during the year and is calculated by taking the natural logarithm of the total number of audit committee meetings.

Earnings Management

In literature, the most commonly used proxy for earnings management is accruals. It is the difference between the reported earnings during the period and the cash earnings during the period. Accruals can be measured using two different approaches-

1. Balance sheet- based approach (BS Approach)
2. Cash flow-based approach (CF Approach)

On the basis of review of literature, it was found that both the approaches have been used by researchers for calculating accruals. However, overall, most researchers preferred the CF approach over the BS approach for calculating total accruals. Therefore, for the purpose of the current study, we use the cash flow-based (CF) approach.

According to the CF approach, total net accruals are calculated as follows:

Total Net Accruals = Accrual Earnings – Cash Earnings

In other words,

$TA_t = NI_t - CFO_t$

Where,

TA_t = total accruals in year t

NI_t = net income in year t

CFO_t = cash flows from operating activities in year t

Therefore, total accruals are the difference between the earnings of a firm and its cash flows generated from operating activities. However, total accruals do not actually reflect earnings management. This is because accruals can either be the result of earnings manipulation or just normal accounting estimations based on future business expectations. Therefore, one has to determine which of the two is the driving force of accruals. For this purpose, accruals are further categorised as discretionary and non-discretionary. Discretionary accruals are that portion of total accruals over which the management can exercise their subjective choices (i.e., discretion). Hence, this estimated portion of accruals is often used as a proxy of earnings management.

Mathematically,

Total Accruals = Discretionary Accruals + Non Discretionary Accruals

$TA = DA + NDA$

Estimating Earnings Management using Modified Jones Model

The current study uses the modified Jones model (Jones, 1991; Dechow *et al.*, 1996) for estimating discretionary accruals. According to this model, non-discretionary component of accruals can be calculated by using the following equation-

$$TA/A_{t-1} = \alpha_1 + \alpha_2 [(\Delta REV - \Delta REC)/A_{t-1}] + \alpha_3(PPE/A_{t-1}) + \varepsilon t \quad (1)$$

Where,

TA = total accruals

A_{t-1} = assets of prior year

ΔREV = change in revenue

ΔREC = change in receivables

PPE = property, plant, and equipment

Control Variables

The reason behind introducing a control variable in our empirical model is that earnings management decisions of an entity may be influenced by several factors in addition to those considered in this paper. In order to capture the impact of these variables, we have included firm performance as the control variable in our study. Return on assets has been taken as the proxy for firm performance and is calculated as follows:

$$\text{Return on assets} = \frac{Net\ income}{Total\ assets} \times 100$$

Econometric Model

Since the study involves panel data (cross-sectional time series data), we have used panel data econometric techniques for estimation.

The general form of the model is as follows:

$$DA_{it} = \beta_0 + \beta_1(BS_{it}) + \beta_2(BI_{it}) + \beta_3(BMF_{it}) + \beta_4(ACMF_{it}) + \beta_5(ACI_{it}) +$$

$$\beta_6(RD_{it}) + \beta_7(ROA_{it}) + \mu_{it} \quad (2)$$

Where,

DA = discretionary accruals of the firm

BS = board size

BI= board independence

BMF= board meeting frequency

ACMF= audit committee meeting frequency

ACI = audit committee independence

RD= CEO and chair duality

ROA = return on assets

β_0 = intercept of the equation

μ = error term

β_1 to β_7 = coefficients

'i' and 't' = subscripts for entity and time period

The research methodology of this paper has been summarized in the following steps:

1. We applied the Hausman test to find the existence of fixed effects and random effects in the data using the financial variables.
2. Then the residuals are computed through the modified Jones model (eq. 1) and named as discretionary accruals (a proxy for earnings management).
3. Then a multivariate regression was run through EViews taking discretionary accruals as the dependent variable and the corporate governance variables (i.e., board size, board meetings frequency, board independence, role duality, audit committee meetings, and audit committee independence) and ROA (control variable) as the independent variables (eq. 2).
4. We again applied the Hausman test using corporate governance variables. Since the Hausman statistic comes out to be statistically significant, it suggests the existence of fixed effects in the data.
5. We then applied the fixed effects panel regression to the above mentioned set of variables to test the impact of corporate governance on earnings management.
6. We also examined the correlation between discretionary accruals (earnings management) and all the corporate governance indicators and also the control variable i.e., ROA.

Hausman Test

Hausman Test developed in 1978 can be used to differentiate between fixed effects model and random effects model in panel data.

Null Hypothesis: Fixed effects and random effect estimators do not differ substantially and random effect model is preferred.

Alternate Hypothesis: Fixed effect model should be preferred.

Estimator	H_0 is true	H_1 is true
Random Effect Estimator	ConsistentEfficient	Inconsistent
Fixed Effect Estimator	ConsistentInefficient	ConsistentPossibly Efficient

Empirical Results

Table No. 1: Hausman Test Results Using Financial Variables

Correlated Random Effects - Hausman Test

Equation: Untitled

Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	2.296520	2	0.3172

Since p-value is not statistically significant even at 10% level of significance, we can say that fixed effects and random effect estimators do not differ substantially. Therefore, the random effect model is preferred and to be used for computing the residuals to be named as discretionary accruals (proxy for the earnings management).

Table No. 2: Hausman Test Results Using Corporate Governance Variables

Correlated Random Effects - Hausman Test

Equation: Untitled

Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	35.504260	7	0.0000

Since p-value is statistically significant, we can say that fixed effects and random effect estimators do differ substantially. Therefore, the fixed effect model should be preferred for further exploring the relationship between corporate governance and earnings management.

Regression Analysis

Table No. 3: Multivariate Regression Analysis

Dependent Variable	**Discretionary Accruals**	
Variable	**Coefficient**	**Prob.**
C	-0.588632	0.5923
LBS	0.683250	0.0490**
LBI	-0.685239	0.0010***
LBMF	-0.202594	0.3373
LACMF	-0.088575	0.6771
ACI	0.025112	0.0000***
RD	0.179853	0.4135
ROA	-0.008477	0.0471**

R-square	0.192336
Adjusted R-squared	0.070752
S.E. of regression	0.719471
F-statistic	1.581920
Prob. (F-statistic)	0.016817***

*Note: *Significant at 10% level of significance; **Significant at 5% level of significance.*
****Significant at 1% level of significance.*

Findings

I. F-statistic is also coming to be statistically significant even at 1% level of significance indicating the model to be a good fit.

II. There is statistically significant positiveassociation between board size and level of discretionary accruals implying that board size increases earnings management. This result is consistent with that of prior study conducted by Abed et al. (2012)who found a negative relationship arguing that less number of board will create better oversight function and will be more focused to convince management to refrain from conducting earnings management.

III. There is statistically significant negative association between board independence and level of discretionary accruals showing that board independence decreases earnings management. This result is consistent with that of prior study conducted by Xie et al. (2003) suggesting that independence of the board is necessary to oversee managerial activities to maintain the

interest of investors and inclusion of large number of outside directors on the board could decrease the probability of manager's opportunistic behaviour. Thus, it implies that in India, in BSE listed companies the role of independent directors on the board is effective in controlling fraudulent reporting by managers and also in making a difference or influencing the company's strategic decision making choices.

IV. There is a statistically significant positive association between audit committee independence and earnings management.

V. The control variable i.e. return on assets (used as a proxy for firm performance) has a statistically significant and negative relationship with the explained variable (DAC), implying that firm performance is negatively related to earnings management.

VI. The regression analysis also provides evidence of a positive but insignificant association between CEO–chair duality and discretionary accruals, implying that firms where the CEO and chairman of its board are one and the same person are engaged in high level of earnings management. This result is in line with the existing literature.

VII. The regression analysis also provides evidence of a negative but insignificant association between board meeting frequency and discretionary accruals and between the audit committee meetings frequency and discretionary accruals showing that board meeting frequency and audit committee meetings frequency decreases earnings management.

VIII. The R-square is the coefficient of determination, and its value of 0.192336 indicates that all the explanatory variables in the model jointly explain 19.23 per cent variation in the discretionary accruals, which means that there are other variables responsible for the rest of the variation in the discretionary accruals. The other corporate governance variables affecting earnings management (discretionary accruals) could be gender composition of the board of directors, ownership structure, nomination, and compensation committee.

IX. Thus, the results are in line with the existing literature implying that board composition, structure and audit committee independence serve as effective monitors of corporate financial reporting and thus, prevent earnings management in the respective sector.

Correlation Analysis

Table 4: Correlation Coefficients between Discretionary Accruals and Corporate Governance Measures

Corporate Governance Variables	**Discretionary Accruals** Correlation Coefficients(p-value)
Board Size	0.074835 (0.1804)
Board Meeting Frequency	-0.056120 (0.3154)
Board Independence	-0.012646 (0.8212)
Audit Committee Meeting Frequency	0.039037 (0.4852)
Audit Committee Independence	0.233832 (0.0000)***
Return on Assets	-0.148114 (0.0078)***

*Note: *Significant at 10% level of significance; **Significant at 5% level of significance.*
****Significant at 1% level of significance.*

Table no. 4 shows the correlation results. Four of the corporate governance variables, namely, audit committee independence (ACI), audit committee meetings frequency (ACMF), board size (BS), and role duality (RD) are positively correlated with discretionary accruals (DAC). However, only the correlation between DAC and ACI is statistically significant while others are statistically insignificant. On the other hand, board independence (BI) and board meetings frequency (BMF) are negatively correlated with discretionary accruals. However, correlation is found to be statistically insignificant. The control variable, namely return on assets (ROA) is negatively correlated with discretionary accruals and the correlation is statistically significant.

The results of the study provide empirical evidence that corporate governance practices have important implications on the opportunistic behaviour by managers and also good corporate governance practices can mitigate earnings management and other fraudulent practices.

Summary and Conclusion

Prior studies have shown that good corporate governance practices can help to control earnings management by companies. Good corporate governance is characterized by transparency of corporate operations, timely disclosure of credible information, accountability of managers and the board of directors towards shareholders, active co-operation between corporations and stakeholders and corporate responsibility towards stakeholders.

The effect of corporate governance indicators on earnings management is evident from the results of this study. Coefficient of board independence is found to be negative and statistically significant indicating that increasing the number of independent directors on the board leads to a reduction in the discretionary accruals, hence showing that directors have independence in true sense and are effective. But the coefficient of board size and audit committee independence is found to be positive and statistically significant showing that board size and audit committee independence increases earnings management.

Furthermore, there is evidence of positive but insignificant association between CEO–chair duality and discretionary accruals indicating that in order to control the earnings management practices the CEO and chairman of the board should not be one and the same person. These two positions should be held by two separate persons to prevent earnings management. Also the coefficients of board meetings frequency and audit committee meetings frequency are negative but statistically insignificant. The coefficient of control variable i.e., Return on Assets was found to be statistically significant and negatively related with the earnings management.

The results of the study provide empirical evidence that corporate governance practices have important implications on the opportunistic behaviour by managers, and also good corporate governance practices can mitigate earnings management and other fraudulent practices.

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