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Does managerial behavior of managing earnings mitigate the relationship between corporate governance and firm value? Evidence from an emerging market

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ABSTRACT

The relationship between corporate governance and managerial choices for value creation is a topic of continuing interest for researchers. One of most significant managerial decisions that affect value is Discretionary Earnings Management (DEM) which is the judgmental adjustments in firm's reported accounting earnings by managers to upsurge firm value temporarily. Effective corporate governance structure to control this opportunistic behavior of mangers can presumably make accounting earnings more reliable and more informative for the stakeholders and hence, increase firm value. Based on 1944 firm year observations for listed firms in Pakistan, this study aims at to analyze the role of corporate governance in enhancing firm value along with the moderating role of DEM using models proposed by Kasznik (1999) and Beatty, Ke, & Petroni (2002) for detecting earnings management practices of managers. The results report that corporate governance significantly and positively influences firm value confirming the positive role of corporate governance in mitigating agency problem and enhancing the firm value. Moreover, corporate governance mechanisms may mitigate the managers' opportunistic behavior of manipulating the reported earnings. Furthermore, the results report that the behavior of managers is opportunistic towards managing earnings and they are destroying the current and subsequent firm value by manipulating the reported accounting earning. Finally, this opportunistic behavior of managers to manipulate earnings is negatively moderating the well-established positive relationship of corporate governance and firm value.

1. Introduction

The researchers in corporate finance have long recognized the widespread separation of ownership and control in firms that has created the potential agency problem which may be costly. The mangers have substantial freedom to pursue their personal benefits at the expense of shareholders' wealth due to limited incentive of shareholders to monitor the behavior and performance of managers (Kolsi & Grassa, 2017). The core objective of shareholders is to earn returns on their invested capital, whereas managers are likely to be focusing on their personal goals such as consummation of perquisites (Jensen & Meckling, 1976), power and prestige of running a large organization (Hubbard & Palia, 1995), or their job security by not investing in risky but rewarding projects (Amihud & Lev, 1981). In this regard, managers' superior access and control over the firm's resources give them upper hand and they take decisions which are aligned with their personal objectives instead those of shareholders. The principle of shareholders' wealth maximization

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will not motivate corporate decision making in the absence of effective corporate governance mechanisms. Since the publication of pioneer work by Berle and Means (1932), immense literature has been stimulated on the agency theory of principal and agents and researchers have tried to explore the potential adverse effects of absence of effective control mechanism and misalignment of shareholders and managers' interests.

Along with the agency phenomenon, the global financial catastrophe and investors' desire for companies to have good corporate governance system also amplified its importance. The Asian Financial Crisis of 1997 had adversely hindered many corporations in South East Asian countries putting long lasting effects on their economies (Sachs, 1998). Generally, poor corporate governance structure is assumed to be the source of these crises up to a certain extent (D'Cruz, 1999; Khas, 2002). Moreover, the financial collapse of conglomerates such as Enron, Etoys, Adelphia, World Com, Parmalat, Commerce bank, XL Holidays have ruined the investor confidence in the capital markets and cautioned the world for the need to have a transparent and fair governance system in companies. During the last couple of decades, regulators, investors, policy makers and other capital market participants have been increasingly focusing on the need for firms of have an effective monitoring and accountability system of corporate governance to minimize agency problem (Epps & Ismail, 2009).

The relationship between corporate governance and managerial choices for value creation is a topic of continuing interest for researchers. It is believed that practices of corporate governance are value enhancing (Johl, Khan, Subramaniam, & Muttakin, 2016) and a firm with effective governance system can increase its value by lowering the conflict of interest between dispersed minority shareholders and empowered managers of firms as well as by reducing information asymmetry and increasing managerial efficiency (Audousset-Coulier, Jeny, & Jiang, 2016). After the implementation of Sarbanes-Oxly (SOX) Act of 2002 in the United States, most of the countries had begun to realize the importance of effective corporate governance mechanisms to reduce agency cost and create value for shareholders. This realization has also ignited research in developed as well as developing countries of the world to investigate the impact of corporate governance on firm value (Core, Guay, & Rusticus, 2006, Sami, Wang, & Zhou, 2011), however, findings are still indecisive. Most of the researchers had documented a strong positive association between corporate governance and firm value (Gompers, Ishii, & Metrick, 2003, Cremers and Nair, 2005, Bebchuk, Cohen, & Ferrell, 2009). On contrary, some also found mixed or no evidence of relationship between corporate governance and firm value (Yermack, 1996, Lehn, Patro, & Zhao, 2007). However, Gompers et al. (2003) and Cornett, Mcnutt, and Tehranian (2009) suggested that relationship between corporate governance and firm value is endogenous which needs to be addressed more comprehensively and rigorously.

Firms possessing good corporate governance practices may outperform their counterparts due to two main reasons. Firstly, better governed firms utilize their financial and human resources in an efficient manner to make profitable investments. Investors feel secure while investing in these types of firms as they believe that less cash flows will be diverted due to mitigated agency problem and expect higher payouts which ultimately leads to increased stock price and enhanced firm value (Jensen & Meckling, 1976; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002). The findings of the popular McKinsey Survey (2000) also reported that majority of the investor respondents assigned more value to the firms with good corporate governance practices. Secondly, firms with good corporate governance may have lower required rate of return on equity (cost of equity capital) as shareholders' costs of monitoring the managers and auditing the reported earnings are much lesser (Shleifer & Vishny, 1997). Good governance practices of companies may prove to be helpful in building optimistic market reputation in capital markets and hence, funds can be acquired at lower costs. However, some researchers have also raised the question mark on this positive relationship of corporate governance and firm value due to high cost associated with implementation of effective corporate governance mechanisms in company which may counterbalance its benefits (Gillan, 2006; Chhaochharia & Grinstein, 2007; Bruno & Claessens, 2010).

One of the most significant value related managerial decisions is Discretionary Earnings Management (DEM). Earnings management is the judgmental adjustments/alteration in firm's reported accounting earnings by managers in order to upsurge firm value temporarily (Cornett et al., 2009; García-Meca & Sánchez-Ballesta, 2009; Cameran et al., 2015). Managing earnings is a choice of accounting rules, voluntary earnings estimates or information disclosures in order to affect the level or quality of reported earnings deliberately. This intentional alteration and manipulation of accounting earnings emasculate the reliability and trustworthiness of disclosed accounting information, which otherwise may be very beneficial to the stakeholders, have underlined earnings management as much important research area. Previous studies in corporate finances have found several managerial motives for discretionary earnings management including obtaining personal benefits like compensation plans (Healy, 1985); job security (Defond & Park, 1997), meeting debt covenants (Bowen, Ducharme, & Shores, 1995, Defond & Jiambalvo, 1994, Sweeney, 1994), meeting analysts and investors forecasts (Matsunaga & Park, 2001, Kasznik, 1999), setting a better listing price after going public (Teoh, Welch, & Wong, 1998), maximizing merger premium and minimizing acquisition cost when stock consideration is used by acquiring firm (Louis, 2004), and reducing loan losses (Beaver & Engel, 1996). Healy (1985) was the forerunner to provide the evidence that managers, as corporate insiders, manipulate the current period earnings on the cost of long-term firm value to increase their salaries and other monetary benefits. There are both good and bad facets of discretionary earnings management (Houqe, Ahmed, & Zijl, 2017). Stocken and Verrecchia (2004) has discussed that it can disclose insider information, and communication among insiders and capital market participants can be enhanced. Contrarily, DEM can result in an opportunistic behavior of managers (Hanna, 1999, Dechow, Sloan, & Sweeney, 1996) and earlier studies found that greater earnings manipulation and a reduced level of earnings informativeness are the topographies of a fragile investor protection framework (DeFond, Hung, & Trezevant, 2007, Leuz, Nanda, & Wysocki, 2003).

The fundamental issue of corporate governance is to ensure accountability of top management while concurrently providing executives with the autonomy and incentives to exploit wealth producing business opportunities (Braswell & Daniels, 2017). Effective corporate governance structure to control the opportunistic behavior of mangers can presumably make accounting information more reliable and more informative for the stakeholders and hence, increases firm value (Dechow et al., 1996). The reliability and