# Corporate Governance and Earnings Management: A Review

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***Abstract- Recent research on corporate governance has identified the impact of different corporate governance variables on earrings management. Corporate collapses all over the world during the recent past have increased the interest in corporate governance. Therefore, it is worthwhile to look in to the previous literature relating to corporate governance and earnings management. Most of the studies were conducted using the board characteristics and audit committee characteristics. Almost all prior studies recommended the need of effective corporate governance practices in order to reduce earnings management and prevent possible corporate collapses.***

## I. INTRODUCTION

Corporate governance has come into action in order to address large business failures and scandals such as Enron and WorldCom which happened during the past few decades. In Sri Lanka, Pramuka Savings and Development Bank and Golden Key Credit Card Company (Edirisinghe 2015) collapsed as a result of poor corporate governance mechanisms. Broadly corporate governance system is the governance of company by the Board of directors and shareholders. Corporate governance is sometimes viewed as a business culture fostering economic growth by building up confidence of investors. (Robert et al. 2013). Also, Man and Wong (2013) explained corporate governance as an internal system encompassing policies, processes, and people that serve the needs of shareholders and other stakeholders by directing and controlling management.

According to Xie et al. (2003), earnings management occurs when accrual accounting techniques are used to record the financial impact of any transaction or any other event which has cash consequences for the entity, not only in the period in which cash was paid or received but also in the period in which such transaction or any other event had occurred. On the other hand, Gelderen (2013) pointed out that earnings management as a situation when managers use judgment in financial reporting and in structuring transactions to alter financial report to either mislead some stakeholders about the underlying performance of the company or to influence contractual outcomes that depend on reported accounting numbers.

Since the corporations can minimize earnings management practices by adopting good corporate governance practices and it leads to the betterment of all the stakeholders, this review focused on examining the prior literature related to corporate governance and earnings management.

## II. LITERATURE REVIEW

As board of directors and audit committee are integral parts of corporate governance, the review is parted into two portions; the first portion is devoted to discussing the relationship between board characteristics and earnings management while the second one is focused on investigating relationship between audit committee characteristics and earnings management.

CEO Duality, Board independence and board size can be identified as the most frequently used board characteristics. Iraya et al. (2015) have found that earnings management is negatively related with board size and board independence by the study conducted in Kenya. According to Uwuigbe et al. (2014), earnings management practices can be very common managerial practices in developing countries such as Nigeria where the research concluded that larger board of directors with diverse knowledge can mitigate the earnings management practices effectively than smaller boards as they are more likely to have independent directors with more corporate and financial expertise. As a supporting to the above findings Abed et al. (2012) emphasize that size of the board of directors had a significant relationship with the earnings management practices. Furthermore, in the USA, Xie et al. (2003) found that board size is negatively associated with the level of discretionary accruals, as a large number of board members with varied expertise leads to effective and synergetic monitoring. However, fast and efficient decision making may be avoided because of excessive size, due to problems of coordination and communication (Gonzalez and Meca, 2013).

Xie et al. (2003) concluded that a board of directors with a higher proportion of independent directors is negatively associated with the discretionary accruals in the USA, and their findings posit that a higher number of independent directors is related with better monitoring, ultimately resulting in a reduction in discretionary accruals. Similarly, Roodposhti & Chamshmi (2011) have found that Board independence is negatively related to earnings management.

CEO duality is where the chairperson of the board and the CEO of the company being held by separate persons. It is clear that there is attentiveness on power in a company when the same person is holding the role of Chief Executive Officer and President of the board (Gonzalez and Meca, 2013). Anderson et al. (2003) have found that the separation between CEO and Board Chair positions appear to positively influence the information content of accounting earnings. But there was no significant relationship between the number of board meetings and discretionary accruals found in the study of Ahmed (2013).

Most of the researchers have used frequency of audit committee meetings, audit committee size and audit committee members with financial expertise as audit committee variables for corporate governance.

The findings of Xie et al. (2003) have shown a negative association between the number of audit committee meetings and the level of earnings management implying that a more active audit committee is associated with a reduced level of discretionary current accruals. Also Saleh et al. (2007) observed that firms which held more audit committee meetings recorded fewer earnings management practices compared with other firms in Malaysian context.

According to Lin et al. (2006) a larger audit committee may provide more oversight over the financial reporting process. Such oversight seems to improve earnings quality by reducing the probability of restating financial statements.

Abbott et al. (2004) stated a negative relationship between the audit committee’s financial expertise and occurrence of earnings restatement. Further, Xie et al. (2003) also identified that when the audit committee is comprised of more independent outside directors with high financial expertise, earnings management is less likely to occur. It was also found that firms which had more knowledgeable audit committee members and held more audit committee meetings recorded fewer earnings management practices compared with other firms (Saleh, Iskandar & Rahmat 2007). However, the study of Lin et al. (2006) provides no evidence that financial expertise of audit committee members have any impact on quality of reported earnings in the context of USA.

## III. CONCLUSION

The different scandals have highlighted certain key weaknesses in the governance mechanism within companies all over the world. This paper reviewed the empirical literature relating to corporate governance factors which affect earnings manipulation in organization. Basically, corporate governance variables were categorized in to two parts as board characteristics and audit committee characteristics. Review emphasized that large boards and independent boards could mitigate earnings management practices. However, the relationship between CEO duality and earnings management varied in different contexts. Furthermore, the number of audit committee meetings and larger audit committees has resulted in lower discretionary accruals. Moreover, it could be underlined that earnings management practices could be mitigated by effective corporate governance practices.

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