CORPORATE GOVERNANCE, PRINCIPAL-PRINCIPAL CONFLICTS AND EARNINGS MANAGEMENT IN BANKING SECTOR OF PAKISTAN

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ABSTRACT

The financial markets are increasingly focusing on Corporate Governance practices to provide unbiased and accurate financial information to shareholders but, managers are induced to engage in earnings management practices to bypass/outwit expectations. Moreover, concentrated ownership structures mainly in banks, cause the majority shareholders to have a definite upper hand over minority shareholders which enables them to exploit the interests of minority shareholders causing principal-principal conflict. The present study intends to investigate the impact of Corporate Governance and principal-principal conflicts on earnings management in the banking sector of Pakistan for the period of 2012-17 by using ordinary least square. The Findings of the present study suggested that 'the proportion of independent directors on boards' is negatively associated with earnings management, while ownership concentration, percentage of voting shares held by largest shareholders and sum of ownership percentage of the five biggest firm shareholders is positively associated with earnings management. Overall, this study finds mixed results for the different characteristics of the board with earning management in banks. The present study has implications for bank management by guiding earning management and regulatory bodies; they must consider earning management behavior of the manager.

Keywords: Earnings management, corporate governance, principal-principal conflicts, banking sector, ownership concentration.

INTRODUCTION

Corporate Governance (CGOV) refers to the rules and regulations through which outsiders' shareholders protect themselves from exploitation by the insiders (La Porta, Silanes, Shleifer, & Vishny, 2000). "Insiders" can be the management and controlling shareholders as well. The introduction of the CGOV mechanism in firms decreases the benefits of control enjoyed by major shareholders by restrictive the incidence of related-party transactions, tunneling and other ways of diverting company profits from minority shareholders (Love, 2010). Siregar and Utama (2008) find that the corporate ownership structure plays a vital role in reducing the agency cost and earning management (EM) activities of the firm through effective monitoring. Javid and Iqbal (2008) find that the ownership is concentrated in the few big shareholders which ultimately disturb the governance mechanism in Pakistan. Moreover, firms that are closely held by insiders like (businesses controlled by families & State-owned) are more inclined to dominate the corporate scenario in most of the emerging countries.

The rules and regulations for firms set by SECP and issued the Pakistan code of CGOV (PCCG) in March 2002 (Revised in April 2012) with the aim of refining CGOV practices and reducing the trust discrepancy among the owners, business community and agents. Insiders ownership of the companies in Pakistan is very common as the governance mechanism is no mature enough to tackle it (Javid & Iqbal, 2008). Earning smoothening refers to attempts by corporate management to manipulate financial figures to achieve their targets and making their financial statements less transparent. According to Richardson (2000) agency conflicts is widely considered as the significant factors which provoke management or firm to involve in earning management activities. According to Latif, Ayesha, & Fahad (2015), agency problems and conflicts are serious in dispersed ownership in comparison to the highly concentrated ownership. Such agency conflicts can be seen as minority shareholder expropriation when the dominant shareholders tend to expropriate firm resources by taking self-centered actions that may not be optimal for the minority 's interest (Annelies & Ann,2012). Thus, the likelihood to opportunistically manage earnings is higher in these settings. These conflicts, tied with the imperfection of capital markets and information asymmetry (that exists in favor of managers), might increase the agency costs and in turn, increase the possibility of EM.

In Pakistan, the focus of most studies is on non-financial sectors excluding/ignoring financial firms (Iqbal, Zheng,& Jebran, 2015; Kamran, 2014). Other studies focusing on non-financial firms excluding financial sectors are: (Sinan, Hijazi, & Rahehlah, 2016; Zalata & Roberts, 2015; Essen, Engelen, & carney 2013 etc.). The present study will contribute several things in literature in several ways. First, it empirically proves the existence of earning management intentions for Pakistan, where insiders control firms. Second, research

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work focused on banking sectors which mainly ignored in previous researchers in the Pakistani context (Iqbal et al., 2015; Aysha, 2015; Zahoor, Huma, Badar, & Fayyaz, 2015; Abbadi & Khali, 2010 etc.).

Third, it extends limited research in Pakistan on the topic of association between governance mechanism and EM in Pakistan by providing a comprehensive picture of this association considering agency problems considering the banking sector (Habbash & Alghamdi, 2017).

LITERATURE REVIEW

Corporate governance fundamentally defined as "the relationship among the corporation and its stakeholders (Arsoy & Crowther, 2008), and as a set of mechanisms through which outside investors protect themselves against expropriation by the insiders" (La Porta et al., 1997). Healy and Wahlen (1999) provide a comprehensive definition: "EM occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." From Existing empirical literature, it is evident that their exit mixed evidence on the relationship between governance practices and EM (Muda, Maulana, & Sakti Siregar, 2018).

After the global financial crisis, governance issues in banks are quite clear and their effects have been well documented. However, the center of attention in these researches is the role of bank governance on investigating the effects on banks' riks, bank risk-taking behavior or performance. There is no consensus in literature, some studies(Mohammed, 2012; Mollah & Zaman,2015; Salim, Arjomandi & Seufert, 2016) support that corporate governance in banks is essential for this Good performance or risk management while(Aebi, Sabato & Schmid, 2012; Nyamongo & Temesgen,2013) finds that governance plays an insignificant role in determining the banks performance.

Lestari (2018) examine the impact of board composition and audit committee diligence by using a sample of Tunisian banks over the period 2003-2007 and reveal that the board and audit committee determine high-quality financial disclosure. The study also concludes that director with large shareholding tends to impact the audit quality negatively. Studies expounded in past literature posit that audit firm ranking and their independence affect the quality of financial disclosure. Likewise, the study of Buchner, Mohamed & Saadoun (2017), describe the phenomena of audit quality and posit that independent auditor and diligence audit committee discourage the earning management behavior by management. Therefore, effectively protect the interest of shareholders and combat agency problems.

Abbadi and Hijazi (2016) observed that there exists an inverse association relationship between EM and CGOV quality by studying the firms listed on Amman Stock Exchange and witnessed that the quality of CGOV has increased over time. Jesus Gonza (2013) pointed out that in case of insider's ownership or high concentration is positively associated with the earning manipulations. Ramzi Benkraiem (2012) empirically found that the independent director's presence can moderate the management of discretionary accruals. Liona and Tam (2016) posit that institutional quality and regulatory pressure determine the quality of financial disclosure. Though internal factor such as the mechanism of corporate governance and audit committee plays a vital role, external factors also remain robust to ensure the quality of financial reporting. Extending this vie the study of Talab, Mohammed and Flayyih (2018) studied the phenomena of earning management in the context of companies listed on the Amman Stock Exchange (ASE). The findings of the study posit that independent audit and shareholder activism predict the quality of financial reporting and protect shareholder rights effectively. The corporate governance along with mandatory compliance, result in high-quality financial disclosure and combat the issue of the agency problem. The quality financial disclosure in turn protect the shareholder rights and mitigates the chances of information asymmetry (Platonova, Asutay, Dixon & Mohammad,2018).

Zalata and Roberts (2015) suggested that strict accounting standards can be replaced by strong internal governance. Nancy and Myring (2013) investigated the relationship between the strength of disclosures quality and the CGOV in pre- and post-regulation periods and found that voluntary execution of stronger CGOV enhanced the quality of the disclosure in the pre-regulation period; however, surpassing the current CGOV standards does not have any significant result in higher quality disclosures post-regulation. Hui and Chang (2014) observed that return on assets significantly negatively affects discretionary accruals and discretionary current. So, in weakly governed firms' managers are likely to use accounting discretion as compared to the strongly governed firms, which lead to the underperformance of the company. Therefore, the first hypothesis is stated as:

Hypothesis 1: Strong CGOV practices are negatively related to earning management.

The companies with concentrated ownership structure mitigate the principal to agent conflict; it may lead to conflicts among minority and majority shareholders (Gospel and Pendleton, 2005). Renders and Gaeremynck (2012) studied the 14 European countries listed companies between 1999 and 2003 and

suggested that when the costs of adopting good governance are very high, then agency conflicts are severe for the majority.

Principal-principal agency conflicts arise when few large majority shareholders abuse their control and get private benefits because of higher authority over them (Dharwadkar, George, & nrandes, 2000; Young & Bruton, 2003). The private benefits that majority shareholders can enjoy including: asset stripping, limiting the incidence of related party transactions, tunneling, and others through which they can divert companies cash flows from minority shareholders, can be significantly reduced by the introduction of good (CGOV) (Love, 2010). The second hypothesis is stated as:

Hypothesis 2: Principal-principal conflict is positively related to earning management.

Several studies have examined the effect of corporate governance on banks' performance, but there is no such study relating corporate governance with earning management by using the lens of principal to principal conflicts of banks except one (Utama, 2018). This study is carried out in the Pakistani context and assesses the potential impact of corporate governance on earnings management. Moreover, the study will shed light on how principal to principal conflict of interest intensifies the problem of earning management.

METHODOLOGY

The sample consists of all public and private sector banks in Pakistan over five years 2012-2017 to study the impact of governance mechanism and Principal-Principal conflicts on earning smoothening. Data of CGOV and conflicts were taken from annual reports and measurement of earning management based on financial statement analysis (FSA) published by SBP. The final sample includes 21 banks (4 public sector banks out of 5 and 17 private sector banks out of totals 22); the remaining six banks were excluded[3] mainly because of the absence of specific CGOV measures.

Earning Management is measured by accrual management, and there is a complete consensus in the literature about its measurement. Considering the financial sectors (banking sector of Pakistan), loan loss provision was used as a proxy for measuring earning management. The study estimates a linear regression model that is based on Taktak, Zouari and Boudriga (2010) which adopts the econometric model used by Perez et al., (2006) in their study to ascertain the EM practices in banks. The proposed model is:

$$LLP_{it} = \beta_1 + \beta_2 LD_{it} + \beta_3 TL_{it} + \beta_4 NPL_{it} + \beta_5 EBTP_{it} + \beta_6 CHGTL_{it} + \beta_7 CHGNPL_{it} + \beta_8 LNTA_{it} + it \ (I)$$

Where:

Variable	Constructs
LLP_{it}	"Loan loss provision of bank i, in year t normalized by the total assets."
$LNTA_{it}$	
TL_{it}	"Ratio of total loans normalized by the total assets of bank i in year t"
NPL_{it}	"Non-performing loans normalized by the total assets of bank i in year t"
$EBTP_{it}$	"Earnings before taxes and provisions normalized by the total assets of bank i in year t"
$CHGTL_{it}$	"Change in the total loans of bank i in year t normalized by total assets."
LD_{it}	Loans to deposit ratio of bank i in year t

Variables changes in nonperforming-loans (CHGNPL) and change in total loans (CHGTL) are used in the econometric model of study to account for the non-discretionary component of the loan loss provisions (Kanagaretnam, Lobo, & Mathieu, 2003). The nature of the ownership structure is the key determinant that is required to be considered while evaluating the CGOV of a firm (Amitava, 2016). Hermalin and Weisbach (2017) advocated that specific board characteristics should be the determinants of CG.

Table 1: Proxies for the principle Conflict and CGOV Measures

Variable	Constructs
Largest	"Percentage of voting shares the largest shareholders owns."
Second_10	
Ownership Concentration	"Natural log of the number of firm shareholders (Rozeff, 1982)"
Big 5 ownership	"Sum of ownership percentage of the five biggest firm shareholders."
	Ownership Structure
	Proportions of the shares held by institutional investors

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[3]Burj Bank has been merged into Al Baraka Bank Pakistan, MCB Islamic bank LTD was incorporated in 2015 and others (Standard Chartered Bank, Bank Al-Habib, Dubai Islamic Bank Pakistan LTD & Samba Bank LTD were excluded due to unavailability of specific variables of CGOV measurement)

INSTH	If the firm is a Public sector unit then 1, otherwise 0
PSU	
	Board of Directors
BS	"Number of directors on the board."
NED	"Number of non-executive directors on the board."
PropID	"Proportion of independent directors on board."
BdMt_No.	"Number of board meetings."
CEODual	CEO duality—variable has value zero where the CEO has this dual role of chairman of the board as well as CEO, one otherwise
	Audit Committee
AdCom_Sz	Audit committee size
AdCom_Mt	"Audit committee meetings —Number of meetings held by the audit committee was calculated every year for all companies."
ID_AdCom	"Independent directors on audit committee—1 if independent directors on the audit committee and 0 otherwise."

(we adopt all Proxies from Renders and Gaeremynck (2012) except Big 5 Ownership proxy & Source for CG proxies: Amitava Roy, 2016).Research also involves control variables of the Age of the firm (AGE), total assets of the firm (SIZE), Leverage (LEV) and Return on assets (ROA). Results of the descriptive statistics for corporate governance and earning management are presented below.

Descriptive Statistics
Table 2: BOD and Ownership Structure Measures

	BD	NED	PROPID	BDMTNO	INSTH
Mean	8.45	5.02	0.31	6.75	73.21
Median	8.00	5.00	0.33	6.00	76.53
Maximum	13.00	12.00	0.62	17.00	100.00
Minimum	4.00	1.00	0.00	3.00	24.97
Std. Dev.	1.90	2.03	0.15	2.32	19.26
Skewness	0.83	1.25	-0.35	1.72	-0.75
Kurtosis	3.57	6.23	2.70	7.22	3.04
Jarque-Bera	12.90	70.01	2.47	123.82	9.60
Probability	0.00	0.00	0.28	0.00	0.00
Sum	845.00	502.00	31.93	675.00	7321.85
Sum Sq. Dev.	358.75	409.96	2.44	534.75	36752.01
Observations	100	100	100	100	100

Table 3: Audit Committee and Principle-Principle Conflicts Measures

	ADCOMSZ	ADCOMMT	LARGEST	OWNCON	BIG5
Mean	3.33	4.78	48.05	8.79	72.00
Median	3.00	4.00	50.78	9.80	73.99
Maximum	5.00	11.00	100.00	11.60	100.00
Minimum	2.00	3.00	12.77	1.79	21.28
Std. Dev.	0.60	1.34	22.55	2.53	19.22
Skewness	1.36	2.45	0.53	-1.87	-0.67
Kurtosis	4.22	10.54	2.73	5.62	3.32
Jarque-Bera	37.37	338.15	5.04	87.36	7.95
Probability	0.00	0.00	0.08	0.00	0.01
Sum	333.00	478.00	4805.64	879.77	7200.18
Sum Sq. Dev.	36.11	179.16	50375.22	637.18	36593.81
Observations	100	100	100	100	100

Table 4: EM Measures

	LLP	TL	NPL	EBTP	LD
Mean	0.04	0.43	0.06	0.03	0.58
Median	0.03	0.43	0.04	0.02	0.54
Maximum	0.15	0.72	0.26	0.11	1.11
Minimum	0.00	0.15	0.00	-0.00	0.30
Std. Dev.	0.03	0.10	0.05	0.01	0.16
Skewness	1.20	0.21	1.52	2.13	1.19
Kurtosis	4.58	3.15	5.20	9.19	4.33
Jarque-Bera	34.67	0.84	58.96	236.02	31.30
Probability	0.00	0.65	0.00	0.00	0.00
Sum	4.04	43.95	6.04	3.28	58.74
Sum Sq. Dev.	0.09	1.04	0.27	0.03	2.55
Observations	100	100	100	100	100

The regression analysis involves two models to be employed. First, Loan loss provisions are regressed with different loan characteristics (model described above) which is used to generate the dependent variable "EM." In the Second model, EM regressed with CGOV measures and Principle-Principle conflicts to determine the dependency of EM practices on CGOV of banks and the conflicts among the majority and minority shareholders.

The second regression model is:

$$EM_{it} = \beta_1 + \beta_2 BD_{it} + \beta_3 NED_{it} + \beta_4 PROPID_{it} + \beta_5 INSTH_{it} + \beta_6 PSU_{it} + \beta_7 ADCOMSZ_{it} + \beta_8 ADCOMMT_{it} + \beta_9 LARGEST_{it} + \beta_{10} OWNCON_{it} + \beta_{11} BIG5_{it} + \epsilon_{it} \quad (II)$$

RESULTS AND FINDINGS

The present research employed correlation matrix and OLS (ordinary least squares) panel regression for analyzing/investigating the dependence of EM on CGOV and principle-principle conflicts.

The correlation results confirmed that there is no serious issue/problem of multi-collinearity in the data set used for the analysis (Given in appendix). INSTH ("Percentage of shares held by institutional investors") is positively and strongly correlated with LARGEST ("percentage of shares held by largest shareholders") with r = 0.6743 which is quite understandable as in Pakistani banks mainly the large pool of the total shares are closely held by a narrow circle of the investors causing the ownership structure as concentrated (evident from the shareholding pattern of the banks in their individuals annual reports).

Loan loss-provision and non-performing-loans are positively and very strongly correlated as the larger NPL requires a bank to have larger loan loss provisions which backed the non-performing loans of a bank. Correlation tables are given in the appendix.

The regression's results are given in Table 5:

Table 5: Regression's results

Model 1: LLP Model		Model 2: EM Model	
Variable	Coefficient	Variable	Coefficient
C	-0.099***	C	-0.025***
	(-4.10)		(-2.136)
TL	-0.033*	BD	0.000
	(-1.70)		(0.35)
NPL	0.466***	NED	0.000
	(13.78)		(-0.18)
EBTP	0.224***	BDMTNO	0.000
	(2.80)		(0.30)
TA	0.004***	PROPID	-0.027***
	(3.47)		(-2.66)
LD	0.070***	ADCOMSZ	0.002
	(5.62)		(1.22)
CHGTL	0.000***	LARGEST	0.000**

Model 1: LLP Model		Model 2: EM Model	
	(0.35)		(2.25)
CHGNPL	0.086	OWNCON	0.001
	(1.25)		(1.92)
		BIG5	0.000**
			(2.33)
		PSU	-0.017***
			(-4.09)
R-squared	0.87	R-squared	0.33
Prob (F-statistic)	0.00	Prob (F-statistic)	0.00

*Note: *,**,*** shows significance at 10%,5% and 1% respectively.*

R-square value of the LLP model is 87.84 per which signifies that 87.84 percent of the variability in loan loss. Non-performing loans, EBTP, total assets (TA) and LD (loan to deposit ratio) are positively related to LLP and these are statistically significant. These findings are the same as of Zoubi and Al-Khazali (2007) who suggested that higher the loans to deposit ratio the more are the need for external funds and to attract external funds, the relevant risk is adjusted by the loan loss provisions. While total loans, change in total loans and non-performing loans are insignificantly related to LLP which is consistent with the findings of Fernando & Ekanayake (2015).

Loan loss provision (LLP) model estimation is used to generate dependent variable, EM which is further regressed with CGOV variables and principal-principal conflicts using Equation: (II) and the results are described below:

Considering the EM Model, Ownership concentration, Largest and Big5 ownership [collectively constructing variable, Principal-Principal conflict) are found to be positively and significantly related to the EM. This suggested that when the higher percentage of shares are held by an individual shareholder (majority shareholder), then there are more EM practices and the firm managers manipulate figures in accounting records making the financial statements less crystal clear. The big5 ownership is evident of principal-principal conflicts as the majority shareholders (i.e. Big5) have more of voting shares in their hands by which they can expropriate minority shareholders and the results are consistent with Kamran & Attaullah (2014).

The independent director's presence on board is inversely associated with the Ems, and consistent with the Benkraiem and Miloudi (2012), who found that the independent director's presence can moderate the management of discretionary accruals. While the number of directors on the board, non-executive directors and number of board meetings are insignificantly related to EM, the same has been suggested by Iqbal & Zhang (2015). Audit committee size and numbers of meetings are also found to be insignificantly related to EM practices. PSU (public sector unit) a dummy variable, shows statistically significant results and negative association suggesting that the public sector banks are less involves in practices of EM.

CONCLUSION

The present study investigated the role of CGOV in managing the principal-principal conflicts and EM practices in public and private sector banks of Pakistan using a sample period of 2012-2017.

The results suggested that independent directors help in restraining the EM practices in banks. The findings confirmed that the agency problem in a concentrated ownership structure is between minority and majority shareholders and the principal-principal conflicts well contributed to the EM in the banking context of Pakistan. The results are consistent with the findings of the (Richardson, 2000).

The study finds that the introduction of good and implemented CGOV would lessen the benefits of control of majority shareholders and would help in making the financial disclosure of the banks more translucent. Good CGOV and alignment of interest in between majority and minority shareholders will help discourage earning management practices.

Implications and Limitations

Although very few studies have focused on earning management practices in financial sector because of a tight and well-controlled environment in which financial institutions operate, still the present study has a limitation in term of its scope i.e. only focusing banking sector while ignoring the leasing companies, investment, insurance, modaraba and mutual funds. So, the study has a future direction in terms of extending it to a broader aspect incorporating the whole financial sector of Pakistan.

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APPENDIX

Co-relation Matrix of Governance Variables

	BD	NED	PropID	BdMtNo	CEODual	INSTH	PSU	AdComSz	AdComMt	IDAdCom	Largest	Sec10	OwnCon	Big5
BD	1.0000													
NED	0.5557	1												
PropID	0.0541	-0.5004	1											
BdMtNo	-0.0268	-0.0908	0.1387	1										
CEODual	-0.1514	-0.3422	0.3335	0.1042	1									
INSTH	-0.1912	-0.1016	0.0356	-0.0493	0.3205	1								
PSU	-0.2904	-0.1901	-0.0861	0.3892	0.4588	0.3389	1							
AdComSz	0.3791	0.3726	-0.1749	0.0594	-0.1260	-0.1133	-0.0666	1						
AdComMt	0.0114	-0.0205	-0.0789	0.2504	-0.1337	-0.2955	0.0261	-0.0465	1					
IDAdCom	0.3425	0.0029	0.5142	0.0000	0.0677	-0.1943	-0.4055	-0.0221	0.0617	1				
Largest	-0.2967	-0.3928	0.3635	0.1056	0.5309	**0.6743**	**0.5221**	-0.3103	-0.1673	-0.0730	1			
Sec10	0.0697	-0.0597	-0.0257	-0.0346	-0.2388	-0.2824	-0.2702	0.1279	0.0365	-0.0620	-0.5548	1		
OwnCon	0.2022	0.2864	0.0753	0.0361	-0.6106	-0.3835	-0.5464	0.2090	0.1701	0.4489	-0.3964	0.0410	1	
Big5	-0.2977	-0.5386	0.3678	0.0452	0.3358	0.3947	0.3269	-0.2709	0.0048	-0.2293	**0.5453**	0.2107	-0.4551	1

Co-relation Matrix of Earning Management Variables

	TL	NPL	EBTP	CHGTL	CHGNPL	LLP
TL	1					
NPL	0.6457	1				
EBTP	-0.2735	-0.5743	1			
CHGTL	-0.0713	-0.0959	-0.1002	1		
CHGNPL	-0.0726	-0.0403	-0.0164	0.1815	1	
LLP	0.6558	0.9008	-0.4745	-0.0338	-0.0231	1