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Decoding Financial Performance: The Influence of Corporate Governance through the Lens of Earnings Management

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ABSTRACT

Corporate governance has gained prominence as one of the subjects of scholarly and policy debate over the past few decades in both developed and developing countries. This rising interest can be traced to the increased incidence of financial and non-financial scandals and to the well-publicized corporate failures that erupted in different parts of the world. Such incidents have led to erosion of public trust in corporations and emphasize putting in place strong governance frameworks. Likewise, it is now accepted that good corporate governance enhances firm performance and makes certain compliance with regulation. The structure and practice of corporate governance varies from country to country, shaped by each country's law, market, social, political, and cultural contexts. Every country crafts its governance laws to fit its own system of corporate management. The study dives into the interplay between corporate governance practices and the financial performance of firms in a developing economy—Pakistan in particular. In this study, 327 companies for 29 non-financial sectors are being analyzed from the secondary data listed on the Pakistan Stock Exchange (PSX) from 2016 to 2023 to see the relationship. Applying different panel data techniques including fixed and random effect models for the purpose of analysis, in addition, the study applied the two-step System GMM for the purpose of further strengthening the robustness of the findings. The results suggest that effective corporate governance is an important variable enhancing the financial performance of an organization, both in the short run and long run. The study identifies the adverse influence of earnings management, which negates long-term financial performance. Importantly, the findings suggest that earnings management acts as a negative mediator in the interaction between corporate governance and performance, effectively draining the power of governance mechanisms and amplifying undesirable financial results. These findings carry substantial implications for corporate managers, investors, policymakers, and regulators.

Introduction

Corporate governance (CG) has emerged as one of the most widespread and prevalent issues in business environment (Al-Matari et al., 2014). Due to collapse and failure of some leading companies such as One Tel (2001), WorldCom (2002), Adelphia (2002), Commerce Bank (1991), Tyco (2002), Northern Rock (2007), Harris Scarfe (2001), Fanny Mae (2008), Enron (2001), Freddy Mac (2008), Lehman Brothers (2008), Global Crossing (2002), Goldman Sachs (2007), Arthur Anderson (2001), HIH (2001), Parmalat and Yukos in European, US and others, researchers and policy makers conducted deep investigations in this regard and showed that manipulation in financial statements is one of key reasons behind their ruin. Resultantly, huge attention was given to corporate governance mechanism that ensure the proper management practices for the protection of investors (Bøhren & Strøm, 2010). Corporate governance is now consider the main issue in academia and in business (Al-Matari et al., 2014). In business world, CG mechanism focusses on the importance of ethical as well as moral conduct in business operations that promote good corporate governance (Ibid).

The structure of CG mechanism delineates the distribution of responsibilities and rights among stakeholders and formalize the procedures and rules governing corporate decision-making processes (Obiyo & Lenée, 2011). Capital cost of structure can be reduced by exercising good CG mechanism in the form of financial information disclosure. Additionally, corporate governance helps to fight against corruption, reduction of capital flight and also attract local as well as foreign investment. Particularly in developing countries, CG mechanism helps in accessing the cheaper sources of funding as well as availability of funding also increased (Yasser, Entebang, & Mansor, 2011). Reduction in wastes, operational efficiency and better decision making is basically due to good corporate governance practices (Gurusamy, 2017).

As per agency theory, ownership and control both are separate in modern corporations (Fama & Jensen, 1983a; Jensen & Meckling, 1976). Amongst the important factors that reduce the agency problems, ownership structure is one of them. Ownership structure impacts significantly on corporate governance system and on firms' performance (Zraiq & Fadzil, 2018). Distribution of firm's shares amongst the owners (investors) of that firm is called ownership structure (Gisbert & Navallas, 2013). OS is considered as key determinant of voluntary corporate governance disclosure and compliance (Eng & Mak, 2003; Huafang & Jianguo, 2007; Ntim, Opong, Danbolt, & Thomas, 2012). As per Mayer (1997), CG mechanism "is concerned with ways of bringing the interests of investors and manager into line and ensuring that firms are run for the benefit of investors". Alchian and Demsetz (1972) proposed that focus on ownership as the internal mechanism for monitoring managers' behavior by the shareholders to reduce the intra-company problems. In determining the objectives of the company, they also argued on the importance of this mechanism.

Several risk factors, poor practices of corporate governance, corporate mismanagement and factors that are external to the firm control causes failure of corporate plans (Cadez & Guilding, 2008). Literature shows that firms often recourse to earnings management when the goals of firms are not being met (Bedard & Johnstone, 2004). Lin, Pizzini, Vargus, and Bardhan (2011) define earnings management as it is the managerial action to decrease or increase the profit of the firm, their revenue or earnings through aggressive accounting strategies. Several regulations and reforms have introduced by stock market regulators to avoid financial crisis especially after several large firms crashed in recent decades. Earnings management is considered as one of the major concern by stock market regulators as it is blamed for major collapses in many of these firms (Habbash,

2019). Earnings management shows the true and actual picture of firms financial position and financial results of business and shows the facts that the investors should know (Habbash, 2019).

In case of Pakistan, most of studies related to corporate governance used one or more mechanisms of governance in their models such as size of boardroom, independence of board of directors, size of audit committee and others to test its impact on performance. Most of studies were focusing on specific sectors. So, the findings of previous studies can't be generalized across all Pakistanis firms. This issue creates a research gap. This study used a comprehensive set of CG mechanism to examine its link with and impact on, firm financial performance. Furthermore, very few studies showed the impact of comprehensive measures of CG mechanism on the performance and the results of these previous studies were mixed and also inconclusive.

The existing literature on relationship between CG mechanism and Earnings Management (EM) presents mixed evidence and results of this relationship are inconclusive. In literature of corporate governance related to Pakistan, various researchers tried to trace this relationship, but their results are inconclusive and mixed. Several variables of corporate governance are associated with EM significantly while few showed insignificant relationship between them, and few found no relationship.

Previous literature shows that rare studies available on CG-performance relationship and mediating effect of EM on this relationship, but the results were inconclusive and mixed. Only one study available in Pakistani context but with limited variables of corporate governance and limited companies and showed no impact of EM on corporate governance-performance relationship. So, there is great shortage of research in their relationship especially for firms listed in Pakistan to generalize their results using more variables and adding more firms (Asghar, Sajjad, Shahzad, & Matemilola, 2020; Quddoos, Akhtar, & Rafique, 2020).

Present study filled all these research gaps by validating the CG mechanism and firm financial performance relationship in the presence of discretionary earnings management as mediators. This study distinguishes itself from prior research in several key aspects. Firstly, it used three mechanisms of corporate governance simultaneously. Secondly, association between CG mechanism and EM, Earnings management and firms' financial performance have investigated thoroughly. Finally, this research also explores the mediating effect of EM on the corporate governance-performance nexus by focusing on non-financial firms listed at Pakistan stock exchange (PSX).

Literature Review

Attention of the researchers have increased toward the active execution of corporate governance and main reason behind is conflict of interests between shareholders and managers of firm. In connection to this, different theories have been established and implemented for the understanding of mechanism of CG and these theories gave solution of the problems related to issues caused by the conflict of interests and ultimately help in maximization of performance of the firm. So, some of the theories related to corporate governance have discussed below for its better understanding and help in building research background.

Agency theory has largely been discussed and adopted in corporate governance literature. It has direct association with the mechanism of corporate governance and considered as founding paradigm of it (L'Huillier, 2014). In modern corporations, the separation between ownership and control are considered as crucial features and to resolve or mitigate principal-agents issues, CG mechanism plays an important role in this regard (Aguilera, Filatotchev, Gospel, & Jackson, 2008). Adam Smith was the economist, author and philosopher who highlighted the agency problems for

the first time in eighteenth century and his idea was explored by (Ross, 1973). Later, Jensen and Meckling (1976) were first who presented detailed description of this theory. After that Fama and Jensen (1983a) and Williamson (1988) in 1980s and in 1990s, Aghion and Bolton (1992) and Hart (1995) contributed in the theory and further explicated agency problems.

In literature, stewardship theory is described most commonly as an alternative to agency theory. Agency theory mainly focuses on the control and conflict. In contrast to this, the stewardship theory put emphasis on cooperation and collaboration (Sundaramurthy & Lewis, 2003). "Agency theory argues that shareholder interests require protection by separation of incumbency of roles of board chair and CEO. Stewardship theory argues shareholder interests are maximized by shared incumbency of these roles" (Donaldson & Davis, 1991). For explanation of relationship, stewardship theory provides non-economic premise (Keay, 2017). Hernandez (2012) define stewardship theory as to safeguarding the welfare of others at long-term, the individual subjugate his or her own interests willingly. McCuddy and Pirie (2007) stated that the stewardship theory is about "doing things that benefit ourselves and the people currently around us". According to Muth and Donaldson (1998), instead of self-interested as well as rational economic man as described in agency theory, the manager work as steward under stewardship model. Stewardship theory posits that all employees of firm including the managers are always motivated by considering the concerns for other's interest as well as fairness and justice to others (Buchanan, 1996). Under this perspective, the firms' managers function as stewards, and they are loyal to the company. They have no concern about the economic interests which are beneficial for themselves as well as to gain self-serving benefits as agency theory hold this concept.

Agency theory mainly focusses on the director's controlling and monitoring role and board independence. But in contrast to this, the resource dependency theory introduces the concept of accessibility to resources. This theory concentrates on the advisory as well as counselling role of the boardroom (Peters & Bagshaw, 2014). This theory highlighted the resource providers role of the board of directors. Board of directors provide various resources to firm and resources are necessary for growth and survival of firm (Hillman & Dalziel, 2003; Muth & Donaldson, 1998). This theory underscores the strategic value of director's knowledge, their skills and their experience which ultimately leads towards the better monitoring of the firm and also enhance the performance. Rather than the relation within the internal firm's environment, the resource dependency theory centers on firm's interactions with its external environment. In shaping the organizational behavior and decision-making process, this theory spread light on the role of external resources.

CG Mechanism and Performance

Corporate governance mechanism and performance of the firm has been widely explored but the finding remain mixed and contradictory results as identified by reviewing the extensive research on corporate governance. Means (2017) argued that conflicts of goals among the management and shareholders cause the waste of company resources. Corporate governance is considered a best way to mitigate this problem and helps firm to maximize its value and profit by utilizing its resources that ultimately enhance performance. According to Shleifer and Vishny (1997), CG mechanism causes many benefits for the firm including its superior performance and higher the value. For the financial success of the firm, Northcott and Smith (2011) suggest that the primary instrument is its corporate governance practices. Efficient corporate governance framework of any firm integrates the goals of firm, its management, its BOD, and all shareholders and stakeholders. Zheka (2006) argued that CG mechanism plays a vital role not only at firm level but also in promoting national economic development. At company level, corporate governance helps to decrease the principal-agent conflict that streamlines the decision making process (Jensen &

Meckling, 1976). At national level, corporate governance creates safe investment climate and causes the attraction for foreigners to invest in the firm which increase the foreign direct investment. So, corporate governance mechanism help countries to increase its economic growth (Brav et al., 2008). Due to this reason many countries are showing importance towards corporate governance and developing their own code of corporate governance or adopting the rules for CG mechanism of other countries (Fulgence, 2014).

Various theories of CG mechanism, including agency theory, resource dependence theory, and stewardship theory, along with many scholars and practitioners, have examined in great detail the relationship between mechanism and performance. Researchers like Bhatt and Bhatt (2017), Chalhoub (2009), Malik and Makhdoom (2016), Mardnly, Mouselli, and Abdulraouf (2018), Mollah, Al Farooque, and Karim (2012) and Siddiqui (2015) found in their research that effective corporate governance mechanism is strongly and positively associated with corporate performance to enhance it. They used corporate governance variables, its aggregate index and its sub-indices while measuring its impact on corporate governance.

Uchida et al., (2011) considered the association between performance and CG mechanism of Bangladesh companies and found that insignificant but positive relationship exist between them. Studying the data of Pakistani firms, Cheema and Din (2013) identified positive linkage between CG mechanism and financial performance. Dabor, Isiavwe, Ajagbe, and Oke (2015) found positive association performance and corporate governance. Hassan, Naser, and Hijazi (2016) found that performance is negatively associated with corporate governance practices. Vu and Nguyen (2017) found inverse relationship among boardroom size and performance while boardroom dependency and CEO duality found significant relation with performance. Mohan and Chandramohan (2018) indicated in Indian context that boardroom size and CEO duality effect the performance negatively and significantly while BOD composition indicated insignificant effect on performance. Based on aim of current study, its objectives, its research questions and the literature review, the hypotheses of the study have developed as follow:

H1: The CG mechanism affects the financial performance significantly.

Corporate Governance and Earning Management

A substantial body of literature has examined the link between CG mechanism and earnings management (EM), particularly in response to increased scrutiny following high-profile corporate failures. Firms often engage in EM when they fail to meet financial expectations, leveraging aggressive accounting strategies to alter reported earnings (Bedard & Johnstone, 2004; Lin et al., 2011). Such practices are viewed as a serious concern by market regulators due to their role in misleading investors and obscuring a firm's true financial condition (Habbash, 2019). Effective corporate governance structures have been proposed as a deterrent to EM. For instance, board characteristics such as size and independence are frequently analyzed for their influence on earnings quality. Some studies find that larger boards offer better monitoring and thus reduce EM (Xie et al., 2003; Hashim & Devi, 2008; Khalil & Ozkan, 2016), although others argue that smaller, more cohesive size of boardroom may be more effective in oversight (Jensen, 1993; Rahman & Ali, 2006). Similarly, board independence is widely acknowledged to enhance monitoring and reduce EM (Fama & Jensen, 1983b; Wu, Chen, & Lee, 2016; Suyono & Al Farooque, 2018), although this relationship does not hold uniformly across all markets (Khalil & Ozkan, 2016; Mohammad, Wasiuzzaman, & Salleh, 2016; Chatterjee, 2020).

The presence of female directors in the boardroom has also been associated with lower EM due to enhanced ethical standards and improved board vigilance (Wahid, 2019; Kyaw, Olugbode, & Petracci, 2015; Lara et al., 2017). However, contrary evidence exists in some regional contexts

where gender diversity on boards did not significantly impact EM (Ye, Zhang, & Rezaee, 2010; Sun, Liu, & Lan, 2011; Waweru & Prot, 2018). Audit committees serve an important part in ensuring the integrity of financial reporting. Research generally supports their effectiveness in curbing EM when they are independent, active, and adequately resourced (DeFond & Jambalvo, 1994; Piot & Janin, 2007; Alzoubi, 2019). However, results remain mixed, with some studies showing no significant influence of audit committees on EM (He et al., 2007; Peasnell, Pope, & Young, 2005), and others suggesting that larger or inactive committees might be less effective (Nelson & Shukeri, 2011; Sharma et al., 2009).

Ownership structure also plays a complex role in EM. Managerial ownership may align managers' interests with shareholders and thus constrain EM (Jensen & Meckling, 1976; Cohen et al., 2008), though other findings suggest it can empower managers to engage in EM (Morck et al., 1988; Al-Fayoumi, Abuzayed, & Alexander, 2010). Institutional investors are generally seen as a mitigating force against EM due to their resources and monitoring capacity (Zang, 2012; Cheng, Luo, & Yue, 2013), though some research shows either a positive or null effect (Roodposhti & Chashmi, 2011; Alves, 2012). Foreign investors, perceived as more demanding in terms of transparency and governance, are often associated with reduced EM (Ben-Nasr, Boubakri, & Cosset, 2015; Guo et al., 2015), although studies like Al-Haddad and Whittington (2019) suggest that their influence may not be uniformly significant. Collectively, these findings indicate that while sound governance mechanisms can limit EM, their effectiveness varies by institutional context and firm-specific characteristics. As per literature, CG mechanism has a significant influence on the nature and extent of earnings management. So, with respect to previous literature, we develop the following hypotheses.

H2: There is a relationship between CG mechanism and EM.

Earnings Management and Financial Performance

Agency theory stresses the friction among managers and shareholders due to discontinuity between control and ownership, which leads the manager to manipulate his earnings to satisfy personal interest (Alhadab & Al-Own, 2017). This includes distorting the earnings performance of managers in a way that the results meet market expectations or circumvent the violation of covenants and eventually creates a deviation of true financial transparency which adversely affects firm financial performance in long run (Gill et al., 2013; Richardson et al., 2006 and Kumari & Pattanayak, 2017).

Much research has correlated EM in the context of accrual-based EM with reduced profitability and reduced shareholder wealth in different countries (Kang & Kim, 2011; Mahdavi Ardekani et al., 2012; Kilic et al., 2013; Alhadab & Al-Own, 2017; Tang & Chang, 2015;). Many researchers argued that Earnings Management can enhance performance for a while or serve as a signaling effect in resource distribution of information asymmetry (Lee et al., 2006; Kasznik, 1999; McNichols, 2000; Dechow et al., 1995). These effects, however, prove to be short-lived and contextually specific. Overall, however, empirical evidence tends to suggest that EM tends to reduce firm value prospects, particularly under weak governance. Based on previous literature, the proposed hypothesis is:

H3: Significant association exists between EM and performance.

Mediating Role of Em in Cg and Firm Performance Relationship

The existing literature examining the interrelationship among CG mechanism, EM, and firm financial performance reveals mixed findings, especially with regard to the mediating role of EM within this dynamic. While the relationship between CG mechanism and performance, as well as

between governance and EM, has been widely studied, relatively few studies have explored EM as a mediating variable linking governance mechanisms to financial performance outcomes of the firm. Savitri et al. (2020) found that EM positively mediates the board of directors (BOD) and firm performance relationship which is measured by ROA. Their conclusions suggest that BOD and size of audit committee are effective supervisory mechanisms that help restrain EM and enhance firm performance, although their study was limited in scope to Islamic banks. Similarly, Ching et al. (2015) suggests that high-quality audits may influence performance outcomes indirectly through their impact on EM behavior.

Contrastingly, Qudoods et al. (2020) found no significant mediating role of EM in CG-performance relationship. Their study showed that EM neither correlates with CG mechanisms like structure of board of directors, audit quality, and ownership characteristics, nor does it influence the governance-performance link. A more nuanced picture is provided by Mahrani and Soewarno (2018) found a significant partial mediation effect of EM. Their results indicated that good governance—particularly through independent boards and Big Four audit firms—reduces EM, which in turn enhances performance and profitability. They argue that limiting EM improves financial transparency and ultimately firm performance by increasing trust and managerial incentives. On other hand, Mayliza, Dewi, and Sari (2019) found that EM did not mediate corporate governance (measured by BOD and audit committee size)-performance relationship, possibly due to limited governance variables and sample size.

Overall, Currently, there is evidence from some studies that earnings management mediates the relationship corporate governance has with firm performance, while others report insignificance. These conflicting findings may be due to differences in governance frameworks of the countries studied, sample compositions, and measures for earnings management and firm performance. More robust, cross-country research is needed to confirm whether EM consistently serves as a mechanism through which governance practices impact organizational success. So, with respect to previous literature, we developed the following hypotheses:

H4: CG mechanism and financial performance relationship is mediated by EM.

Research Design

Total 544 companies were listed at Pakistan Stock Exchange (PSX) till 31 December 2023. There were 36 sectors at PSX among which 7 sectors are financial sector. Remaining 29 non-financial sectors was initial total population for this study. These 29 non-financial sectors comprise of 418 companies. Data collected for the period of 2016 to 2023 for corporate governance, earnings management, and other firm specific variables. Some filtering techniques was applied on the data to refine the sample. Non-operational firms during the time span of the study were eliminated from the sample. Likewise, those firms with incomplete financial information or any company merging during the time of research was omitted from the study. The analysis only focuses on firms which remain operational and have complete datasets for the entire study period. All data collected are sourced from secondary sources including annual reports published at the Pakistan Stock Exchange (PSX), company websites, and the Business Recorder.

For the selection of sample, financial sectors of PSX dropped from the population. The rationale behind is this that these sectors have unique characteristics as well as specific requirements and regulations for their annual reports and according to Alqatamin, Aribi, and Arun (2017), Athanasakou and Hussainey (2014) and Alqatamin (2018), these may impact over the results. Companies of these sectors follow strict set of regulations as compared to other companies (Chen, Chen, & Wei, 2009). Reporting rules as well as distinctive features of their financial statements are different from other companies that make them incomparable (Abed et al., 2012). The KSE-100

index has large-cap non-financial companies that represent a wider classification of non-financial companies listed on the Pakistan Stock Exchange (PSX) (Shahzad, Ali and Rehman, 2024). In addition, the KSE-100 index serves as the principal benchmark for the evaluation of market performance in Pakistan. Financial companies were omitted from the analysis because they work under fundamentally different operational structures and regulatory frameworks compared to non-financial companies (Upadhyay, 2015, Shahzad, Ali and Rehman, 2024).

Econometric Models

To address the first objective of present study -- examining the relationship between CG mechanism and performance -- the following model is estimated. Corporate governance Index has used in this model.

$$FP_{i,t} = \alpha_0 + \alpha_1(CGIndex_{i,t}) + \alpha_2(Size_{i,t}) + \alpha_3(LCAP_{i,t}) + \alpha_4(SGrowth_{i,t}) + \varepsilon_{1,i,t} \dots\dots\dots (1)$$

Corporate Governance and Em

To address the second objective of present study -- examining the relationship between CG mechanism and EM -- following model is estimated. Comprehensive measure of CG mechanism has used in this model.

$$EM_{i,t} = \alpha_0 + \alpha_1(CGIndex_{i,t}) + \alpha_2(Size_{i,t}) + \alpha_3(LCAP_{i,t}) + \alpha_4(SGrowth_{i,t}) + \varepsilon_{5,i,t} \dots\dots\dots (2)$$

Em and Financial Performance

To address the third objective -- examining relationship between EM and financial performance -- following model is estimated.

$$FP_{i,t} = \alpha_0 + \alpha_1(EM_{i,t}) + \alpha_2(Size_{i,t}) + \alpha_3(LCAP_{i,t}) + \alpha_4(SGrowth_{i,t}) + \varepsilon_{7,i,t} \dots\dots\dots (3)$$

Mediating Role of Em in Cg-Performance Relationship

To address the sixth objective -- analyzing the impact of EM as mediator on CG mechanism-performance relationship-- following model is estimated.

$$FP_{i,t} = \alpha_0 + \alpha_1(CGIndex_{i,t}) + \alpha_2(EM_{i,t}) + \alpha_3(Size_{i,t}) + \alpha_4(LCAP_{i,t}) + \alpha_5(SGrowth_{i,t}) + \varepsilon_{9,i,t} \dots\dots (4)$$

Where:

(i) subscript	represent firm
(t) subscript	represent time
FP	= Financial performance (Tobin's Q)
CGIndex	= Corporate governance index
EM	= Earnings Management
Size	= Total Assets of the company as control variable
LCAP	= Log of market capitalization as control variable
SGrowth	= Sales growth of the firms as control variable

Formation of CG -Index

Researchers of CG mechanism are facing a challenge in the measurement of corporate governance because in literature, there is no dominate measure for it (Aldamen et al., 2020). Instead of using single or few measures of corporate governance, researchers are now focusing more on composite corporate governance index (Aldamen et al., 2020; Brown, Beekes, & Verhoeven, 2011). Individual corporate governance dimensions may not fully capture the variability in the climate of governance (Aldamen et al., 2020). Therefore, rather than focusing on individual governance dimensions, we compute a composite corporate governance-index which reflects the firms' aggregate governance structure.

Aldamen et al. (2020), Al-Najjar and Al-Najjar (2017), Aman and Nguyen (2008), Al-Najjar (2015), Mardnly et al. (2018) and Mathew, Ibrahim, and Archbold (2017) developed the measurement of corporate governance index. All these researchers used different variables of CG mechanism for measurement of composite CG-index. In Pakistan, Nazir (2016) developed an index of CG mechanism that was based on 28 provisions of CG mechanism. Based on the study of Nazir (2016), we used 13 corporate governance variables to make a single CG composite index. In this study, we used Boardroom directors' characteristics (i.e. number of directors in boardroom, independence of board, occurrence of meetings of BOD and gender diversity), Audit committee Characteristics (i.e. its number of directors in audit committee, its Independence, its Meetings and External Auditor Quality) and OS (i.e. Block-holders' ownership, Associated companies Ownership, Insider ownership, Foreign ownership and Institutional ownership)

Before measuring composite corporate governance index, each governance attribute was transformed into binary scale. Value 1 was allocated to each individual CG mechanism variable if its value is above from sample median value as measured by Mathew et al. (2017), Aldamen et al. (2020) and Aman and Nguyen (2008). In this scenario, the direction of influence of each CG mechanism on financial performance matters. So, in this study, 13 dichotomous variables have added to produce a single corporate governance composite index. 13 was the maximum value of corporate governance-index and 0 was minimum value. Maximum value indicates strong CG and minimum value indicate weak CG (Aldamen et al., 2020; DeFond, Hann, & Hu, 2005). Higher value of corporate governance-Index indicate that the firm is being governed in a better way (Aman & Nguyen, 2008). Corporate governance index is as follow:

$$CGindex_i = \sum_{j=1}^{15} CG_{ji} \dots \dots \dots (5)$$

Where CG-index is the composite index of CG for firm (i) and CG_{ji} is the jth individual variable of CG for firm (i).

Measurement Approaches of EM

Previous literature shows that accurate measure of EM that are accepted generally has not been developed yet and with the passage of time, improvement in measuring EM techniques are being made. According to Healy and Wahlen (1999), strong evidences exists that EM exists but it is very difficult for researches to document it convincingly. Literature shows that various models and methodologies are being used to detect the engagement of the firm in EM activities. We used Cimini (2015) model in this study to measure the EM.

Cimini (2015) Model

Cimini (2015) modified the model of Larcker and Richardson (2004) by using a slightly different approach. She added market value of equity to the Modified-Jones model.

$$TAC_{i,t}/A_{i,t-1} = \alpha_0 + \alpha_1(1/A_{i,t-1}) + \alpha_2(\Delta R_{i,t}/A_{i,t-1} - \Delta R_{C_{i,t}}/A_{i,t-1}) + \alpha_3(PPE_{i,t}/A_{i,t-1}) + \alpha_4(MV_{i,t}/A_{i,t-1}) + \alpha_5(OCF_{i,t}/A_{i,t-1}) + \varepsilon_{20,i,t} \dots \dots \dots (6)$$

Where:

- (i) subscript represent firm
- (t) subscript represent time
- $TAC_{i,t}$ = Total Accruals
- $A_{i,t-1}$ = Previous value of Total Assets
- $\Delta R_{C_{i,t}}$ = Change in account receivable
- $\Delta R_{i,t}$ = Change in revenue

$PPE_{i,t}$	= Property, plant and equipment
$MV_{i,t}$	= Market value
OCF_i	= Change in cash flow from operations
$\varepsilon_{20,i,t}$	= Residual (error term)

The residuals predicted by the Cimini (2015) model are used in the subsequent chapter as a proxy for DEM

Measurement of Tobin's Q

In the present study, we measured Tobin's Q as "the ratio of market value of the firm and the book value of its assets" as used by Aslam, Haron, and Tahir (2019), Singh et al. (2018) and Abdullah, Shah, and Khan (2012) based on Pakistani data. Mathematically, it is denoted as:

$$\text{Tobin's Q} = \frac{\text{Market value of the firm i.e. (market value of equity + book value of Debt)}}{\text{Book value of total assets of the firm i.e. (Total assets value + liabilities)}} \dots\dots (7)$$

Control Variables

The regression model controls for factors outside the model, which may be influencing earnings management (EM) or financial performance so that corporate governance, EM, and firm performance can be more cleanly assessed. The present study adopted firm size, market capitalization, and sales growth as control variables from the previous governance literature to make the empirical analysis more robust and valid.

Large number of transactions as well as complicated operations of firms give the opportunities to the managers to manipulate the earnings (El Diri, Lambrinoudakis, & Alhadab, 2020). Market capitalization is calculated in this study as "the multiplication of market price per share and the total number of shares outstanding at the end of financial year" (Heenetigala, 2011) and then take a log of it (Bhat et al., 2018) and this is called total value of shares outstanding in market (Bhat et al., 2018). In the present research, we followed the measurement for firm's growth as calculated by Ntim et al. (2012) and later used by Patel et al., (2018), Ajanthan and Kumara (2017), Aryani, Setiawan, and Rahmawati (2017). They calculated sales growth as "the sales of current year minus the sales of previous year and then divide it by the sales of previous years" and we labelled it as SGrowth.

Empirical Results

Descriptive Statics

Descriptive statistics represent the basic research tools, mainly for large and complex datasets. This serves to summarize and organize raw data into a more interpretable and mechanized representation. The descriptive statistics give a general view of variables from 2,616 observations. Tobin's Q, a proxy for financial performance, has a mean of 1.49 and a standard deviation of 2.22, so firms in the sample vary very widely with regard to value.

The Corporate Governance Index has a mean of 8.95 out of a maximum observed value of 13, thus indicating that the average firm in the sample has rather good governance practices. The standard difference from the mean is 1.65, which shows some difference among the firms but is not an extreme amount so as to denote some fairness among them. EM has a near-zero mean with very high extremes (-13.63 to 23.83), with 75% of observations clustered between -0.03 and 0.05, indicating conservative reporting for most firms.

Table 1: Descriptive Statics

	<i>N</i>	<i>Mean</i>	<i>Standard Deviation</i>	<i>Minimum</i>	<i>25%</i>	<i>Median</i>	<i>75%</i>	<i>Max</i>
<i>Tobin's Q</i>	2616	1.493305	2.221321	0.106463	0.742402	0.974469	1.427391	62.11202
<i>CGIndex</i>	2616	8.954511	1.646084	4	8	9	10	13
<i>EM</i>	2616	3.82E-11	0.557089	-13.6292	-0.02908	0.015752	0.050413	23.82991
<i>Size</i>	2616	22.51313	1.943309	15.29893	21.22443	22.53275	23.90775	27.98454
<i>Market Capitalization</i>	2616	21.40405	2.318535	15.82908	19.66247	21.40483	23.14551	27.33117
<i>Sales Growth</i>	2616	0.248675	5.149321	-1	-0.03836	0.083344	0.255718	261.0683

Control variables-Size (total assets) and Market Capitalization- are symmetric (mean = median) and have moderate variability (SD 1.94-2.32), typical of large firms while Sales Growth is severely right-skewed (mean=0.25 vs. median=0.08) owing to extreme outliers (max=261.07) indicating to the fact that most of the firms are growing at slow pace but a few agile ones are experiencing growth at an exponential rate.

Correlation

A matrix correlation exposes several noteworthy interactions among the variables. Financial performance, represented by Tobin's Q, positively correlated with CGIndex (0.088), interestingly suggesting that better corporate governance is linked to higher market valuation. Earnings management (EM) is weakly correlated with lesser Tobin's Q (-0.100**), holding that overtly aggressive accounting practices do undermine investor confidence. However, EM has not shown serious links to indices of governance (e.g. CG-Index: 0.031), thus questioning the extent to which governance structures in this sample inhibit such practices.

Table 2: Correlations

	<i>Tobin's Q</i>	<i>CGIndex</i>	<i>EM</i>	<i>Size</i>	<i>Market Capitalization</i>	<i>Sales Growth</i>
<i>Tobin's Q</i>	1					
<i>CGIndex</i>	.088**	1				
<i>EM</i>	-.100**	0.032	1			
<i>Size</i>	-.188**	.413**	.077**	1		
<i>Market Capitalization</i>	.096**	.430**	.042*	.834**	1	
<i>Sales Growth</i>	.041*	0.009	-0.009	-0.023	0.007	1

Effect of Corporate Governance on Financial Performance

For our first objective of this research, the present study investigates relationship among CG index and firms' performance. The estimates gleaned through the application of these three models, namely Random Effects Model (REM), and Fixed Effects Model (FEM), reflect the estimation results concerning the place where corporate governance (CG Index) and financial performance (Tobin's Q) while controlling Size, Market Capitalization and Growth in Sales of the firm.

Table 3: Direct effect of CG index on Financial Performance

	Random Effect Model		Fixed Effect Model	
Independent and Control Variables	Coefficient	z-Statistic	Coefficient	t-Statistic
Constant	10.99326	(13.68) ***	32.65867	(16.55) ***
CG Index	0.0522945	(1.83) *	0.2128966	(6.75) ***
Size	-1.337294	(-26.54) ***	-2.166808	(-28.07) ***
Market Capitalization	0.9407689	(23.22) ****	0.7338428	(12.53) ***
Sales Growth	0.0088091	(1.5)	0.0107951	(1.89) *
R-sq:			R-sq:	
	within	0.2439	within	0.2805
	between	0.2644	between	0.1016
	overall	0.2331	overall	0.1057
Wald chi2		(775.09) ***	F	(222.74) ***
Breusch and Pagan Lagrangian multiplier test				
chibar2		(1478.97) ***		
Hausman Test				
chi2		(227.92) ***		

t-values (in parentheses) report the significance levels using *, **, and *** as thresholds at the 10%, 5%, and 1% levels, respectively.

Random Effects Model (REM): The CG Index turns positive but is only marginally significant (0.052, $p=0.068$), indicating that, when random within-firm effects are taken into account, the governance-performance relationship becomes weak. Hausman Test shows a very solid preference for FEM to REM ($\chi^2=227.92$, $p=0.000$), which says that FEM is a consistent method.

Fixed Effects Model (FEM): This model isolates the association between CG Index and financial performance (Tobin's Q) controlling for potentially biased unobserved, time-invariant firm-specific characteristics (e.g., industry norms, management culture, regulatory environment) effects. Hence, the compulsive nature of this model indicates a significantly positive and statistically significant coefficient value for the CG Index (0.213, $p=0.000$). This reveals a 0.213-unit rise in the Tobin's Q variable concerning a unit increase in governance quality while holding all other variables constant. The Hausman Test ($\chi^2=227.92$, $p=0.000$) decisively rejects the Random Effects Model and favors FEM since firm-specific effects are correlated with the predictor, making FEM the consistent estimator.

The results of this study regarding the effect of CG mechanism on financial performance are in consistent with the results of the studies of researchers like Bhatt and Bhatt (2017), Chalhoub (2009), Malik and Makhdoom (2016), Mardnly, Mouselli, and Abdulraouf (2018), Mollah, Al Farooque, and Karim (2012), Ahmed and Hamdan (2015), Siddiqui (2015) and Cheema and Din (2013). The results of this study are in contradict with numerous studies which showed no relationship between CG and performance particularly in developing countries. For example, study of Ghana (Aboagye & Otioku, 2010), study of Indonesia (Jamali, Sutrisno, Subekti, & Assih, 2017), study of Egypt (Shahwan, 2015) and study of India (Arora & Sharma, 2016) found no significant relationship between CG mechanism and the performance of corporation.

CG Index and EM

Random Effects Model: CG index remains slightly positive (0.0025, $p=0.074$) that is indicative of a very feeble association between governance and less EM, while adjusting for random firm-level effects. Weak support for the REM over the OLS comes through the Breusch-Pagan LM test ($\chi^2=1$, $p=0.016$).

Fixed Effects Model: This makes the CG Index negative and significant (-0.0106, $p=0.039$). It means that improving governance within the same firm over time reduces earnings management. In line with theoretical expectations, stronger governance reduces manipulative practices.

The strength of FEM, therefore, will be in its capacity to remove from the models an element of bias introduced by all those unobserved time-invariant firm factors (like external regulatory environment and long-term incentives). The Hausman test suggests that fixed effects models should be favored over random effects models because firm-specific effects are correlated with the predictors, requiring the use of fixed effects for unbiased estimation ($\chi^2=13.29$, $p=0.0099$).

Table 4: Direct effect of CG-index on EM

	<i>Random Effect Model</i>		<i>Fixed Effect Model</i>	
<i>Independent and Control Variables</i>	<i>Coefficient</i>	<i>z-Statistic</i>	<i>Coefficient</i>	<i>t-Statistic</i>
<i>Constant</i>	-0.526433	(-3.99) ***	-2.816906	(-3.63) ***
<i>CG Index</i>	0.0024776	(0.33) *	-0.0105786	(-0.85) **
<i>Size</i>	0.040236	(3.82) ***	0.1419009	(4.67) ***
<i>Market Capitalization</i>	-0.0187567	(-2.11) **	-0.0132198	(-0.57)
<i>Sales Growth</i>	-0.0004866	(-0.23)	-0.000173	(-0.08)
	R-sq:		R-sq:	
	within	0.0073	within	0.0097
	between	0.0295	between	0.028
	overall	0.0077	overall	0.0063
	Wald chi2	(19.59) ***	F	(5.61) ***
	<i>Breusch and Pagan Lagrangian multiplier test</i>			
	chibar2	(1) **		
	<i>Hausman Test</i>			
	chi2	(13.29) **		

*t-values (in parentheses) report the significance levels using *, **, and *** as thresholds at the 10%, 5%, and 1% levels, respectively.*

The results established the presence of a significant negative relationship between governance and EM. Firms with more forceful governance structure were less prone to EM practices, proving governance to be a constraint against opportunistic earnings manipulation. This finding is consistent with past studies like (Dechow, Sloan, & Sweeney, 1996; Klein, 2002), Patrick, Paulinus, and Nympha (2015), Cheng (2008), Hashim and Devi (2008), Damak (2018), Orazalin (2019), Khalil and Ozkan (2016) and Thinh and Tan (2019).

Financial Performance and EM

Random Effects Model (REM): This model introduces random variations at the firm level to account for unobserved heterogeneity. In this case, the coefficient for EM slightly strengthens to -0.3146 ($p=0.000$) in support of earnings management's negative effect on performance. The

Breusch-Pagan Lagrangian multiplier test ($\chi^2=1653.18$, $p=0.000$) further supports REM being more appropriate than OLS.

Fixed Effects Model (FEM): This model identifies within-firm variation by controlling for time-invariant factors such as governance practices or risk in the industry. Here again, the coefficient on EM is negative and significant (-0.2876 , $p=0.000$), showing that EM reduces performance, even when accounting for firm-specific factors. The Hausman test ($\chi^2=141.51$, $p=0.000$), therefore, robustly endorses the FEM over the REM on the ground of endogeneity.

Table 5: Direct effect of EM on Financial Performance

	<i>Random Effect Model</i>		<i>Fixed Effect Model</i>	
<i>Independent and Control Variables</i>	<i>Coefficient</i>	<i>z-Statistic</i>	<i>Coefficient</i>	<i>t-Statistic</i>
<i>Constant</i>	10.82555	(13.32) ***	30.12406	(15.31) ***
<i>EM</i>	-0.3146351	(-5.82) ***	-0.2875581	(-5.39) ***
<i>Size</i>	-1.300696	(-26.59) ***	-1.953562	(-26.64) ***
<i>Market Capitalization</i>	0.9319835	(22.97) ***	0.7170177	(12.21) ***
<i>Sales Growth</i>	0.0091384	(1.57)	0.0119169	(2.08) **
	R-sq:		R-sq:	
	within	0.2485	within	0.2754
	between	0.2718	between	0.1125
	overall	0.2428	overall	0.1175
	Wald chi2(4)	(815.33)***	F	(217.11)***
<i>Breusch and Pagan Lagrangian multiplier test</i>				
chibar2 (1653.18)***				
<i>Hausman Test</i>				
chi2 (141.51)***				

*t-values (in parentheses) report the significance levels using *, **, and *** as thresholds at the 10%, 5%, and 1% levels, respectively.*

This relationship persisted and clearly indicates that EM is a value-destroying practice even after holding the firm-specific factors constant. Earnings management negatively related to financial performance, thus supporting the hypothesis that EM works against conveying true financial results and, ultimately, value to the firm. Extreme cases of EM are perceived as managerial opportunism, reducing investor confidence and damaging performance. Findings of present study are in consistent with the previous studies such as Fairfield, Whisenant, and Yohn (2003), Hassan and Ahmed (2012), Mahdavi Ardekani, Younesi, and Hashemijoo (2012), Kilic et al., (2013), Kumari and Pattanayak (2017), (Cohen & Zarowin, 2010; Farooqi, Harris, & Ngo, 2014; Kang & Kim, 2011; Mahdavi et al., 2012). Similarly, Alhadab and Al-Own (2017), Gill et al. (2013) and Tang and Chang (2015). The results of this study is against Kasznik (1999), McNichols (2000), Dechow et al. (1995) and Lee, Li, and Yue (2006). They showed positive relation between earnings management and performance of the firm.

Mediating Role of EM in CG-Value Relationship

Random Effects Model (REM): The CG Index is positive but somewhat significant (0.0529, $p=0.063$), suggesting an ill-defined relationship between governance and performance when the random firm-level variations are included. EM would, therefore, continue to remain strongly

negative (-0.314, $p=0.000$), affirming its mediation role. The Breusch-Pagan LM test ($\chi^2=1519.98$, $p=0.000$) justifies REM over OLS but the Hausman Test ($\chi^2=217.47$, $p=0.000$) later invalidates REM in favor of FEM.

Table 6: Mediating Role of EM in CG-Performance Relationship

	<i>Random Effect Model</i>		<i>Fixed Effect Model</i>	
<i>Independent and Control Variables</i>	<i>Coefficient</i>	<i>z-Statistic</i>	<i>Coefficient</i>	<i>t-Statistic</i>
<i>Constant</i>	10.76468	(13.39) ***	31.86644	(16.2) ***
<i>CG Index</i>	0.0528766	(1.86) *	0.2099215	(6.7) ***
<i>EM</i>	-0.3142484	(-5.8) ***	-0.2812432	(-5.32) ***
<i>Size</i>	-1.318389	(-26.19) ***	-2.1269	(-27.58) ***
<i>Market Capitalization</i>	0.9313197	(23.06) ***	0.7301248	(12.54) ***
<i>Sales Growth</i>	0.0087879	(1.51)	0.0107464	(1.9) *
	R-sq:		R-sq:	
	within	0.2542	within	0.2893
	between	0.2624	between	0.1028
	overall	0.2376	overall	0.1096
	Wald chi2	(818.86) ***	F	(185.98) ***
	<i>Breusch and Pagan Lagrangian multiplier test</i>			
	chibar2	(1519.98) ***		
	<i>Hausman Test</i>			
	chi2(4)	(217.47) ***		

*t-values (in parentheses) report the significance levels using *, **, and *** as thresholds at the 10%, 5%, and 1% levels, respectively.*

Fixed Effects Model (FEM): This model accounts for time-invariant characteristics, such as the regulatory environment and long-term governance practices, to isolate within-firm variation. Strongly positive and significantly large, the CG Index (0.2099, $p=0.000$) indicates governance changes within the same firm, over time, positively affect Tobin's Q. Earnings manipulation still retains a negative coefficient (-0.281, $p=0.000$) and can, thus, be seen as a mediating factor: governance enhances performance by restraining EM.

Improvements in corporate governance within the firms improve financial performance, while earnings management acts as a significant mediator. The need to control for firm-specific heterogeneity is underscored by the changing significance of the CG Index across the models. Governance reforms should be the priority of policy makers and managers to mitigate earnings manipulation and open value over the longer term, especially for larger firms bogged down by scale-related inefficiency. Through mediation analysis, it was proved that EM partially mediates the governance-performance link. The governance directly helps with performance via oversight and strategic alignment; it also plays the indirect path of curbing financial misreporting, working both ways in value creation. The effective governance of firms minimizes EM, thereby enhancing performance, thus confirming the mediation hypothesis and further reinforcing the role of governance structures in enhancing integrity.

The findings of this hypothesis of the study is in consistent with the study of previous researchers like Savitri et al., (2020), Ching, Teh, San, and Hoe (2015), Quddoos et al. (2020), Mahrani and Soewarno (2018) and Mayliza, Dewi, and Sari (2019) which shows the mediating role of EM between CG mechanism and firm's performance relationship.

Robustness Check

The use of “Dynamic panel-data estimation, two-step system Generalized Method of Moments (GMM)” has been applied on our model specifications for enhancing robustness to different forms of statistical bias. Such important and influential contributions have shown that GMM is capable of tackling the problems of endogeneity and heterogeneity (e.g., Wintoki et al., 2012; Ullah et al., 2018). Two-step GMM was preferred over one-step GMM because the two-step GMM produces a lower asymptotic variance (Wintoki et al., 2012). Results from the two step GMM estimations are as follows.

Direct Effect of CG Index on Financial Performance

As per CG index coefficient being highly positive and highly significant at the level of (0.571, $p=0.000$), improvement in CG mechanism directly enhances the financial performance of different firms compared to their governance with lower cases *ceteris paribus*.

Table 7: Direct Effect of CG Index on Financial Performance

<i>Tobin's Q</i>	<i>Coefficient</i>	<i>Std. Err.</i>	<i>t</i>	<i>P> t </i>
<i>Tobin's Q (Lag-1)</i>	0.537485	0.023	22.95	0.0000
<i>CG Index</i>	0.571241	0.099	5.8	0.0000
<i>Size</i>	-2.09931	0.155	-13.51	0.0000
<i>Market capitalization</i>	0.621834	0.109	5.7	0.0000
<i>Sales Growth</i>	-0.04062	0.072	-0.57	0.5720
<i>Constant</i>	29.82604	3.230	9.23	0.0000
F		403.1	Prob > F	0.0000

“Arellano-Bond test for AR(1) in first differences: $z = -2.36$ $Pr > z = 0.018$ ”

“Arellano-Bond test for AR(2) in first differences: $z = -0.29$ $Pr > z = 0.768$ ”

The Arellano-Bond tests confirm no second-order autocorrelation (AR2: $p=0.768$), thereby validating the GMM setup. Good governance hinders performance in the case of market capitalization and is, therefore, important for enhancement of performance.

Effect of CG Index on EM

A negative and significant coefficient has been reported for CG Index (-0.350, $p=0.000$) and hence it shows that governance increases the counter to earnings manipulation. This is in agreement with the theory of agency which shows that governance constrains opportunistic practices. Arellano-Bond tests confirm no second-order autocorrelation AR2: $p=0.353$, thus supporting model validity.

Table 8: Direct Effect of CG Index on Earnings Management (EM)

<i>EM</i>	<i>Coefficient</i>	<i>Std. Err.</i>	<i>t</i>	<i>P> t </i>
<i>EM Lag-1</i>	-0.29574	0.03099	-9.54	0.000
<i>CG Index</i>	-0.34973	0.074952	-4.67	0.000
<i>Size</i>	0.456348	0.073567	6.2	0.000
<i>Market Capitalization</i>	-0.13813	0.070476	-1.96	0.051
<i>Sales Growth</i>	0.04275	0.051643	0.83	0.408
<i>Constant</i>	-4.16454	0.798612	-5.21	0.000
F		34.9	Prob > F	0.0000

“Arellano-Bond test for AR(1) in first differences: $z = -1.77$ $Pr > z = 0.077$ ”

“Arellano-Bond test for AR(2) in first differences: $z = -0.93$ $Pr > z = 0.353$ ”

Effect of EM on Financial Performance

Earnings management, with a coefficient of -0.921 and a p-value of 0.000, has a strong negative effect and is statistically significant. This implies that companies that manipulate earnings heavily perform poorly.

The coefficient of the lagged dependent variable Tobin's Q (Lag-1) is quite strong and positive, at 0.849, while the p-value is around conventional level of 0.000, indicating a very high level of persistence in performance. It is an indication that performance in prior year informs the current results, which stresses the basis for maintaining consistent value creation.

Table 9: Effect of EM on Financial Performance

<i>Tobin's Q</i>	<i>Coef.</i>	<i>Std.</i>	<i>t</i>	<i>P> t </i>
<i>Tobin's Q (Lag-1)</i>	0.8487892	0.021729	39.06	0.000
<i>EM</i>	-0.9209761	0.104272	-8.83	0.000
<i>Size</i>	-0.6743919	0.108363	-6.22	0.000
<i>Market Capitalization</i>	0.2695733	0.060575	4.45	0.000
<i>Sales Growth</i>	0.0201157	0.014642	1.37	0.170
<i>Constant</i>	9.736625	2.074486	4.69	0.000
	<i>F</i>	<i>1289.64</i>	<i>Prob > F</i>	<i>0.0000</i>

“Arellano-Bond test for AR(1) in first differences: $z = -1.87$ $Pr > z = 0.062$ ”

“Arellano-Bond test for AR(2) in first differences: $z = -0.80$ $Pr > z = 0.423$ ”

The Arellano-Bond tests approve for the robustness of the model. The first-order autocorrelation (AR1: $p=0.062$), which is expected in dynamic specifications, is present, while the absence of second-order autocorrelation confirms that considered error terms of the model are serially uncorrelated and support the validity of the GMM estimator (AR2: $p=0.423$).

Mediating Role of EM Between CG Index and Financial performance

CG Index remains positive and significant (0.330, $p=0.001$), although the coefficient has a smaller value than indicated in Table 22, which means EM is partially mediating this relationship. EM is shown to impact performance negatively such that the higher the earnings management, the lesser the performance (-0.782, $p=0.000$). This confirms the harmful role of EM in value destruction.

The system GMM outcomes strongly corroborate the dynamics in the triad of CG mechanism, EM, and performance. Table 7 suggests that corporate governance positively promotes firm performance, meaning improved governance structures lead to higher value for the firm. However, Table 8 further confirms CG has a negative and significant association with Earnings management. In Table 10, when EM is configured as a mediating variable, it therefore lowers the effect of CG Index on performance but its effect remains significant, thereby confirming partial mediation. Thus, the implications of the findings reveal that notwithstanding the fact that governance directly improves performance, part of its effect actually operates through EM. The GMM results show that corporate governance enhances financial performance on both counts, namely, directly and by curbing EM.

Table 10: Mediating Role of EM Between CG Index and Performance

<i>Tobin's Q</i>	<i>Coefficient</i>	<i>Std. Err.</i>	<i>t</i>	<i>P> t </i>
<i>Tobin's Q Lag-1</i>	0.875035	0.026103	33.52	0.000
<i>CG Index</i>	0.329505	0.09534	3.46	0.001
<i>EM</i>	-0.78188	0.098578	-7.93	0.000
<i>Size</i>	-0.89276	0.173598	-5.14	0.000
<i>Market Capitalization</i>	0.297339	0.071723	4.15	0.000
<i>Sales Growth</i>	-0.07724	0.058119	-1.33	0.185
<i>Constant</i>	11.02628	3.314365	3.33	0.001
	F	902.9	Prob > F	0.000

“Arellano-Bond test for AR(1) in first differences: $z = -2.54$ $Pr > z = 0.011$ ”

“Arellano-Bond test for AR(2) in first differences: $z = -0.25$ $Pr > z = 0.800$ ”

Conclusion

This study focused on studying a complex relationship between CG mechanism, earnings management, and performance. The study finds a negative relationship, suggesting earnings manipulation negatively affects performance. This suggests that firms that engage in excessive earnings management lose investor confidence, and eventually harm their long-term performance. This is consistent with an earlier study that associates EM with decreased firm value.

This study investigates the extent to which earnings management serves as a mediator along the governance-performance linkage. The results indicate that earnings management serves as a partial mediator, with governance ex ante preventing performance decrement through effective oversight and proper strategic alignment, and ex-post reducing earnings manipulation, ultimately enhancing performance. This finding is consistent with the perspective that good governance enhances the transparency and integrity of financial reporting.

In summary, the study emphasizes the pivotal role of CG mechanism in fostering financial performance through the control of earnings management. The findings indicate that structures of governance exert a direct positive impact on firm outcomes and, additionally, promote the long-term growth of the firm by curtailing manipulation. Together, these results highlight the importance of effective governance mechanisms to sustain business performance over the long run.

This presentation makes a contribution to the corporate governance literature with respect to non-financial firms in Pakistan, while also making some important caveats. Although the sample is large, and much larger than many studies, missing some firms due to missing data limits generalizations of results. The corporate governance index that has been used may not capture all governance mechanisms which would indicate room for improvement. The sample excludes some sectors and emerging markets into which the scope is narrowed further. Future research could enhance external validity by adding a larger sample, using mixed methods, and adding qualitative data. Cross-market comparisons, sector analyses, and longer governance variables could enhance insight. Policy implications concern strengthening regulations, improving audit practices, and increasing board independence relating to enhanced firm performance and investor confidence.

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