Chapter 10
How Different Corporate Governance and Corporate Social Responsibility Impact Earnings Management:
Eastern and Western European Countries

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ABSTRACT

Nowadays, companies increasingly focus on corporate concerns as they are in need of the detecting and controlling management activities in order to improve good business practices, objectivity, and integrity. This research addresses the question of the role of corporate governance and corporate social responsibility in earnings management. Previous studies confirmed that both mechanisms play an important role in limiting earnings management. In this context, the objective of the study is to test whether the effectiveness of both in constraining earnings management is the same or vary within the Eastern and Western Europe. By analyzing a sample of 1,339 firms from three developing Eastern European countries and three Western European countries over the period of 2010–2018, the findings confirm the positive impact of corporate social responsibility on the quality of the earnings. Additionally, the analysis shows that corporate governance is more effective in controlling earnings management in Western European countries.

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INTRODUCTION

Corporate governance is directly involved in monitoring managers' decisions, as the good corporate governance serves as an effective mechanism to alleviate the opportunistic behaviors of management and to improve a company's reporting quality. At the same time, firms with poor corporate governance are more vulnerable to managerial opportunism and EM (e.g. Francis and Wilson, 1988; Klein, 2002; Xie, Davidson and DaDalt, 2003; Cornett, Marcus and Tehranian, 2008; Jaggi, Leung and Gul, 2009; Mishra and Malhotra, 2016; among others).

Seemingly, firms that are socially responsible are more ethical in their reporting behaviors less likely to manipulate their earnings numbers. In other words, EM occurs less often in companies with a strong commitment to social responsibility, as corporate social responsibility (CSR) boosts transparency and reduces the number of opportunities to manage earnings (e.g. Shleifer, 2004; Bansal, 2005; Prior, Surroca and Tribo, 2008; Chih, Shen and Kang, 2008; Gao and Zhang, 2015; Kim, Park and Wier, 2012, among others).

Nevertheless, the literature also strikes differences in the practices in corporate governance and CSR within the different countries, economies or included within the firms in the same environment. Corporate governance will be different because firms may perform differently depending on the environment, because the range of the governance control devices may be different, etc. The degree of CSR adoption may be different because the level of economic development of the country influences, because local community relations change, relationships with suppliers and customers change, including culture may change, etc.

Boards dominated by outsiders are arguably in a better position to monitor and control managers by being more independent of the firm's managers, and bringing a greater breadth of experience to the firm (Brickley, Coles, and Terry, 1994; Byrd and Hickman, 1992; Weissbach, 1998; Cornett, Marcus and Tehranian, 2008). However, in other environments some authors point out opposite results. Osma and Noguer (2007), for example, show that reductions in the proportion of independent directors on the board are associated with a lower level of EM. They clarify the inefficiency of simply adding numerous independent directors to the board for improving the quality of information and reduction of EM.

In this research, considering the existence of the differences in terms of the mechanisms of corporate governance and CSR disclosure between Eastern and Western economies, the principal objective is to test whether the effectiveness of both mechanisms in constraining earnings management is the same or vary within these two blocks of countries.

The study contributes to the EM literature at least in two important ways. First, the research responds about the differences in effectiveness of corporate governance and CSR for controlling EM in Eastern and Western European countries.

Second, the study contributes by verifying the existence of EM in firms from emerging Eastern European countries. Therefore, present research may also give insights to the literature of developing Eastern European countries in terms of the effectiveness of the mechanism of corporate governance and CSR in limiting EM.

The study focuses on three developing Eastern European countries (Poland, Hungary, and the Czech Republic) and three Western European countries (Germany, Spain and France) during the period from 2010 to 2018. Four research hypotheses have been tested with a methodology based on discretionary accruals.