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Corporate Governance and Financial Performance in Pakistan's Manufacturing Sector: The Moderating Role of Earnings Management

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ABSTRACT

This study examines the influence of corporate governance (CG) mechanisms on the financial performance of manufacturing firms in Pakistan, emphasizing the moderating effect of earnings management. It aims to determine how board characteristics impact firm performance and whether earnings manipulation changes this relationship. A quantitative design under the positivist paradigm is adopted, using secondary data from annual reports of firms listed on the Pakistan Stock Exchange. The analysis employs panel data regression through the two-step system Generalized Method of Moments (GMM) to address endogeneity concerns, focusing on the textile sector due to data availability. Findings reveal that board size, independence, and gender diversity negatively affect performance measured by Return on Assets (ROA) and Return on Equity (ROE), whereas foreign ownership has a positive effect. The presence of sustainability committees shows a

minimal impact. Earnings management exerts a strong negative influence on financial performance and significantly weakens the governance-performance link. Among control variables, firm size negatively correlates with profitability, while firm age has a positive association. The study recommends maintaining an optimal board size of 7–9 members, promoting real independence instead of symbolic compliance, and ensuring merit-based gender inclusion. For regulators, enhanced enforcement, stronger audit quality, and whistleblowing mechanisms are vital to reduce earnings manipulation. This research enriches CG literature by addressing the moderating role of earnings management in an emerging market context, offering practical and theoretical insights for Pakistan's manufacturing sector.

Keywords: Corporate governance, financial performance, board characteristics, earnings management, Pakistan manufacturing sector.

INTRODUCTION

Background Of Study

Corporate governance (CG) describes a system by which companies are governed and controlled to promote accountability as well as fairness in a relationship with their stakeholders (Aguilera & Haxhi, 2019). This concept started to be studied worldwide with the advent of corruption scandals involving corporate giants like Enron and WorldCom that showed cracks in sound monitoring and ethical practices (Garas & El-Massah, 2018). This series of events caused the arrangement of some governing frameworks, such as the OECD Principles of Corporate Governance, aimed at providing international standards based on transparency and accountability for better treatment of shareholders (OECD, 2015; Mohsin, 2025). Effective corporate governance guarantees that decisions made at the corporate level are delivered in alignment with stakeholder interests, minimizes possible conflict between managers and owners, and engenders confidence among the investing public (Lavin & Montecinos-Pearce, 2021; Lim, 2021). Whereas countries with a strong governance system have a lesser chance of experiencing incidents of fraud or financial mismanagement (Alghizzawi et al., 2024; Boeva, 2024). The growing trend toward sustainability and environmental, social, and governance (ESG) reporting serves to reinforce the notion that CG is vital to long-term value creation (Al-Hiyari et al., 2023; Musa, 2024). Essentially, strong corporate governance is a bulwark against the opportunistic behavior of managers and instability within the market, representing, therefore, a general sine qua non for corporate success across the globe (Nuhu, 2024).

Corporate governance in Pakistan has mostly evolved over time. The first Code of Corporate Governance, introduced by the SEC of Pakistan, was intended to improve transparency and investor confidence. The code was revised in 2012 and later in 2017 to meet international practices (Farooq et al., 2022; Khan et al., 2022; Ullah et al., 2021). The code includes an obligatory appointment of two or one-third independent directors and having one female director, establishment of audit and risk management committees, and heightened disclosure requirements (Saddique & Haq, 2025). In addition, the revised code would usher in a concept of sustainability and corporate social responsibility, thus signalling towards ESG principles (Muhammad, 2022). However, compliance remains

mostly symbolic rather than functional. Many firms appoint independent and female directors solely for legal compliance and have limited impact over strategic decisions (Latif, 2018). Audit committees remain starved of autonomy requisite for any rigorous oversight, especially regarding family-owned enterprises that constitute the core of Pakistan's corporate strings (Hassan, 2014). These impediments to normal activities are aggravated with minimal penalties for noncompliance and underdeveloped monitoring mechanisms (Hussain et al., 2025). Consequently, firm-specific publications generally vary greatly in their quality of governance, interfering badly with investor confidence and limiting access to international capital markets (Farooq et al., 2022). To achieve any meaningful gains, Pakistan must have a robust enforcement structure, highly mobilised shareholders, and cultural changes in favor of real governance implementations as opposed to mere compliance (Khan et al., 2022). These reforms are pivotal in making quality governance and economic growth feasible in a fiercely competitive global environment (Saddique & Haq, 2025).

Importance on Manufacturing & Textile Sector

The manufacturing sector is one of the main proponents of the economy in Pakistan, accounting for roughly 19% of the GDP and employing millions of workers, with textiles contributing over 60% toward exports (Arif et al., 2023). The state of this sector affects the stability of the economy, foreign earnings, and industrial development. Being an export-orientated sector, compliance with international governance as well as reporting standards are imperative to remain competitive in trade and woo foreign investors (Zia & Burton, 2023). Nevertheless, governance practices in firms are still tentatively functioning. Family ownership structures predominate in industry, thereby limiting the independence of boards and dissuading diversity (Arif et al., 2023). Thus, some companies would only be adopting governance codes in a surface manner while focusing only on regulatory compliance and not on operational efficiency and accountability (Ullah, 2022). Such a symbolic approach gives rise to poor financial disclosure, increased agency costs, and exposure to fraud (Siddique, 2022). Weak governance mechanisms also dissuade firms from keeping access to low-cost financing that hampers the upgrading of technology and expansion of operations (Ali et al., 2025). Such issues in governance need to be addressed to enhance competitiveness, improve investors' confidence, and offer sustainability of manufacturing in Pakistan from global economic influences and changes in trade (Farooq et al., 2022).

Research Gap

There are wide gaps despite extensive global research on corporate governance and firm performance, especially in emerging economies like Pakistan (Majumder et al., 2024; Qaim & Ellahi, 2024). Most of the historical studies have been conducted abroad, especially in developed countries with extremely good legal provisions, advanced monitoring mechanisms, and investor protection laws (Jamal et al., 2025; Salman et al., 2025). The results from such contexts cannot be generalised in developing economies in which institutional weaknesses as well as family ownership dominance depend significantly on culture-determined dynamics and create quite different governance practices and outcomes (Khan et al., 2025; Salam et al., 2025). This produces an evidence

gap in the sense that the impact of governance mechanisms in weaker law enforcement environments remains underexplored. Another big gap in knowledge is there has been scant exposure of earnings management as a moderating factor. International research finds the phenomenon of earnings manipulation a great threat to financial transparency. However, it has been considered either an outcome variable or a control factor in most studies, and little has been done to see its interaction with governance in shaping firm performance (Majumder et al., 2024; Qaim & Ellahi, 2024). In Pakistan, this gap is more pronounced due to concentrated ownership structures, symbolic board independence, and low audit quality, which collectively create fertile ground for opportunistic practices (Salman et al., 2025). Understanding how earnings management influences governance effectiveness is crucial to assessing the reliability of financial indicators such as ROA and ROE (Khan et al., 2025). A practical knowledge gap exists because organizations and regulators often lack evidence-based strategies to mitigate earnings manipulation and enhance governance efficiency (Qaim & Ellahi, 2024). Without empirical insights into how governance mechanisms operate under the influence of earnings management, policymakers cannot design robust frameworks to improve accountability and investor confidence (Jamal et al., 2025). Similarly, corporate managers lack clear guidance on strengthening governance practices beyond mere regulatory compliance (Salam et al., 2025).

From a methodological perspective, prior research in Pakistan has relied heavily on cross-sectional designs, limiting the ability to capture long-term governance impacts (Khan et al., 2025). Few studies have adopted panel data approaches that control firm-specific variations over time. Additionally, sector-specific investigations are rare, resulting in an empirical gap for industries such as textiles that dominate Pakistan's manufacturing output and export earnings (Salman et al., 2025). The theoretical gap arises from the limited integration of multiple governance theories in explaining governance-performance dynamics under the moderating influence of earnings management. While agency theory is frequently applied, complementary perspectives such as resource dependency theory and stewardship theory are often ignored, restricting the depth of conceptual understanding (Majumder et al., 2024). The population gap persists because most studies have analyzed either financial or mixed sectors, leaving the manufacturing sector largely unexplored (Qaim & Ellahi, 2024). Considering that textiles represent Pakistan's largest industrial contributor, studying this sector provides context-specific insights essential for improving governance practices in a critical segment of the economy (Jamal et al., 2025). This study addresses these gaps by focusing on the textile industry, employing a longitudinal panel data design, and integrating earnings management as a moderator within a comprehensive theoretical framework. The findings will not only enhance academic understanding but also offer actionable strategies for regulators, corporate boards, and investors in emerging market settings.

Research Objectives

1. To measure the impact of board characteristics on the financial performances of Pakistani textile sector.
2. To measure the moderating role of earning management between board

characteristics and the financial Performance of Pakistani manufacturing sector.

Significance of the Study

The research contributes to the existing literature on corporate governance by addressing the interplay between governance mechanisms and financial performance within the unique institutional environment of an emerging market. Unlike most prior studies that focus on developed economies, this study investigates Pakistan's manufacturing sector, where governance enforcement and cultural dynamics differ substantially. By incorporating earnings management as a moderating variable, the research offers new insights into how opportunistic practices can weaken governance effectiveness, a dimension largely overlooked in previous studies. This integration strengthens the conceptual understanding of agency theory and complements it with insights from resource dependency and stewardship theories, broadening the theoretical scope of governance research.

The findings of this study provide actionable guidance for multiple stakeholders. For policymakers and regulators, the results highlight the need for stricter enforcement of governance codes and mechanisms to curb earnings manipulation. For corporate boards and management, the research emphasizes the importance of moving beyond symbolic compliance and adopting functional governance practices that enhance decision-making and accountability. Investors and financial institutions can use these insights to evaluate governance quality and earnings reliability when making investment decisions, reducing the risk of misinformed capital allocation.

Improving governance quality has broader implications for Pakistan's economic stability and growth. Strengthening governance frameworks and reduced earnings manipulation foster transparency, which is critical for attracting foreign direct investment and improving market credibility. This, in turn, supports capital inflows, boosts investor confidence, and enhances the competitiveness of the manufacturing sector, particularly textiles, in global markets. Better governance practices also contribute to sustainable corporate growth, employment stability, and long-term economic development, making the study highly relevant to national policy objectives.

REVIEW OF LITERATURE

Corporate Governance

Corporate governance has undergone evolution in the face of financial scandals and crises. At the worldwide level, institutional frameworks such as the Sarbanes-Oxley Act of the US and the Cadbury Report of the UK emphasized transparency, accountability, and independent oversight (Sultan, 2022; Uzma, 2018). For instance, OECD guidelines were global principles for governance, focusing on shareholder rights, disclosure, and board responsibilities (Clarke, 2015; OECD, 2015). Governance development in Pakistan has been initiated through the proclamation of a Corporate Governance Code by the Corporate SECP in 2002 to cater to increased levels of investor confidence and corporate accountability (Saddique & Haq, 2025; Zubair & Jalal, 2025). Revisions to the years 2012 and 2017 resulted in the addition of clauses that require the appointment of independent

directors, the inclusion of at least one female nominee on boards, and stricter audit provisions (Tariq et al., 2022). These changes were required mainly to conform with best practices all over the world and to improve transparency in the corporate sector (Ashraf, 2025; Hussain et al., 2025). Engross and Fauji Fertilizer have transformed into real-life models in terms of adhering to these reforms, using strong governance as a platform for attracting foreign investment and ensuring long-term survival (Rehman et al., 2023).

Through governance, corporate governance therefore directly impacts financial performance by enforcing mechanisms for efficiency, accountability, and transparency (Hassan et al., 2021; Khan, 2016). A well-governed corporation seeks to minimize agency costs by ensuring that management decisions are made in the interest of the shareholders. This, in turn, increases investors' confidence, making it easier for the firm to attract financing at competitive rates (Clarke, 2015; Uzma, 2018). For instance, MNCS operating in Pakistan adopt stringent codes of governance to comply with international standards in attracting global investors (Alam et al., 2024). Strong governance reduces the chances of fraud and misrepresentation in financial statements, thereby reducing the legal and reputational risks involved (Saddique & Haq, 2025). Governance regimes that are centered on active audit committees and a periodic disclosure framework, as a rule, report higher profitability and enhanced operational control (Sultan, 2022). Governance assists in long-term strategic planning toward sustainable growth instead of mere short-term profit generation (Boubaker & Nguyen, 2014). These companies develop market valuation and shareholder confidence by investing in governance, which in turn enhances their financial success (Zia & Burton, 2023).

The Board of Directors, as the central pillar of corporate governance structure, is charged with strategic oversight, ensuring compliance, and protecting the interests of shareholders (Javed et al., 2024; Razzaq & Niazi, 2018). Therefore, boards oversee executive action, approve major decisions, and ensure that the organization's objectives conform to ethical and legal standards (Hassan, 2014). A properly constituted board is one with independent directors, executive members, and committees to handle issues of audit, risk management, and remuneration policies (Ishak & Nugraha, 2024; Kalita, 2024). For instance, the leading companies in Pakistan, chairing the audit and nomination committees by independent directors, safeguard the objectivity and accountability of these committees (Hussain et al., 2025). Worldwide, the best tendency is to separate the roles of CEO and chairman so that no undue concentration of power occurs (Aggarwal & Varma, 2024; Din et al., 2024). In the process of crisis management, the boards also ensure that plans are put into place that are compatible with the financial and operational crisis (Ahmed & Uddin, 2024; Ullah, 2016). Strong governance practices enforced by the board create transparency, minimize risks, and foster an environment of accountability and good decision-making in a way that translates into corporate success (Shabbir et al., 2024; Tariq, 2014).

Board Characteristics and Their Impact

Board composition essentially means directors structure and mixes, particularly the balance between independent and executive members who significantly determine the governance, quality and performance of a company (Al-Matari, 2020). The

introduction of independent directors is meant to broaden objectivity on strategic issues and reduce the likelihood of opportunism among managers through keeping an eye on their actions (Boivie et al., 2021; Suryavanshi, 2023). For example, Nestlé would have included many independent directors on its board to ensure compliance with international standards and facilitate impartial guidance. (Adebayo, 2024; Chang & Rogers, 2022). In Pakistan, at least two or one-third of independent members of the board are required to be there under SECP regulations to achieve transparency and accountability in the decision-making process (Hussain et al., 2025; Saddique & Haq, 2025). Evidence on board composition has often been mixed. Several studies maintain that firms with high proportions of independent directors increase their financial performance because of better monitoring and strategic advice (Bonini et al., 2022; Salim, 2023).

The number of directors on a board considered from the total number of directors on a board has long drawn heated debate about its influence on governance and performance (Raffia et al., 2022). A larger board is often associated with diverse skills, increased decision-making, and better abilities to monitor (Nahum & Carmeli, 2020). For instance, with global players, a large board consists of members with finance, technology and risk management specialties for boosting strategic oversight (Jhunjhunwala, 2023). Similarly, the boards of companies in the banking sector of Pakistan are larger to cope with regulatory compliance and for handling complex operating environments (Hussain et al., 2025). It is, however, true that larger board sizes have their own share of disadvantages. The larger the board, the more difficult it becomes to coordinate activities and thus delay in decision-making. The larger board can also result in "social loafing", where the directors tend to be less involved in discussions, and hence decisions made are not effective. This is evident in big family conglomerates in South Asia, where large boards tend to result in diluted accountability and slow response to dynamic market changes (Patel et al., 2024; Vereen & Aveng, 2022). However, small boards may suffer from a lack of knowledge and diverse opinions in such intricate governance issues, creating the inherent potential risks of group thinking and over-reliance on executive management (Portal & Sorely, 2024; Tshaka, 2024).

The board's procurement of gender diversity emerged as an essential dimension of contemporary governance, with numerous authors pinpointing its contribution in decision-making, risk management, and corporate reputation at large (Biafra et al., 2020). Theoretical rationales for gender diversity are suggested from resource dependency and social role theories, which view women's participation as unique perspectives that enrich problem-solving capacities to further promote ethical governance practices (Anglin et al., 2022). Some multinational corporations, like Unilever and IBM, have shown that gender-diverse boards nurture innovation and trust among stakeholders (Leone et al., 2025). Outside developed countries, the situation reflects tokenism and hardly any participation (Kaur et al., 2025). In Pakistan, although SECP's regulations incorporating at least one-woman director on the board date back to 2017, most of these appointments are still largely symbolic, with little to no involvement in strategic discussions and decisions (Hoor-Ul-Ain & Iraqi, 2022).

The appointment of foreign directors to corporate boards is increasingly identified as a mechanism to strengthen governance through the introduction of global expertise, raising transparency, and instilling confidence in investors (Alshabibi, 2021; Liao et al., 2022). Foreign directors occasionally carry specialised knowledge, international exposure, and exposure to best practices, which can be of utmost benefit to companies in competitive markets (Samara & Yousef, 2023). For example, major Pakistani firms with foreign ownership, such as Unilever Pakistan, sustain foreign directors who help align local operations with global governance standards to assure compliance and strategic integration (Jahan, 2024; Khan et al., 2025). The presence of foreign directors is also a signal to international investors that the company is serious about high standards of governance (Al-Gamrh et al., 2020). This is especially pertinent in emerging markets, wherein doubts around weak enforcement of regulations with concentrated ownership hamper foreign entry (Tran, 2020).

Furthermore, in family-run businesses, the influence that foreign directors can have is limited because controlling shareholders may not allow them into the internal picture, as has been argued by Ahmed and Uddin (2024). Still, the strategic embedding of foreign directors, especially in critical sectors like banking and FMCG, has shown improvements regarding quality of governance, networking globally, and reputation (Chouaibi et al., 2022; Yadava, 2023). This practice underscores the importance of diversity in experience and perspective for boards seeking sustainable growth in increasingly globalized markets (Hossain et al., 2024).

Financial Performance Indicators

Return on Assets (ROA) is an indicator of the efficiency of a company in converting its total assets into net income. It shows an amount set out for both operational effectiveness and asset utilisation (Khan et al., 2025; Salman et al., 2025). In governance-performance research, this becomes a very important indicator because management is seen in light of how well it leverages the resources with which they have been endowed under the board's strategic oversight (Saddique & Haq, 2025; Shakri et al., 2025). A higher ROA suggests strong internal controls, prudent investment policies, and efficient management practices, hallmarks of robust corporate governance (Khan et al., 2025; Naeem et al., 2025). The example is like the one set by Fauji Fertilizer Company, in that it has continuously had a better report of ROA as opposed to other companies in Pakistan because of its governing framework, which includes a lot of capital discipline and clear financial reporting (Khan & Arshad, 2025; Latif et al., 2025). There is also an effect in these multinational corporations like Unilever, where independent board oversight ensures efficient allocation of assets across global operations (Salman et al., 2025).

ROE represents the measure used to evaluate the efficiency with which a corporation earns profits from shareholders' equity and is regarded as one of the most important parameters by the investors (Hameed et al., 2025; Shah, 2025). While ROA measures the efficiency of asset utilisation, ROE measures the efficient use of equity capital under the governance structure (Ilyas & Abbas, 2025; Nazeer et al., 2025). Therefore, boards serve as a crucial link in the chain of actualising ROE by way of

strategic financing choices, distribution policies, and oversight of managerial activities in the corporate landscape (Momand & Khel, 2025; Saddique & Haq, 2025). A high ROE usually indicates good governance, supported by the premise that profits are generated with relatively low debt levels (Khan et al., 2025; Shakri et al., 2025). Engro Corporation in Pakistan, for example, has consistently declared competitive ROE numbers and attributes these numbers to its governance practices that highlight long-term capital planning, effective board oversight, and compliance with SECP regulations (Latif et al., 2025; Tariq et al., 2025).

Earnings Management

Earnings management refers to the purposely managed financial statements to misrepresent the actual financial performance of the company by management (Alrawashedh & Zureigat, 2025; Touski & Seyfideli, 2024). It is, however, legal most of the time under accounting flexibility, yet misleads the stakeholders concerning the true financial state of the firm (Mlawu et al., 2025). Broadly, there are two kinds of earnings management: accrual-based and real activities manipulation. Accrual-based earnings management takes place without affecting actual operations but through manipulation of accounting policies (Khan et al., 2025; Shira, 2025). For instance, a company might want to inflate its profit by extending the depreciation schedules or changing the provision for doubtful debts. This was evident in the WorldCom case; it became a therapy for operational inefficiencies through aggressive capitalizations of expenses (Shira, 2025). However, real earnings management is a type of management that makes it possible to change actual business activities to meet a financial target (Hunjra et al., 2025; Mansoori & Al-Abdallah, 2024). Common techniques to manipulate earnings include, among others, the postponement of research and development expenditure, offering deep discounts to stimulate year-end sales, and cutting costs associated with discretionary spending like marketing (Bhatti et al., 2022). The 2008 global financial crisis observed many companies in Asia cut down on marketing and personnel training expenditures to preserve profit margins (Mlawu et al., 2025). Both methods are equally dangerous.

Earnings management exists under the motivation and incentive constructs, which, because they tend to favor managerial rather than shareholder interests, create agency conflicts (Mlawu et al., 2025; Yahaya, 2025). Agency theory regards the separation of ownership from control, which permits managers to use their discretion to manipulate financial outcomes in their favor by way of bonuses, job retention, or targets linked to performance (Gupta, 2025; Lizinska et al., 2025).

Earnings management should be scrutinized in targeted emerging markets because of weak regulatory enforcement, concentrated ownership, and cultural norms that favor relationships over formal compliance (Mlawu et al., 2025; Shira, 2025). All of these factors create an accounting manipulation-friendly environment somewhere in South Asia, including Pakistan (Saeed & Mohammed, 2025; Wahyuningrum et al., 2023). Family-owned businesses comprise the greater part of the corporate structure in Pakistan, where controlling shareholders always manage financial reporting to protect reputational prestige or enable favorable credit terms (Khan et al., 2025; Mustafa et al., 2025). This inclination diminishes the independence of boards and audit committees from curbing

that opportunism (Hunjra et al., 2025). The cement and textile industries in Pakistan serve as an application case for income smoothing, whereby companies manipulate provisions and defer expenses to display financial stability (Hamdan et al., 2025). Further, the revenue recognition practices of Indian corporations had a history of exploiting loopholes in them, culminating in infamous events such as the Satyam scam, where inflated earnings hid operational inefficiencies (Badulescu et al., 2021; Javaria & Masood, 2025).

The presence of earnings management significantly modifies the relationship between corporate governance and firm performance by blurring the effectiveness of governance mechanisms (Gbadago, 2025; Mishra et al., 2025). Strong governance structures like independent boards and active audit committees are designed to ensure transparency and protection of shareholder interests. On the contrary, earnings manipulation by managers renders these structures incapable of reflecting the real financial position of the company, thus reducing their effectiveness in performance monitoring (Mishra et al., 2025). For example, a firm with independent directors can still report inflated profits if management were to manipulate profits with real activities that cannot even be easily detected by standard control mechanisms (Kulkarni et al., 2025). This dynamic was observed in several listed companies in Pakistan, where boards met regulatory requirements but failed to prevent income smoothing practices designed to maintain stock market valuations (Gbadago, 2025). Consequently, governance appears robust on paper, but its practical impact on performance diminishes (Mishra et al., 2025). Earnings management also misleads external stakeholders, including investors and regulators, by masking operational inefficiencies.

Research Framework

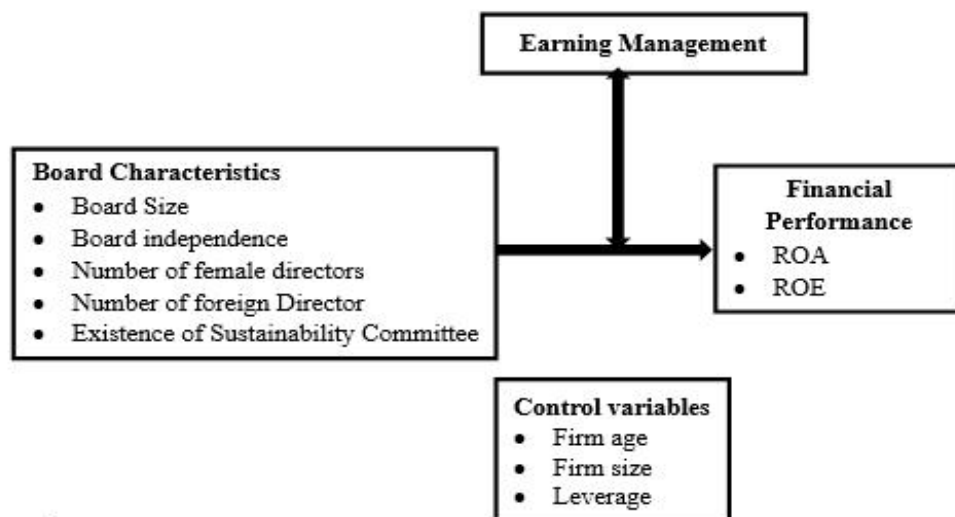


Figure 1: Research Framework

Hypotheses Development

H1: Board size has significant impact on Firm Performance.

H2: Board Independence has significant impact on Firm Performance.

H3: Number of Female Directors in the board have significant impact on Firm Performance.

H4: Number of foreign Directors in the board have significant impact on Firm Performance.

H5: Existence of sustainable Committee has significant impact on Firm Performance.

H6: Earning management moderates the relationship between Board size and firm performance

H7: Earning management moderates the relationship between Board independence and firm performance.

H8: Earning management moderates the relationship between Number of Female Directors and firm performance.

H9: Earning management moderates the relationship between Number of Foreign Directors and firm performance.

H10: Earning management moderates the relationship between the Existence of Sustainable Committee and firm performance.

Methodology

The present study adopts a quantitative research approach to empirically examine the impact of corporate governance and earnings management on firm performance in the Pakistani textile sector. A quantitative method is most suitable as the research focuses on measurable financial indicators, hypothesis testing, and drawing objective conclusions from numerical data.

The research design employed is longitudinal, making use of panel data collected over multiple years for the same set of firms. This design allows for the analysis of both cross-sectional variations across firms and temporal changes within firms, thereby providing a more robust estimation of the relationships under study compared to cross-sectional analysis alone.

The study is grounded in the positivist research philosophy, emphasizing the existence of objective reality that can be measured and analyzed using statistical tools. Under positivism, this research relies on hypothesis testing, use of structured models, and generalizable findings. The deductive research approach is applied, as the study is based on existing theoretical frameworks including Agency Theory, Positive Accounting Theory, and Resource Dependency Theory, which provide the rationale for testing the linkages between corporate governance, earnings management, and firm performance.

The research strategy is archival, relying on the analysis of secondary data collected from company documents and regulatory filings. The unit of analysis is the company (firm), and the study focuses specifically on the textile firms listed on the Pakistan Stock Exchange (PSX). The target population therefore comprises the Pakistani manufacturing sector, with emphasis on textile firms due to their significant contribution to exports and the economy.

A convenience sampling procedure is employed based on the availability and completeness of data. This pragmatic approach ensures that only firms with reliable and consistent financial information are included in the study. The expected sample size ranges between 50 to 70 textile firms, observed over a seven-year period, which yields approximately 300+ firm-year observations for analysis.

The study relies on secondary data, which are extracted from audited annual reports, Securities and Exchange Commission of Pakistan (SECP) filings, PSX disclosures, and official company websites. Such sources ensure reliability, objectivity, and replicability.

For data processing and econometric analysis, software packages such as STATA and EViews are used. The analysis techniques include descriptive statistics (to summarize data characteristics), correlation analysis (to identify preliminary relationships), and panel regression models (Fixed Effects and Random Effects) to test hypotheses. Two model specifications are tested:

$$\text{Model 1: } FP_{it} = \beta_0 + \beta_1 CG_{it} + \beta_2 \text{Controls}_{it} + \varepsilon_{it}$$

$$\text{Model 2: } FP_{it} = \beta_0 + \beta_1 CG_{it} + \beta_2 EM_{it} + \beta_3 (CG \times EM)_{it} + \beta_4 \text{Controls}_{it} + \varepsilon_{it}$$

Where FP refers to firm performance, CG denotes corporate governance, EM represents earnings management, and Controls include firm-level control variables.

To ensure robustness, several diagnostic tests are applied: the Hausman test for model selection (fixed vs. random effects), Variance Inflation Factor (VIF) for multicollinearity, Breusch-Pagan test for heteroskedasticity, and Wooldridge test for serial correlation. The significance level is set at $p < 0.05$ to ensure statistical reliability.

The study complies with ethical standards, as only publicly available secondary data are used. No confidential information is accessed or manipulated, and all sources are properly cited.

Finally, the study acknowledges certain limitations. It focuses exclusively on the textile sector, which may restrict generalizability to other industries. Additionally, only accrual-based earnings management is considered, excluding real activity manipulation. The use of convenience sampling further limits the representativeness of the findings.

RESULTS AND DISCUSSION

Descriptive Statistics

The descriptive statistics offer a detailed overview of the variables used in the study, highlighting the patterns and distribution characteristics that may influence model outcomes (Table 1). Board Size (BSIZE) has a mean of 2.091 and low variability, indicating consistent board sizes across firms. Its moderate right skewness and high kurtosis suggest a few firms have unusually large boards. Board Independence (BIND) averages 24.9%, with some firms having fully independent boards and others none. Its slightly right-skewed and flat distribution reflects moderate variability in board independence. Gender Diversity (GENDER) averages 22%, with a relatively symmetrical distribution and no extreme outliers, showing that female board representation is modest and consistent. Foreign Ownership (FOWN), on the other hand, is low on average (9.2%)

but highly right-skewed and leptokurtic, meaning only a few firms have substantial foreign investment, while most have little to none.

Table 1: Descriptive Statistics

Descriptive Statistics										
	BSIZE	BIND	GENDER	FOWN	CEM	ROA	ROE	FAGE	FS	LEV
Mean	2.091	0.249	0.220	0.092	0.012	0.118	0.410	3.506	15.659	0.506
Median	2.079	0.143	0.210	0.004	0.025	0.070	0.388	3.526	15.607	0.531
Maximum	2.708	0.714	0.500	0.742	11.360	0.788	0.841	7.608	21.077	0.789
Minimum	1.946	0.000	0.000	0.000	-29.294	-0.564	0.105	0.693	10.591	0.060
Std. Dev.	0.163	0.146	0.110	0.168	0.782	0.181	0.178	0.592	1.726	0.169
Skewness	1.235	0.611	0.284	2.075	-22.903	1.351	0.418	-0.292	-0.051	-0.416
Kurtosis	4.263	2.066	2.913	6.458	945.292	5.432	2.341	7.262	2.890	2.223

BSIZE=Board Size, BIND=Board Independence, Gender=Female Representation, FOWN=Foreign Ownership, CEM=Earnings Management, ROA=Return on Assets, ROE=Return on Equity, FAGE=Firm Age, FS=Firm Size, LEV=Leverage

Earnings Management (CEM) exhibits extreme distributional features, including a highly negative skew (-22.903) and very high kurtosis (945.292), indicating the presence of extreme outliers. While most firms have typical earnings behaviour, a few exhibit unusually aggressive earnings practices. Return on Assets (ROA) is positively skewed with a mean of 0.118, suggesting that while most firms earn modest returns, a few achieve notably high profitability. Return on Equity (ROE) is more balanced, with a mean of 0.410, reflecting generally strong shareholder returns.

Firm Age (FAGE) and Firm Size (FS) show relatively symmetric distributions, with average firm age around 3.5 and firm size clustered closely around the mean. Leverage (LEV) is stable across firms but slightly negatively skewed. In summary, while several variables are normally distributed, others like earnings management and foreign ownership reveal outliers and skewness, which must be accounted for in further analysis to ensure valid model interpretation.

Correlation Analysis

The correlation matrix provides insight into the linear relationships among variables used in the study (Table 2). Overall, the correlations are weak, suggesting that multicollinearity is not a major concern, except for a strong negative relationship between return on equity (ROE) and leverage (LEV).

Board Size (BSIZE) shows a weak positive correlation with Board Independence (BIND) (0.210) and Firm Size (FS) (0.294), indicating that larger firms tend to have bigger and slightly more independent boards. However, its correlations with other variables are minimal. BIND has a modest positive correlation with return on assets (ROA) (0.200), suggesting independent directors may be associated with better performance. It is negatively related to Foreign Ownership (FOWN) (-0.182), implying foreign investors may be less prevalent in firms with highly independent boards.

Gender Diversity (GENDER) shows negligible correlations across the matrix, with

the highest being with Firm Age (FAGE) (0.048), indicating female board representation is relatively stable across firm characteristics. FOWN is BSIZE=Board Size, BIND=Board Independence, Gender=Female Representation, FOWN=Foreign Ownership, CEM=Earnings Management, ROA=Return on Assets, ROE=Return on Equity, FAGE=Firm Age, FS=Firm Size, LEV=Leverage negatively associated with ROA (-0.193), BSIZE (-0.111), and BIND (-0.182), suggesting that firms with foreign ownership may have lower asset returns and smaller, less independent boards.

Table 2: Correlation Analysis

		Correlation Analysis								
	BSIZE	BIND	GENDER	FOWN	CEM	ROA	ROE	FAGE	FS	LEV
BSIZE	1.000									
BIND	0.210	1.000								
GENDER	-0.042	0.031	1.000							
FOWN	-0.111	-0.182	0.035	1.000						
CEM	-0.033	-0.042	0.011	0.008	1.000					
ROA	0.018	0.200	-0.003	-0.193	-0.021	1.000				
ROE	-0.124	-0.048	-0.027	0.003	-0.076	0.033	1.000			
FAGE	0.053	0.027	0.048	0.007	-0.044	-0.068	0.093	1.000		
FS	0.294	-0.029	-0.021	-0.100	-0.031	-0.079	-0.071	0.009	1.000	
LEV	0.030	0.048	0.023	0.028	0.085	-0.025	-0.687	-0.112	-0.038	1.000

Earnings Management (CEM) has very weak correlations overall, the highest being a slight positive relationship with LEV (0.085), possibly reflecting a marginal increase in earnings manipulation in more leveraged firms. ROA is positively associated with BIND and negatively with FOWN, while its correlation with ROE (0.033) is almost negligible, indicating different behaviour between asset and equity-based returns. ROE is strongly and negatively correlated with LEV (-0.687), the most notable finding in the matrix, reinforcing that high debt reduces shareholder returns. Other variables have limited impact on ROE. FAGE and FS also show weak correlations throughout, with FS only moderately linked to BSIZE.

The dynamic panel data analysis uses a two-step system GMM model to examine how governance and firm-level factors affect return on equity (ROE). The lagged ROE is positively and significantly associated with current ROE (0.2035, $p = 0.000$), indicating performance persistence over time. Larger board size and higher board independence are both negatively associated with ROE, suggesting that excessive board size or ineffective independent directors may hinder firm performance.

Gender diversity on boards and female CEOs also show significant negative effects on ROE, though these results may reflect industry or cultural dynamics rather than capability. Foreign ownership has a small but positive effect, indicating potential benefits of external oversight and governance practices. Earnings management shows a strong negative relationship with ROE (-0.5172, $p = 0.000$), reinforcing that real activity manipulation harms long-term shareholder value.

Results with ROA as Dependent Variable

```

. xtddp roa L.roa bsize bind gender fown cem bsem inem gem fgem fs lev fage, twostep dgmiv(bsize bind cem fs fage) artests(2
> )

Dynamic panel-data estimation          Number of obs   =    2,000
Group variable: sno                   Number of groups =     200
Time variable: years

Obs per group:
      min =    10
      avg =    10
      max =    10

Number of instruments =    216          Wald chi2(13)   =   35028.20
                                          Prob > chi2    =    0.0000

Two-step results
-----+-----
      roa | Coefficient  Std. err.   z   P>|z|   [95% conf. interval]
-----+-----
      roa |
      L1. | .2920366    .0041343    70.64  0.000    .2839335    .3001398
      bsize | -.119218   .0129828   -9.18  0.000   -.1446639   -.0937722
      bind | -.0535308   .0117147   -4.57  0.000   -.0764913   -.0305703
      gender | -.0543169   .0029121  -18.65  0.000   -.0600246   -.0486093
      fown | .0130455    .0090686    1.44  0.150   -.0047287    .0308197
      cem | -.6705151   .0268143  -25.01  0.000   -.7230701   -.6179601
      bsem | .3013478    .0120927   24.92  0.000    .2776466    .3250491
      inem | -.3456607   .0200533  -17.24  0.000   -.3849645   -.3063569
      gem | .222949    .013982    15.95  0.000    .1955448    .2503531
      fgem | -.1329839   .0284409   -4.68  0.000   -.1887269   -.0772408
      fs | -.0728774   .0010126  -71.97  0.000   -.0748622   -.0708927
      lev | .002988    .0042797    0.70  0.485   -.0054001    .0113761
      fage | .0049315    .0002071   23.82  0.000    .0045257    .0053373
      _cons | 1.482465    .0295778   50.12  0.000    1.424493    1.540436

Warning: gmm two-step standard errors are biased; robust standard
errors are recommended.
Instruments for differenced equation
GMM-type: L(2/.)bsize L(2/.)bind L(2/.)cem L(2/.)fem L(2/.)fage
Instruments for level equation
Standard: _cons

. estat sargan
Sargan test of overidentifying restrictions
H0: Overidentifying restrictions are valid

      chi2(202)   =   194.2142
      Prob > chi2   =    0.6403

. estat abond, artests(2)

Arellano-Bond test for zero autocorrelation in first-differenced errors
H0: No autocorrelation

Order      z      Prob > z
-----+-----
      1   -4.5754   0.0000
      2   -.83954   0.4012

```

Frequent board meetings contribute positively to ROE, implying that active board involvement enhances decision-making and firm oversight. Institutional ownership is negatively linked with ROE, which could be due to passive engagement by institutional investors. Firm size is negatively associated with ROE, indicating that larger firms may face inefficiencies or diminishing returns. Leverage has a strong negative effect, consistent with the idea that financial risk reduces equity returns. Firm age, however, is positively associated with ROE, suggesting that mature firms benefit from stability and experience.

The Sargan test ($p = 0.6125$) confirms instrument validity, while the Arellano-Bond test ($AR2\ p = 0.3897$) confirms no second-order autocorrelation, supporting model reliability. Overall, firm performance measured through ROE is shaped by a mix of board composition, ownership, and firm characteristics, where certain governance mechanisms enhance performance, while others may diminish it.

Hypotheses Summary

Table 3: Hypotheses Decision Summary

Hypothesis	Statement	Result	Decision
H1	Board size has a significant impact on firm performance.	Significant (Negative)	Accepted
H2	Board independence has a significant impact on firm performance.	Significant (Negative)	Accepted

H3	Number of female directors on the board has a significant impact on firm performance.	Significant (Negative)	Accepted
H4	Number of foreign directors on the board has a significant impact on firm performance.	Significant (Positive)	Accepted
H5	Existence of sustainability committee has a significant impact on firm performance.	Not Significant	Rejected
H6	Earnings management moderates the relationship between board size and firm performance.	Significant	Accepted
H7	Earnings management moderates the relationship between board independence and firm performance.	Significant	Accepted
H8	Earnings management moderates the relationship between number of female directors and firm performance.	Significant	Accepted
H9	Earnings management moderates the relationship between number of foreign directors and firm performance.	Significant	Accepted
H10	Earnings management moderates the relationship between sustainability committee and firm performance.	Not Significant	Rejected

DISCUSSION OF KEY FINDINGS

Board size demonstrates a strong negative effect on ROA and ROE, indicating that larger boards tend to create inefficiencies in communication and slow strategic decision-making. Similar results are reported by Ansari et al. (2025) and Sobhan and Mia (2024), who argue that big boards in emerging markets often suffer from coordination issues and diluted accountability. This finding stands in contrast to the resource-based perspective, which suggests that large boards can enhance access to knowledge and resources through diversity, as noted by Sunny and Hoque (2025). Within Pakistan's corporate environment, excessive board size appears to amplify agency costs due to family dominance and symbolic compliance with governance codes. The independence of directors shows a negative relationship to financial performance, contradicting agency theory's postulation that independent directors improve monitoring and help reduce opportunism. Ali and Butt's (2025) evidence supports the underlying theoretical expectation; however, the situation in Pakistan is different because weak enforcement of the regulations and concentrated ownership diminish the very independence of directors to a mere facade. This concern is further fortified in the findings of Saleem et al. (2025), who argue that a board with independent directors lacking real authority will not be able to achieve much in terms of performance or monitoring. Gender diversity, too, shows a negative relationship with ROA and ROE, in contrast to international literature generally promoting the inclusion of women for added creativity and effectiveness. Hameed et al. (2023) and Laique et al. (2023) further argue that boards in conservative settings are often

only nominally gender-diverse, putting competence aside. Such traditional thinking, they argue, limits women's contribution to strategy and oversight, implying that in Pakistan, diversity policies need cultural and organizational reforms to have any value. Foreign directors, according to Alshareef and Sulimany (2024) and Tahir et al. (2025), do offer a positive impact on the performance of firms by promoting governance effectiveness through the reduction of information asymmetry and application of global standards. They build investor confidence, especially in emerging economies where local practices may be lenient. Conversely, the presence of sustainability committees has very minimal influence on the financial performance outcomes.

The analysis establishes that earning management usefully and powerfully diminishes financial performance, whether in ROA or ROE, in this negative direction. Furthermore, Alshowaiman (2025) and Oreshile and Adeneye (2025) corroborated this outcome, showing earnings management based on short-term profit targets that undermines profitability and long-term shareholder value. Such real manipulations as overproduction or discretionary expense cuts really affect operational efficiency and hinder future growth. The results show that earnings management weakens the governance-performance relationship. Moreover, Al- Matari (2024) and Rabbi & Rabbi (2025) revealed that board independence and board size enhance performance, but these performative contributions are considerably degraded when earnings manipulation is involved. Independent directors are restrained from exercising their influence when financial reporting truly is dominated by management discretion. This is in harmony with positive accounting theory, a theory that states that managers will apply the discretion inherent in the accounting principles to best serve their own interests or the interests of others engaged with the firm, rather than to protect the long-term sustainability of the firm.

CONCLUSION

This study deals with the influence of corporate governance on financial performance in the manufacturing sector of Pakistan, particularly focusing on earnings management as an intervening variable. The research employs panel data and the two-step system GMM approach, through which it provides strong evidence of context-specific governance dynamics. From the findings, it may be said that one set of board characteristics affects firm performance; however, not every time as classical theories predict. Board size showed a negative relationship with ROA and ROE, indicating inefficiencies with larger boards. Likewise, independence and gender diversity of the board were negatively linked to performance, indicating, in the Pakistani context, symbolic compliance, weak enforcement, and cultural restraints. Conversely, foreign ownership positively impacted financial outcomes, suggesting that international directors improve governance through enhanced oversight and best practices. The existence of sustainability committees had minimal effect, underscoring their compliance-oriented role rather than strategic integration. Earnings management emerged as a critical factor, exerting a strong negative direct effect on profitability and weakening the governance-performance link across all board attributes. This confirms the opportunistic behavior

predicted by Positive Accounting Theory and emphasizes the limitations of governance mechanisms when financial manipulation persists. The study contributes theoretically by demonstrating the interaction between governance and earnings management in emerging markets. Practically, it highlights the need for effective regulatory enforcement, enhanced audit quality, and cultural reforms to ensure substantive governance practices. Limitations include reliance on secondary data and a single-sector focus. Future research should adopt mixed methods, including additional moderators such as audit quality, and expand to other industries for broader generalizability.

Three notable contributions to corporate governance research arise from this study. Theoretically, it advances our understanding by discussing the moderating influence of earnings management on the governance-performance relationship in emerging markets, an under-theorized area. Empirically, it can give sector-specific insights by concentrating on the manufacturing industry in Pakistan, unveiling the influence of contextual factors like concentrated ownership and cultural norms on governance outcomes. Methodologically, the two-step GMM system was used in this study to address endogeneity concerns and provide robust evidence regarding dynamic interactions between governance variables and financial performance.

The study acknowledges several limitations. First, secondary data on annual reports were used alone, restricting the behavioral aspects of board functioning and managerial decision-making. Second, the assumption that findings relevant to the manufacturing sector will also apply to other industries, such as banking or services, needs to be reviewed because governance structures and regulatory frameworks differ considerably between the sectors. Third, although the potential endogeneity was reduced by system GMM, unobserved heterogeneity or omitted variable bias can still have their influence on results.

Future studies should widen their inquiry beyond the manufacturing sector to the banking, energy and technology sectors with differing governance dynamics and regulatory oversight. Adding mediators/moderators, such as audit quality, ownership concentration, and corporate culture, can help shed light on the governance-performance nexus. Qualitative or fundamentally mixed method approaches with qualitative dimensions, including interviews or case studies, will better capture the behavioral dimensions and contextual nuances these quantitative studies tend to ignore. These longitudinal designs that cut across the different economic cycles can help better observe how the relationship between governance and earnings management evolves.

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