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## Navigating Risk and Performance through Earnings Management: The Double-Edged Sword

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**Abstract:** This study emphasizes assessing the impact of earnings management on both the risk and performance of textile sector companies operating in Pakistan. Spanning the tenure from 2016 to 2021, the present research work uses the data of 148 companies operating in the textile sector of Pakistan and applies a two-step Generalized Method of Moments (GMM) to comprehensively analyze the intricate association between earnings management, firm risk, and performance. The study's findings indicated a significant influence of earnings management on firm risk, suggesting that the manipulation of financial outcomes directly correlates with increased risk within these textile sector firms. The research established a noteworthy relationship between the company's performance, management practices, and earnings. In essence, the present research contributed towards valuable cognizance of the dynamics of earnings management of the Pakistan textile sector. The study emphasized the significance of establishing ethical financial reporting practices for long-term sustainability and stakeholder confidence in the businesses.

**Key Words:** Earnings Management, GMM, Financial Risk, Financial Performance

### Introduction

Financial reporting in developing economies faces unique challenges, often leading to earnings management, where companies manipulate results to present a more favourable financial position (Oh, 2016; Lee & Hong, 2017). Earnings management, involving the manipulation of financial results, aims to create a misleading impression of a business's performance. Managers often use their GAAP knowledge to engage in earnings management, driven by motivations such as improving debt negotiations and converting losses into profits (Habib, 2004; Watts & Zimmerman, 1986). High-profile examples include Microsoft and General Electric (Myers et al., 2007).

Earnings management reduces financial transparency and effectiveness of reported information, directly challenging the rationale and provisions of the IFRS framework by prioritizing income over quality (Arya et al., 2003). This practice impacts metrics like earnings per share, which are used for assessing performance and usually executive compensation (Khan et al., 2021; Simpson, 2021). The area of interest in this context is the recording of accrual-based estimates during a reporting period. Accrual accounting, inherently subjective and mandated by US GAAP, allows managers to manipulate earnings by altering transactions and misrepresenting expenses (Healy and Wahlen, 1998). Bergstresser and Philippon (2006) identified discretionary accruals as a primary source of manipulation, especially when senior management compensation is performance-linked. Black et al. (2017) pointed out the misuse of discretionary accruals and inside information by senior management, including CEOs, calling for an investigation by the Securities and Exchange Commission (SEC) due to breaches of public trust. Earnings are managed or manipulated to change the reported profits during a period directly.

Reported earnings impact decision-making and investment prospects (Al-Absy et al., 2020; Mohammadi & Nezhad, 2015) and are often prime indicators for driving stock prices, with many of the analysts and potential investors deriving their estimated intrinsic values based on reported earnings.

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variables. The stock price is crucial for investors as it reflects the firm value and informs investment policies. Price to Book Value (PBV) helps determine market value, with undervalued shares attracting buyers (Kassamany et al., 2017). Stock prices are directly linked with reported performance that reflects how well a firm manages its business, with firm value being a key measure (Shah et al., 2020).

Initially, firm value was viewed as shareholders' anticipation of asset values (Isidro & Sobral, 2015). Corporate governance enhances firm value by mitigating agency issues (Taufik, 2024). Effective governance controls positively impact business value (Le and Nguyen, 2023). Conflicts can arise if senior management lacks ownership in the company, but strong shareholder-management bonds boost performance and firm value (Roodposhti & Chashmi, 2011; El Moslemany et al., 2013).

Reported performance coupled with existing risk are prime motivators that often dictate the adoption of earnings management to present strong financial performance and risks faced regarding firm stability (Suryani et al., 2019). According to signalling theory, investors rely on earnings signals to gauge a firm's value and financial performance for current and future strategies (Brigham, 2015). Consistent earnings attract investors; hence, earnings management minimizes volatility as this could include masking the actual performance of a firm, particularly its management or obscuring the actual level of financial risk that a company at a time holds (Khan et al., 2023).

Financial distress, a major concern, can lead to bankruptcy and increased costs, affecting operations and reputation (Habib et al., 2016). Effective financial risk management is essential to maintain stability and growth (Pera, 2017). A firm with high leverage faces a high risk of bankruptcy due to the potential inability to meet debt payments (Zagers-Mamedova, 2009). When seeking new loans, such firms encounter strict criteria and covenants, pressuring managers to manipulate earnings to avoid debt covenant violations (Sweeney, 1994; Dichev, 2002). However, these practices vary across countries (Sanusi et al., 2012).

Globally, high-profile financial scandals in the 1980s and 1990s led to significant losses and diminished stakeholder confidence (Halabi et al., 2019). The Cadbury Committee (1991) and subsequent reports like the Smith Report (2003) and Turnbull Report (1999) strongly advocated transparency in reported performance and perceived risk levels, with goals of misrepresenting actual facts and characteristics which could impair value judgements of a firm (Khan et al., 2021).

In competitive markets, firms strive to boost market value by generating substantial income. The Corruption Perceptions Index (CPI) 2023 by Transparency International scores global corruption from 0 (highly corrupt) to 100 (very clean). Among developing countries, Pakistan scored 29, indicating high corruption, while India and China scored 39 and 42 respectively (Transparency International, 2023). In 2022, the Securities and Exchange Commission of Pakistan (SECP) fined various corporations five billion rupees for earnings management (Dawn, 2022). In October 2023, SECP warned against business with AA Enterprises due to fraudulent activities (Business Recorder, 2023).

This research highlights the importance of transparent financial information for policymakers. Shareholders prioritize firm value, which reflects company performance and is influenced by earnings signals (Brigham et al., 2015). This study aims to investigate the implications of earnings management on key facets of corporate financial performance. The research is intended to explore the potential instances that may contribute to earnings management practices. More specifically, instances such as periods of higher financial risk and poor financial performance may dictate firms to deploy earnings management practices to obscure the financial results, thereby compromising data integrity and transparency.

## Literature Review

Earnings management is an accounting engineering that manifests in reported earnings. The motivation underlying this process is multifaceted and may originate from a continuum of factors. Czajor et al. (2013) found that macroeconomic factors such as higher GDP growth correlate with better earnings quality in Poland, suggesting that economic conditions and capital structure play crucial roles in earnings management. Authors such as Mensah and Boachie (2023) have gone to the extent of linking earnings management with board gender diversity, concluding that gender diversity significantly regulates the



relationship between corporate governance mechanisms and earnings management, underscoring the oversight capabilities of female directors. Nevertheless, researchers in the fields of finance have used more prominent factors, such as corporate governance mechanisms, organizational factors, macroeconomic factors, and expectations of existing and potential investors, analysts, regulators, etc., for analyzing the existence of a possible relationship between these factors and earnings management.

In the realm of corporate governance, Le and Nguyen (2023) investigated board characteristics and ownership structure in the strict context of agency conflicts and corporate governance in Vietnam, noting that older and experienced boards and higher ownership percentages typically sought to avoid downward earnings adjustments. In the context of agency theory, Khunkaew et al. (2022) investigated the possible relationship between executive compensation and earnings management in Thai companies and found that short-term executive benefits were negatively associated with accrual earnings management but positively related to real activities earnings management. This contrasted with post-employment benefits, which had the opposite effect. Farooq et al. (2024) identified a negative impact of agency costs on leverage and firm value in MENA countries.

Researchers have found that corporate governance practices are directly influenced by organization size, suggesting a potential investigative area for analyzing earnings management in the context of organizational sizes (Buallay and Hamdan, 2019; Zahoor et al., 2000). Ali et al. (2015) conducted research that investigated organizational factors, particularly the effect of firm size on earnings management, and found a direct relationship between firm size and earnings. This finding of this research appears to be in accordance with Uwugbe et al. (2015), who also concluded that larger Nigerian firms are more likely to engage in earnings manipulation due to the complexity of operations.

In contrast, Bui et al. (2021) found negligible effects of company size on earnings management in their study of 147 Vietnamese manufacturing firms. This discrepancy suggests that the relationship between firm attributes and earnings management might vary across different contexts and industries. Other factors, such as strategic positioning, also play an instrumental role in influencing earnings management (Muktiyanto, 2017). Several researchers have attributed earnings management to strategic motivations. Authors such as Wahyuni and Handayani (2022) analyzed corporate strategies in Indonesian manufacturing firms, concluding that defensive strategies coupled with higher profitability led to lesser earnings management, while prospective strategies moderated this particular tendency. This was further supported by Herusetya et al. (2023), who found that prospector-type strategies resulted in lower accrual-based and real activities manipulation compared to defender strategies.

Nurlis et al. (2020) examined another set of corporate strategic decisions, such as financial leverage, tax planning, company size, and corporate governance mechanisms that influence earnings manipulations in Indonesian manufacturing companies. The authors found significant relationships, particularly between strategic decisions and earnings management. Amongst these other strategic decisions, Karjalainen et al. (2023) conducted their research on earnings management in small and medium-sized private companies in firms operating in Finland, with a dedicated focus on the influence of dividend decisions. They found that dividend policies significantly affect earnings management since such dividend decisions directly influence the opinions of potential investors and analysts. Yaghobnezhad and Tajiknia (2023) also believe that firms engage in earnings manipulation to maintain favourable analyst opinions, particularly through accruals for accounts receivables on the Tehran Stock Exchange. Aslamiah et al. (2023) believe that the reactions of analysts in the stock market are harsher in response to corporate financial distress and financial risk practices. The majority of the investors are risk-averse.

Financial distress, which is typically defined as the failure to meet contractual obligation agreements with creditors (Ghazali et al., 2015), is a prime concern for companies, impacting their financial stability and performance. Theoretical frameworks like Agency Theory, Signaling Theory, and Positive Accounting Theory offer explanations for how financial distress impacts earnings management, suggesting that managers may manage earnings to secure their positions or achieve favourable contractual outcomes (Meckling & Jensen, 1976; Watts & Zimmerman, 1986). Prior research highlights financial distress or financial risk could profoundly contribute to earnings management (Andrade et al., 1998). However, the empirical evidence remains inconclusive.

The relationship between earnings management and financial distress is critical, as earnings management practices can significantly affect financial performance, with dire consequences for investors and creditors. For firms going out of business due to mismanaged financial risk, Ghazalat et al. (2021) noted that discretionary accruals were highest in unaudited firms 12 months prior to their filed bankruptcy. Studies also suggest that financially distressed firms may manipulate earnings to evade debt covenant violations or attract investors, while other studies indicate that firms may reduce earnings to alleviate tax liabilities or delay difficult decisions (Saleh & Ahmed, 2005; Fink, 2002).

Selvia et al. (2022) analyzed earnings management and financial risk in 87 Indonesian companies from the Property and Real Estate sector, concluding that these factors negatively affect firm value. Mamatzakis et al. (2023) studied Greek firms and found that liquidity risk, as a component of financial risk, reduces earnings manipulation, while taxes negatively impact income management, highlighting the need for a broader exploration of these factors. Sanusi et al. (2012) revealed that earnings manipulation was more common in financially healthier firms, highlighting the importance of accurate financial reporting and further analysis with varied accrual models.

Nevertheless, from insights from existing research, a notable research gap exists in comprehending how earnings management practices specifically impact firm risk and financial performance across different contexts (Ali et al., 2015; Nurlis et al., 2020; Wahyuni & Handayani, 2022), but there is limited empirical analysis on how financial risk practices affect firm risk metrics and financial performance, particularly in diverse industries and regions. While some research suggests that earnings management is influenced by strategic management of financial risk practices and governance mechanisms (Karjalainen et al., 2023), the interplay between earnings management, firm risk, and financial performance remains underexplored. Addressing this gap could provide a more comprehensive understanding of how earnings management influences firm stability and financial outcomes, contributing to comparatively better effective regulatory frameworks and management strategies to protect stakeholders and maintain market integrity.

## Methodology

This present study uses a systematic methodology to ensure reliable and valid findings, starting with a detailed theoretical framework and hypotheses. It highlights the measurement of variables methods and the approach for data collection and analysis. Conceptual analysis is critical for defining and clarifying the concepts of earnings management and its impact on firm performance and risk. The present study proposes its hypothesis as follows:

**H<sub>1</sub>:** There is a significant relationship between earnings management and firm performance.

**H<sub>2</sub>:** There is a relationship between earnings management and firm risk

Under the rationale of The Signaling Theory, the research examines how companies utilize financial signals to influence investor perspectives and decisions and maintain transparency. Utilizing a descriptive research design, the study aims to describe the effects of earnings management on financial performance and risk in Pakistan's textile sector with a data set ranging from 2016 to 2021. The deductive approach tests existing theories and hypotheses, focusing on how earnings management affects firm performance. A purposive sampling technique opted to select textile companies significant to the research based on their relevance to earnings management. Data were collected from the financial statements of 148 companies, incorporating recent economic conditions and government schemes. Panel data analysis, including dynamic panel models and the generalized method of moments, was used to address endogeneity and examine the relationships between earnings management, firm performance, and risk.

Earnings Management (EM) models are continuously evolving and influenced by industry diversity. Prominent models include Jones (1991), Modified Jones (1995), Performance Matched, and Discretionary Revenue Models, with the classic Jones Model being preferred for this study due to its widespread recognition. Total accruals, derived from the difference between reported earnings and operating cash flows, are calculated using the Balance Sheet Approach (BSA) and the Cash Flow Approach (CFA). CFA is

favoured for its lower measurement error. Discretionary accruals, representing management's specific adjustments, are an established measure of earnings management.

Total accruals under the Balance Sheet approach are given as follows:

$$TA_t = \Delta CA_t - \Delta C_t - \Delta CL_t + \Delta DCL_t - DA_t$$

$TA_t$  represents total accrual value as time t.

$\Delta CA_t$  represents the change in current asset value at time t.

$\Delta C_t$  represents a change in cash and cash equivalents at time t.

$\Delta CL_t$  represents a change in current liability at time t.

$\Delta DCL_t$  represents debts included in the current liability value at the time t.

$DA_t$  represents depreciation and amortization expenses at time t

Total accruals under the Cash Flow approach are given as :

$$TA_t = EBEOI_t - CFO_t$$

$TA_t$  represents total accruals at the time t

$EBEOI_{it}$  shows earnings before extra – ordinary items of firm i at time t

Several studies have been conducted to test the effectiveness of the above-mentioned approaches and are of the view that in terms of detection power, the CFA approach is much more efficient than BSA as the effectiveness of BSA is significantly impaired by measurement errors (Hribar and Collins, 2002).

The Jones Model (1991) calculates non-discretionary accruals and uses residuals to gauge discretionary management.

Jones (1991) model is given as:

$$\frac{TAC_t}{Alag} = \alpha_1 \left( \frac{1}{Alag} \right) + \alpha_2 \left( \frac{\Delta R_t}{Alag} \right) + \alpha_3 \left( \frac{PPE_t}{Alag} \right) + \epsilon$$

$TAC_t$  shows total accrual value at time t

$Alag$  shows previous value of total asset at t – 1

$\Delta R_t$  shows the change in revenue of firm i at time t.

$PPE_t$  is the property, plant and equipment value of a firm at time t.

The residuals of the above equation are representatives of discretionary powers of management. The elements of this model are mounted by assets (lagged value) to reduce the issue of heteroskedasticity (Pornupatham, 2006). However, some authors argue against this model because of its assumption that all revenues should be non-discretionary.

The current research predominantly relies on classical performance measures such as Return on Assets and Asset Utilization.

Return on assets and Return on equity has been previously used by the researchers Hermeindito (2022). The formula used to calculate Return on Assets (ROA) is given by:

$$ROA_t = 100 * \frac{Net Profit_t}{Total Assets_t}$$

$$ROE_t = 100 * \frac{Net Profit_t}{Total Equity_t}$$

The rationale for using both of these return measures is to understand the impact on returns from the perspectives of a debt investor and an equity investor. Debt, being a cheaper source of finance, may depict a different level of variation with earnings management, and earnings management may significantly contribute to higher risk in a firm.

The adoption of the asset utilization proxy aligns with the findings presented in Wang's (2020) and Wang et al. (2020) research. Asset utilization is calculated using the formula:

$$Asset Utilization_t = 100 * \frac{Total Sales_t}{Total Assets_t}$$



The measurement of firm risk will be carried out through gearing ratios. Gearing ratios, also known as leverage ratios, are financial metrics that assess the proportion of a company's capital structure financed by debt in relation to equity.

$$Debt\ to\ Equity_t = \frac{Total\ Debt_t}{Total\ Equity_t}$$

$$Debt\ to\ Assets_t = \frac{Total\ Debt_t}{Total\ Assets_t}$$

The size of the firm will be measured as a log of total assets. In addition, an additional measure of interest coverage will also be used to measure financial risk from the perspective of an analyst. The approach follows the work of Khan et al. (2013), who are of the view that coverage ratios often provide a wider perspective for analyzing the financial risk of a firm.

Panel data analysis extends traditional regression analysis by incorporating both spatial and temporal dimensions. The spatial dimension includes cross-sectional units of observation, such as countries or firms, while the temporal dimension covers periodic observations of these units over time (Yaffee, 2003). This method is useful for studies involving variables from annual financials or annual reports of multiple firms over several years. The current research applies dynamic panel statistical regression, as proposed by Kremer et al. (2013), to investigate the relationship between earnings management and corporate performance. Kremer et al.(2013) approach builds on Hansen's (2008) work and the cross-sectional contributory variable onset model by Caner & Hansen (2004). As the panel is short, unbalanced and dynamic, both researchers strongly advocate the use of the generalized method of moments to address the resultant endogeneity issues. The empirical model used in this study is a dynamic panel model focusing on earnings management and its impact on firm performance, with performance measured through gearing ratios.

$$DE_{it} = \alpha_i + \beta_{i1}EM_{it} + \beta_{i2}Size_{it} + \varepsilon_{it} \dots \dots \dots Eq. 3.1$$

$$DA_{it} = \alpha_i + \beta_{i1}EM_{it} + \beta_{i2}Size_{it} + \varepsilon_{it} \dots \dots \dots Eq. 3.2$$

$$AU_{it} = \alpha_i + \beta_{i1}EM_{it} + \beta_{i2}Size_{it} + \varepsilon_{it} \dots \dots \dots Eq. 3.3$$

$$ROA_{it} = \alpha_i + \beta_{i1}EM_{it} + \beta_{i2}Size_{it} + \varepsilon_{it} \dots \dots \dots Eq. 3.4$$

$$ROE_{it} = \alpha_i + \beta_{i1}EM_{it} + \beta_{i2}Size_{it} + \varepsilon_{it} \dots \dots \dots Eq. 3.5$$

This study utilizes the Linear Dynamic Panel Model with the Generalized Method of Moments (GMM) introduced by Arellano and Bond (1991). This model also addresses the issue of unobserved panel-level effects, which could be either fixed or random, and provides consistent parameter estimates. GMM is particularly effective when the dataset has fairly greater cross-sectional elements in comparison to time periods and relies on five-year data for proper implementation. The model is characterized by its reputation for efficiency in handling smaller sample sizes by using small t-statistics and reporting t-values rather than traditional 2-statistics or chi-square tests.

The study focuses on the classical blend of independent and dependent variables, with control variables included to manage endogeneity issues. The GMM approach assists in addressing issues related to principle statistical problems such as autocorrelation, heteroscedasticity, and endogeneity, enhancing the robustness of the model. To minimize firm-specific effects, the first difference transformation is used, leading to a differenced regression equation. This transformation helps manage endogeneity and introduces new error terms, which are, in turn, managed by ensuring that lagged variables and descriptive variables are orthogonal to these errors in particular.

Furthermore, as demonstrated by Blundell and Bond (1998), GMM offers flexibility for the extension of basic models, including interactions between observed covariates and unobserved heterogeneity. This extension improves the accuracy of estimators by expanding the list of instruments used. In this study, GMM is applied to data from 148 textile companies over the period from 2016 to 2021, using STATA to control for endogeneity and provide estimates that are unbiased. The GMM approach can assumed to be a fairly robust method for analyzing the impact of earnings management on firm performance that may offer reliable results despite the inherent complexities of dynamic panel data.



## Results and Discussion

**Table 1**

Descriptive statistics

Variable	Observations	Mean	Std. Dev.	Minimum	Maximum
Earning Management Ratio	606	3.438	108.911	-423.759	1857.316
Firm Size	606	6.572	0.67	3.663	8.117
Debt to Equity Ratio	606	2.332	37.786	-524.894	337.808
Debt to Assets Ratio	606	0.666	0.38	0.025	3.499
Debt to Capital Ratio	606	0.171	15.736	-323.531	60.016
Interest Coverage	606	12.29	171.434	-1241.845	2537.024
Return on Assets	606	-0.16	9.8	-78.085	33.148
Assets Utilization	606	3.438	10.068	-71.236	38.068

**Table 2**

Correlation matrix

Variable	EM	FS	DER	DAR	DCR	ICR	ROA	AU
EM	1							
FS	0	1						
DE Ratio	-0.001	-0.03	1					
DA Ratio	-0.04	-0.11	0.024	1				
DC Ratio	0.001	0.074	0.332	-0.061	1			
IC Ratio	-0.001	-0.01	0.001	-0.18	0.007	1		
ROA	-0.059	0.334	0.047	-0.407	0.058	0.183	1	
AU	-0.057	0.375	0.053	-0.358	0.078	0.175	0.77	1

**Table 3**

Proxy of firm risk – debt to asset ratio

Independent Variable	Random Effect		Fixed Effect		Two-step GMM	
	Coef.	P-Value	Coef.	P-Value	Coef.	P-Value
DA L1	-	-	-	-	0.323	0.111
EM Ratio	0	0.848	-8.66	0.919	0.003	0.021
Firm Size	-0.014	0.705	0.057	0.315	0.168	0.069

**Table 4**

Proxy-dependent variable firm performance

Independent Variable	Random Effect		Fixed Effect		Two-step GMM	
	Coef.	P-Value	Coef.	P-Value	Coef.	P-Value
DE L1	-	-	-	-	-0.145	0
EM Ratio	0	0.995	-0.002	0.988	0	0.906
Firm Size	-0.171	0.971	12.492	0.209	-1.088	0.857

**Table 5**

Proxy of firm risk – debt to capital ratio

Independent Variable	Random Effect		Fixed Effect		Two-step GMM	
	Coef.	P-Value	Coef.	P-Value	Coef.	P-Value
DC L1	-	-	-	-	0.041	0
EM Ratio	0	0.975	2.86	0.608	0	0.198
Firm Size	1.758	0.066	0	0.997	-0.511	0.789

**Table 6**

Proxy of firm risk – debt to interest coverage ratio

Independent Variable	Random Effect		Fixed Effect		Two-step GMM	
	Coef.	P-Value	Coef.	P-Value	Coef.	P-Value
IC L1	-	-	-	-	0.033	0
EM Ratio	0	0.997	0.001	0.986	-0.004	0.005
Firm Size	-0.323	0.98	27.87	0.621	-21.283	0.296

**Table 7**

Dependent variable firm risk

Proxy of Firm Risk	Independent Variable	Random Effect		Fixed Effect		Two-step GMM	
		Coef.	P-Value	Coef.	P-Value	Coef.	P-Value
Debt to Assets Ratio	DA L1	-	-	-	-	0.323	0.111
	EM Ratio	0	0.848	-8.66	0.919	0.003	0.021
	Firm Size	-0.014	0.705	0.057	0.315	0.168	0.069
Debt to Equity Ratio	DE L1	-	-	-	-	-0.145	0
	EM Ratio	0	0.995	-0.002	0.988	0	0.906
	Firm Size	-0.171	0.971	12.492	0.209	-1.088	0.857
Debt to Capital Ratio	DC L1	-	-	-	-	0.041	0
	EM Ratio	0	0.975	2.86	0.608	0	0.198
	Firm Size	1.758	0.066	0	0.997	-0.511	0.789
Interest Coverage Ratio	IC L1	-	-	-	-	0.033	0
	EM Ratio	0	0.997	0.001	0.986	-0.004	0.005
	Firm Size	-0.323	0.98	27.87	0.621	-21.283	0.296

**Table 8**

Proxy of firm performance – return on assets

Independent Variable	Random Effect		Fixed Effect		Two-step GMM	
	Coef.	P-Value	Coef.	P-Value	Coef.	P-Value
ROA L1	-	-	-	-	0.118	0.113
EM Ratio	-0.004	0.189	-0.003	0.295	-0.003	0.000
Firm Size	5.467	0.000	3.410	0.162	24.967	0.026

**Table 9**

Proxy of firm performance – assets utilization

Independent Variable	Random Effect		Fixed Effect		Two-step GMM	
	Coef.	P-Value	Coef.	P-Value	Coef.	P-Value
AU L1	-	-	-	-	-0.128	0.307
EM Ratio	-0.003	0.240	-0.003	0.366	-0.003	0.000
Firm Size	6.246	0.000	5.018	0.041	7.223	0.501





**Table 10**

Dependent variable firm performance

Proxy of Performance	Independent Variable	Random Effect		Fixed Effect		Two-step GMM	
		Coef.	P-Value	Coef.	P-Value	Coef.	P-Value
Return on Assets	ROA L1	-	-	-	-	0.118	0.113
	EM	-0.004	0.189	-0.003	0.295	-0.003	0.000
	Firm Size	5.467	0.000	3.410	0.162	24.967	0.026
Assets Utilization	AU L1	-	-	-	-	-0.128	0.307
	EM	-0.003	0.240	-0.003	0.366	-0.003	0.000
	Firm Size	6.246	0.000	5.018	0.041	7.223	0.501

**Table 11**

Hypothesis testing table

Hypothesis	Null Hypothesis (H0)	Alternative Hypothesis (H1)	Significance Level	Test Statistic	Decision Rule	Conclusion
<b>Firm Risk</b>						
Debt to asset	EM does not affect FR	EM affect FR	0.05	P=0.021	Reject <b>H0</b> if P>0.05	Ho Rejected
Debt to Equity	EM does not affect FR	EM affect FR	0.05	P=0.908	Reject <b>H0</b> if P>0.05	Ho Accepted
Debt to Capital	EM does not affect FR	EM affect FR	0.05	P=0.198	Reject <b>H0</b> if P>0.05	Ho Accepted
Interest coverage	EM does not affect FR	EM affect FR	0.05	P=0.005	Reject <b>H0</b> if P>0.05	Ho Rejected
<b>Firm Performance</b>						
Return on asset	EM does not affect FR	EM affect FR	0.05	P=0.000	Reject <b>H0</b> if P>0.05	Ho Rejected
Asset utilization	EM does not affect FR	EM affect FR	0.05	P=0.000	Reject <b>H0</b> if P>0.05	Ho Rejected

The findings in this study augment the understanding of the relationship between earnings management and a firm’s financial performance, supporting several established theories and simultaneously offering new perspectives. Research by Roychowdhury (2006) and Dechow, Sloan, and Sweeney (1995) established that earnings management tends to correlate negatively with financial performance measured by metrics such as return on assets (ROA) and is associated with higher financial distress. The present study also supports these conclusions, suggesting that earnings management often undermines long-term firm performance due to its propensity to distort financial statements, with potential benefits in the short term,

The complexity of the relationship between earnings management and firm performance is highlighted by the multifaceted impact of several types of earnings management activities, the industrial environment, and ongoing market conditions. While earnings management may provide temporary boosts, it generally creates challenges for investors, potential investors, analysts, and policymakers by obscuring the true and actual financial state and future prospects of the firm.

In terms of financial risk, the study’s findings are particularly distinctive. The negligible impact of earnings management on the financial leverage ratio stands in harmony with previous research by Dechow & Skinner (2000), suggesting that firms might prefer employing alternative strategies to manage their financial positions and leverage ratios without significantly altering their debt-to-equity structure. This could well imply that firms use earnings management more strategically to influence other financial indicators rather than using them as an adjusting item in the capital structure.

The significant positive impact of earnings management on the debt-to-assets ratio highlights concerns about the increased financial risk associated with aggressive financial reporting practices. This aligns with Roychowdhury (2006), who posits the warnings regarding the risks of financial misrepresentation. Similarly, the pronounced negative effect on the interest coverage ratio evidences how earnings management can worsen financial distress by impairing a firm's ability to adequately meet its debt obligations, as previously suggested by Cohen & Zarowin (2010).

The current study also indicates that earnings management's influence on return on equity (ROE) and firm size aligns with earlier research. The insignificant relationship between earnings management and ROE, as suggested by Jones & Wu (2010) and Schipper & Vincent (2003), shows that firms might not place a heavy reliance on earnings management to manage ROE. In contrast, the positive correlation between firm size and the debt-to-assets ratio, supported by research from Titman & Wessels (1988), indicates that larger firms may leverage their market access to carry higher debt in comparison to their assets.

## Conclusion

The present research aimed to explore the influences of earnings management on risk and performance in the textile sector in Pakistan from 2016 to 2021. Risk, particularly financial risk, is proxied with the classical debt-to-equity ratio, debt-to-assets ratio, debt-to-capital ratio, and interest coverage ratio while evaluating performance through return on assets (ROA) and asset utilization.

The findings revealed that in terms of financial risk, earnings management does not significantly affect the debt-to-equity ratio, suggesting that this facet is a relatively less risky area. In other words, it may suggest that the choice of funding may not necessarily direct earnings manipulation. Interestingly, if we are to analyze the impact of earnings management on total capital, i.e., Debt + Equity or Total Assets, a substantial positive impact is reported in the results of current research, indicating that firms engaging in such practices should be cautious about accumulating excessive debt relative to their assets.

Analysts and potential investors should independently assess earnings management practices and financial risk evaluation of the firm. Fundamental analysis of a firm may not effectively communicate earnings management practices and may necessitate a separate analysis for analyzing earnings management while assessing volatility in revenues (Khalid et al., 2023; Khan et al., (2023). This is because financial leverage is usually measured by the proportion of Debt in relation to equity. The positive relationship of earnings management with Debt to total capital and a negative relationship with interest coverage is alarming and may indicate heightened financial risk and an absolute lack of transparency with regard to financial reporting. The findings of the current research indicate that while analyzing earnings management, an analyst or a potential investor may be required to amend the measurement of financial risk while establishing relationships with earnings management.

In the context of financial performance, the current research concluded negative relationships between earnings management and return on assets and asset utilization. This could be interpreted as when the efficiency and performance of a firm are relatively on the lower side or decreasing, and the firm may indeed resort to earnings management practices. Khan et al. (2023) believe the focus on short-term gains may serve as the prime motivator for this instance, where executives, out of cognitive dissonance, may opt for manipulation of earnings.

To address the risks of earnings manipulation, this study offers some crucial policy recommendations. Firstly, it's essential for companies to uphold financial reporting integrity to gain trust and ensure long-term stability. Regulators and stakeholders should emphasize the importance of transparent financial practices to deter earnings manipulation. Larger firms, often exhibiting varying performance metrics, should focus on enhancing their return on equity to align with expectations. Regularly evaluating financial ratios, with a specific focus on earnings management, is crucial for developing adaptable financial strategies. These recommendations aim to guide stakeholders in making informed decisions, fostering robust financial practices, and promoting sustainable firm performance. The key takeaways are the importance of maintaining financial reporting integrity, strategic debt management for financial stability, and monitoring financial ratios to adapt to earnings management challenges, especially for larger firms.



By implementing these recommendations, companies can navigate the complexities of earnings management and strive for long-term, sustainable growth.

This research holds immense significance for a diverse array of stakeholders, from investors and policymakers to auditors and regulators. For those seeking to invest or have already invested, the study sheds crucial light on how earnings management can obscure a firm's true performance and risk, guiding them to scrutinize financial statements more critically and steer clear of deceptive practices.

Policymakers can leverage these insights to champion stronger regulatory measures and enforce stricter reporting standards, enhancing transparency and safeguarding market integrity. Regulators will find this research indispensable in formulating and implementing effective policies that address earnings manipulation and ensure compliance with ethical reporting practices. Auditors, too, can utilize the findings to refine their strategies, focusing on the detection and mitigation of earnings management to improve the accuracy of financial reports.

By highlighting the broader implications of earnings management, this study underscores the need for comprehensive financial oversight and informed decision-making, ultimately fostering more transparency and a stable financial landscape. Future research should expand its scope beyond the textile sector and Pakistan, exploring other industries and countries, considering longer time periods, examining various types of earnings management, and investigating the role of corporate governance. Analyzing relationships between other financial risk metrics, such as the Springate model and analyzing the relationship between earnings management firm value variables, such as Tobbin's Q, is recommended for the future.

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