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Evaluating the effects of ESG reporting on earnings management in an emerging economy

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Abstract

Research question: How does the disclosure of Environmental, Social, and Governance (ESG) information affect the practice of earnings management (EM) in the Kuwaiti context?

Motivation: This research is motivated by the growing emphasis on ESG elements in corporate reporting and governance worldwide, and it aims to investigate the relationship between ESG disclosures and earnings management in the Kuwaiti business environment. In Kuwait, business organizations are required to report ESG information in order to fulfill changing stakeholder and regulatory demands for increased openness. This study aims to clarify the ways in which these disclosures affect Kuwaiti company behavior and financial reporting procedures, especially in light of recent regulatory and economic changes that favor better corporate governance and sustainability. In order to help stakeholders, policymakers, and regulators advance effective disclosure frameworks and promote sustainable business practices, this research aims to shed light on whether ESG disclosures in Kuwaiti firms mitigate or exacerbate earnings management practices.

Idea: The study investigates how ESG disclosure affects Earnings Management practices in Kuwait, a context that might differ from more developed economies.

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Data: The data were collected from 37 Kuwaiti companies listed on the Kuwait Stock Exchange (KSE) over a five-year period, spanning 2017 to 2021, giving 185 company-year observations.

Tools: The research used linear regression to determine the relationship between ESG disclosure and EM.

Findings: The results indicate a significant negative correlation between ESG disclosure and EM. This suggests that greater disclosure of ESG information by companies is associated with a reduced likelihood of engaging in EM practices.

Contribution: The study contributes to the existing body of knowledge by expanding the literature on the relationship between ESG disclosure and EM in the Kuwaiti context. It should be highlighted that most previous studies have mainly focused on the environmental aspect of ESG, whereas this study explores the impact of ESG in its entirety on EM.

Keywords: Corporate Social Responsibility, Environmental, Social and Governance, Earnings Management, Kuwait.

JEL Codes: M14, M4.

1. Introduction

In recent years, the global business landscape has undergone a paradigm shift towards greater transparency, accountability and sustainability. At the heart of this transformation is the increased disclosure of environmental, social and governance (ESG) information by companies worldwide. This trend reflects the growing recognition by stakeholders that a company's success is not appropriate to measure solely by its financial performance, but also by its impact on the environment, society and governance structures. As a result, academics, practitioners, investors and regulators have sought to understand the implications of ESG disclosure for various aspects of corporate behavior and performance.

The practice of earnings management (EM), defined as the manipulation of financial statements to achieve specific financial objectives, has long been a matter of concern in the field of corporate governance and financial reporting. While some degree of EM may be legitimate and necessary to smooth fluctuations in earnings, excessive or fraudulent manipulation can erode investor confidence, distort market efficiency and undermine the reliability of financial statements. In this context, the intersection between ESG disclosure and EM has become a subject of considerable interest and scrutiny.

A robust body of literature has explored the relationship between ESG disclosure and corporate financial performance, with a focus on how ESG considerations influence firm value, risk management, and access to capital. Studies by Eccles and

Serafeim (2013) and Clark *et al.* (2019) have highlighted the positive correlation between strong ESG performance and financial outperformance, suggesting that companies that prioritize sustainability and ethical business practices tend to generate superior long-term returns for investors. Moreover, research by Grewal and Serafeim (2019) and Khan *et al.* (2020) has underscored the role of ESG disclosure in mitigating information asymmetry and reducing the cost of capital, as investors reward firms with transparent and reliable ESG reporting with lower capital costs.

However, the relationship between ESG disclosure and earnings management remains a relatively underexplored area, particularly in the context of emerging markets such as Kuwait. While the literature on earnings management is extensive, much of it has focused on traditional financial metrics and regulatory environments in developed economies. Limited empirical evidence exists on how ESG disclosure practices affect the incentives, mechanisms, and consequences of earnings management in the unique socio-economic and regulatory context of Kuwait.

Given the increasing emphasis on ESG considerations in corporate decision-making and investment analysis, understanding the dynamics of ESG disclosure and its implications for earnings management in Kuwait is of paramount importance. Kuwait, as a prominent player in the Gulf Cooperation Council (GCC) region, is undergoing significant economic diversification efforts and regulatory reforms aimed at enhancing corporate governance, sustainability, and transparency. Therefore, the Kuwaiti context provides special opportunity for our study to unearth novel understandings on the connection between ESG disclosure and earnings management. First, in contrast to more mature economies, Kuwait is an emerging economy with unique market features, legal systems, and cultural values. An in-depth understanding of how businesses manage these dynamics in the face of changing market conditions and regulatory frameworks can increases by examining EM and ESG disclosure practices in this context. Secondly, as comparison to previously researched regions, the Kuwaiti environment offers a largely unexplored research area relating ESG reporting and EM.

We close this gap in the literature by focusing our investigation on Kuwait and provide insightful information about the particular difficulties, motivators, and results related to ESG disclosure and EM practices in an emerging market context. In addition, Kuwait's distinct socioeconomic environment may have an impact on businesses' ESG reporting practices and inclination toward earnings management. Investigating these contextual variables can provide new light on how businesses in Kuwait's resource-dependent economy strike a compromise between sustainability concerns and financial success goals. Moreover, Kuwait offers a special setting in which to assess how ESG reporting affects profits management because of a number of unique characteristics. Kuwait is a high-income economy that depends heavily on oil. As such, the country's resource riches and the need for sustainable growth and diversification have a significant impact on Kuwait's financial and corporate policies. A regulatory framework that is changing to conform to global norms while preserving unique regional features shaped by the country's sociopolitical context governs the corporate sector in Kuwait. Furthermore, Kuwaiti society's cultural emphasis on reputation and social responsibility can have a significant impact on how corporations conduct ESG activities and financial reporting. In conclusion, our emphasis on the Kuwaiti context offers a chance to produce fresh insights and expand comprehension of the intricate interactions between EM and ESG disclosure in the unique socio-economic and regulatory framework of an emerging market, ultimately enhancing academic discourse and educating practitioners and policymakers alike.

Against this backdrop, investigating the impact of ESG disclosure on earnings management practices in Kuwait can provide valuable insights for policymakers, regulators, investors, and corporate leaders striving to foster a culture of accountability, integrity, and long-term value creation in the country's business landscape.

Therefore, this study seeks to address the following research question: How does the disclosure of Environmental, Social, and Governance information affect the practice of earnings management in the Kuwaiti context?. By exploring this question, we aim to contribute to the existing literature on corporate governance, financial reporting, and sustainability, while offering practical implications for stakeholders involved in promoting transparency, accountability, and responsible business practices in Kuwait and beyond.

In this study, we will delve into the dynamics of ESG reporting and its potential influence on EM practices in Kuwait. Through empirical analysis and rigorous investigation, we aim to shed light on the relationship between these two critical facets of corporate behavior. Our findings will contribute to a deeper understanding of the role that ESG disclosure plays in shaping financial integrity and transparency within Kuwait, as well as the broader implications for emerging economies navigating the path of sustainability and responsible corporate governance. Moreover, our research fills a vacuum in the literature by focusing on a developing economy that has not gotten as much attention: the relationship between accounting and sustainability. We manually gathered ESG-related data from yearly reports. Thus, our work creates a dataset that was previously unavailable in the literature. Furthermore, our research offers a thorough grasp of how, specifically in the Kuwaiti context, the incorporation of moral principles into business plans strengthens the framework for financial reporting and governance.

The remainder of this study is structured as follows. Section 2 outlines the theoretical background, elucidating the core concepts and models that guide our research and presents the development of our hypotheses and an in-depth review of the literature review, positioning our work within the existing academic discourse. In section 3, we detail our research methodology and sample selection, elucidating our data collection process. Finally, Section 4 encapsulates our study with a concise summary of key outcomes, recognition of limitations, and an outline of future research directions.

2. Literature review and hypothesis development

The relationship between Corporate Social Responsibility (CSR) and Environmental, Social, and Governance (ESG) intertwines deeply, reflecting a nuanced approach to sustainable business practices and ethical investment. According to authors such as Carroll (1991) and Dahlsrud (2008), CSR encompasses voluntary actions taken by companies to address societal and environmental concerns beyond legal obligations, often reflecting a commitment to ethical conduct and stakeholder value creation. These initiatives can range from philanthropy and community engagement to environmental stewardship and ethical labor practices. On the other hand, ESG, as discussed by authors like Eccles *et al.* (2012) and Sustainalytics (2020), focuses specifically on evaluating a company's performance in key areas including environmental impact, social responsibility, and corporate governance. Through ESG analysis, investors seek to understand the long-term sustainability and ethical impact of their investments, recognizing that factors such as carbon emissions, labor practices, and board diversity can affect financial performance and risk management. In recent years, authors such as Mackey *et al.* (2017) and Jensen (2020) have highlighted the integration of CSR initiatives into ESG strategies, emphasizing how CSR activities contribute to a company's overall ESG performance. This integration not only aligns with ethical investment principles but also enhances a company's reputation, mitigates risks, and fosters long-term value creation. Thus, the relationship between CSR and ESG reflects a symbiotic partnership, where CSR initiatives contribute to ESG performance, and ESG considerations inform and guide CSR strategies, ultimately driving sustainable business practices and responsible investment decisions.

A myriad of studies have examined the relationship between CSR practices and earnings management. One important perspective is that CSR can act as a mechanism to reduce earnings management. Firms with stronger CSR commitments may face higher scrutiny and are motivated to maintain transparency and credibility. For instance, Cheng *et al.* (2014) found that firms with high CSR scores engage in less earnings management.

What is more, prior studies of the literature have produced mixed findings, which relates to a set of factors, including the theoretical framework, the context of the study, and the validity of the data that might affect economic, statistical, and political incidents. There are actually significant differences between countries' CSR legislation since these regulations may be optional or mandatory, depending on the country's policies on socially responsible duties. For instance, the Corporate Sustainability Reporting Directive (CSRD, 2023) modernizes and strengthens the rules concerning the social and environmental information that companies have to report. A broader set of large companies, as well as listed SMEs, will now be required to report on sustainability. Some non-EU companies will also have to report if they generate over EUR 150 million on the EU market.

Similarly, only a few governments, including China, India, and Indonesia, have made it mandatory for companies to implement CSR programs to operate in sustainably manner (Lin, 2020). Additionally, as was already mentioned, the disparities in laws and regulations among countries had a part in the contradictory findings of earlier studies, which certainly affected the outcomes of the analysis. According to Amar and Chakroun (2018), it is less expected that CSR would have a significant impact on regulating the manager's behavior and, as a result, have an impact on earnings quality in a situation where regulations are voluntary to pursue.

An empirical analysis by Grougiou *et al.* (2014) investigates the bi-directional relationship between CSR and EM in the US banking sector using a sample of 116 listed U.S. commercial banks during the five-year period (2003–2007). The findings reveal that there is a positive correlation between CSR and EM because US bank executives prefer to increase their involvement in CSR initiatives when they manage earnings. In addition, the CSR-EM relationship is not bi-directional since adopting CSR does not determine EM tactics.

The study of Cho and Chun (2016) aims to explore whether corporate governance mechanisms moderate the relationship between CSR and real-activity earnings management in a Korean setting. The authors used 1,432 firm-year observations of firms listed on the Korea Stock Exchange for the 2005–2010 period. The authors draw the conclusion that, from the standpoint of the stakeholders, since the incorporation of CSR initiatives into the business operations of the firms stresses a favorable relationship with stakeholders; real-activity earnings management will be restricted. The findings also suggest that strong corporate governance intensifies the negative association between CSR and real-activity earnings management, resulting in more accurate and reliable financial records, stronger business persistence, and profitable long-term investments.

The bidirectional link between ESG performance and EM was the subject of recent empirical evidence from Germany by Velte (2019). The sample for this study consists of 548 firm-year observations of non-financial companies listed on the German Prime Standard from 2010 to 2017. The findings reveals that ESG performance has a negative impact on accruals EM but not real EM, in accordance with stakeholder theory. Moreover, by splitting the three ESG performance variables, governance performance has a more negative influence on accruals than social and environmental performance.

Amar and Chakroun (2018) conducted an empirical study to determine if CSR affects EM in a French context. The study includes 595 firm-year observations from 119 non-financial companies included in the CAC All Tradable index for the years 2010 to 2014. To assess the degree of EM in the chosen sample, the authors employed the discretionary accruals model by referring to Dechow *et al.* (1995). The CSR score, which includes related items to social actions, has been built using a set of societal dimensions provided by ISO 26000 standards, including corporate governance, human rights, labor relations and conditions, environment, fair practices, consumer issues, and community involvement. The authors find a significant and negative relationship between the key variables within the framework of signaling and stakeholder theories, which suggests that firms with more CSR commitment, engage in less earnings management.

Recent work by Palacios-Manzano *et al.* (2021) looked into the impact of firms' CSR orientation on reporting incentives in terms of earnings management activities. The study concentrated on the Spanish context by selecting the top 100 publicly listed Spanish companies based on the MERCO index from 2011 to 2015, with 452 firm-year observations. According to the authors' findings, involvement in CSR operations lessens the chance of turning to unethical tactics, notably earnings control, which highlights a negative relationship between EM and CSR.

The empirical results of this relationship, as was previously highlighted, exhibit conflicting findings. Indeed, the majority of earlier studies have focused on using discretionary accruals to estimate the level of earnings management within a specific sample.

In the light of stakeholder and legitimacy perspectives, several earlier studies highlighted a negative relationship between earnings management and the degree of safeguarding the company's sustainable growth through reporting initiatives (Hong & Andersen, 2011; Kim *et al.*, 2012; Cho & Chun, 2016; Amar & Chakroun, 2018; Gerged *et al.*, 2020; Kumala & Siregar, 2020; Palacios-Manzano *et al.*, 2021). The negative relationship reflects the fact that companies that do not satisfy community expectations will find it challenging to legitimize their actions and will, as a result, deal with social and financial consequences such as having their business operations restricted and witnessing a decrease in demand for their products and services (Deegan, 2019). However, stakeholder and legitimacy theories are both considered to have their foundations in political economy theory (Deegan, 2002).

According to the legitimacy theory, companies adapt their operations or organizational forms to match what the outside environment perceives as legitimate. This suggests that managers engaged in disclosing sustainable information are less likely to operate unethically. In other words, if a company establishes a social contract between its stakeholders, it will drive management to safeguard the company's survival and ensure the stability of its operations from a legitimacy standpoint. Furthermore, based on a stakeholder background, third parties expect firms to serve their needs, which improves both their reputation and future performance. According to Velte (2019), in addition to shareholders and creditors, a company often has obligations to other interested parties with non-financial interests. Additionally, to show that they are satisfying stakeholders' expectations, managers are motivated to provide specific stakeholder groups with information about their different initiatives and programs (Deegan, 2002).

Stakeholder theory predicts that companies will disclose more insightful financial and non-financial information, resulting in better CSR and financial performance (Velte, 2017). This evidence, under a negative CSR-EM relationship, can be explained by the preference of socially responsible companies for stable relationships with their stakeholders (Velte, 2019). On the other hand, various studies have shown a positive CSR-EM association. For instance, managers manipulate earnings in a way that both meets stakeholder expectations and gives them the ability to deal with stakeholder activism and vigilance while operating under various constraints imposed by stakeholders' competing interests (Amar & Chakroun, 2018). Additionally, many academics have recently examined the connection between earnings management and non-financial organizations' performance, including sustainability, social responsibility, and environmental, social, and governance (ESG) performance (Chouaibi & Zouari 2022; Khatib *et al.* 2023; Velte 2019). According to the literature, businesses that are more devoted to upholding their moral obligations are less prone to use forceful earnings management techniques. According to Ehsan *et al.* (2020), different approaches to measuring social responsibility and earnings management have led to inconsistent results in the literature that looked at the relationship between profit management practices and corporate social responsibility. Earnings management is one of the behaviors that undermines stakeholder confidence in company reports. The social responsibility approach has the potential to make earnings management and discretionary accrual-based processes more manageable.

As per Velte's (2019) findings, accrual-based earnings management suffers from the ESG practices, whereas REM is not affected. Furthermore, Gaio *et al.* (2022) validated this pattern and established a negative correlation between profitability management and social performance, as the most ethically conscious businesses tend to exhibit higher levels of social responsibility. However, Moratis and van Egmond (2018) contended that there is not a connection between managing profitability and engaging in CSR. According to Gonçalves *et al.* (2021), managers who demonstrate high levels of corporate social responsibility (CSR) compliance abstain from actions that could negatively affect profits due to their greater moral beliefs. Moreover, Alodat *et al.* (2024) investigates the relationship between sustainability disclosure practices and earnings management in the Jordanian context, which based on an analysis of 66 non-financial firms listed on Amman Stock Exchange (ASE), spanning the period of 2017–2020. The findings of this research revealed that companies' compliance with the disclosure of sustainability improves their ethical behavior, which limits earnings management practices and increases the reliability of their financial statements.

Based on the literature review mentioned above, we add to the existing body of literature relating to discretionary accruals, which base on accounting standards and represent management's discretion in implementing accounting policies, offer a quantitative and objective indicator of earnings management. This strategy guarantees uniformity and comparability among businesses, enabling insightful examination of the evolution and variation in the relationship between ESG reporting and earnings management. Furthermore, regulatory monitoring and auditing processes apply to discretionary accruals, which strengthens the measurement's validity and dependability. This study can more accurately identify potential manipulations and evaluate the transparency of financial reporting practices related to ESG disclosure by concentrating on discretionary accruals. This helps to clarify the relationship between ESG reporting and earnings management in Kuwait's context as an emerging economy.

Eventually, we assume that socially accountable companies are less motivated with earnings management strategies that drives us to construct the following hypothesis:
RH. *Companies with higher ESG disclosure rates are less likely to engage in earnings management activities.*

3. Research methodology

3.1 Sample selection and data

In the beginning, we used a sampling frame that included all 185 Kuwaiti Stock Exchange (KSE) businesses listed between 2017 and 2021. The study's time period makes sense for a couple of reasons: (1) by selecting 2017 as the beginning year because the KNDP released ESG guidelines for reporting in 2017 in fulfillment of the unified challenge "New Kuwait 2035"; and (2) to provide a more recently sample than prior research that are concerned alongside a similar relationship. Due to the limited number of organizations reporting on their sustainable policies, we were unable to collect complete data, so we included those companies who followed the ESG requirements. Data cleansing is crucial for accuracy; nevertheless, the financial sector was left out due to its unique regulatory framework (Al-Shaer, 2020; Huang and Wang, 2015). This exclusion aligns with the practices of EM literature, supported by Jha (2013), who underscores the importance of removing the financial sector for consistency in analysis, a perspective echoed by previous studies (Gerged *et al.*, 2020; Jordaan *et al.*, 2018; Velte, 2017, 2019; Zang, 2012). Consequently, 64 financial and insurance companies were excluded, resulting in a final sample of 96 firms engaged in industrial and service-related activities.

Following the removal of companies with unavailable annual reports, incomplete information, and those that joined the KSE after 2017, we arrived at our ultimate sample, comprising 37 non-financial firms and encompassing 185 firm-year observations. These companies were listed on the KSE from 2017 to 2021, as detailed in Table 1.

Table 1. Sample Selection

Sample	**Total number**
Population	160
Financial/Insurance sectors	(64)
Unavailable information	(55)
Listed firms after 2017	(4)
Selected sample	**37**

Table 2 shows the distribution of our selected sample by sector.

Table 2. Sample Distribution by Sector

Sector	**Number**	**Percentage**	**Observations**
Consumer Staples	2	5.4%	10
Real Estate	20	54.1%	100
Telecommunication	2	5.4%	10
Basic Materials	3	8.1%	15
Energy	2	5.4%	10
Consumer Discretionary	3	8.1%	15
Industrials	5	13.5%	25
Final Sample	**37**	**100%**	**185**

3.2 Measurement of earnings management

There are multiple methods for estimating the level of Discretionary Accruals (DA) that have been used in previous studies of EM (i.e., Jones (1991); Dechow *et al.* (1995); Kothari *et al.* (2005)). This study uses the model of Kothari *et al.* (2005), following earlier studies (Gerged *et al.*, 2020; Gerged *et al.*, 2021; Kim *et al.*, 2012; Velte, 2019), as a proxy of Accruals Earnings Management (AEM) to detect the level of DA since this model uses the return on assets (ROA) lag to check for any excessive operational performance. The model specification will be as follows (equation 1):

$$\frac{TACC_{it}}{TA_{it-1}} = \alpha_0 + \beta_1 \frac{1}{TA_{it-1}} + \beta_2 \frac{\Delta REV_{it} - \Delta REC_{it}}{TA_{it-1}} + \beta_3 \frac{PPE_{it}}{TA_{it-1}} + \beta_4 ROA_{(it)} + \varepsilon_{it} \quad (1)$$

Where **$TACC_{it}$** is the entire amount of accruals calculated as the difference between the firm's net income before extraordinary items and the cash flows from operations for the year, divided by the firm's total assets (TA) at the end of the year.
TA_{it-1} is the lagged total assets of firm i at the end of period t-1.
ΔREV_{it} is the movement in sales revenue.
ΔREC_{it} is the change in accounts receivables of firm i between the period of the event (t) and t-1.
PPE_{it}/TA_{it-1} constitutes the gross property, plant, and equipment of firm i at the end of year t scaled by **TA_{it-1}**.
ROA_{it} is the return on assets, which is earnings before extraordinary items divided by lagged total assets.
α β_1 β_2 β_3 β_4 are the estimated parameters and **ε_{it}** covers the residual that represents a proxy for DA.

3.3 Measurement of ESG disclosure

In this study, we adopt the intensity-based approach for evaluating ESG information disclosure, as established in prior research (Ananzeh, 2022; Michelon *et al.*, 2015; Cooke, 1989). We quantify the ESG disclosure intensity on a scale from zero to 100, calculated by dividing the aggregate predicted score by the comprehensive score derived from the predefined checklist items in the study (see Table 3). In summary, our research constructs a 24-item checklist of ESG components, guided by Boursa Kuwait's sustainability principles. However, the ESG checklist that we utilized for our study is an extensive collection of indicators drawn from credible sources, including the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI), and regional regulations that are particular to Kuwait. These indicators, such as corporate governance structure, diversity and inclusion, employee relations, environmental management, and ethical business practices, cover numerous ESG aspects. Every item on the checklist represent both regional and global best practices in ESG disclosures, as well as the breadth and depth of information pertinent to Kuwaiti businesses.

To calculate the ESG disclosure score (ESGD), this study uses the same method as Ananzeh (2022). Equation 2 provides the description of the intensity degree method:

$$INTSY_{it} = \frac{1}{K_{it}} \sum_{j=1}^{k_{it}} DC_{it} \quad (2)$$

where **$INTSY_{it}$** is the level of intensity of firm i in year t; **k_{it}** is the higher number of ESG components expected to be reported in a companies' annual reports; and **DC_{it}** is the overall score for the items that were disclosed, with **k_{it}** = 24 items.

While engaged in the coding process, researchers may be prone to errors. Thus, in order to maintain data validity and measurement reliability, we utilized Cohen's kappa as our metric. One author coded all 185 reports, and a research assistant randomly coded 75 reports to calculate Cohen's kappa, resulting in a robust agreement score of 0.90, as per Tashman *et al.* (2019).

Table 3. Checklist of ESG disclosure items

Categories	Components
Environmental	E1. The company follow a formal Environmental Policy
	E2. The company follow specific waste, water, energy, and/or recycling or treatment polices
	E3. The company collaborate with eco-friendly associations/organizations
	E4. The Board/Management team oversee and/or manage climate-related risks and/or other sustainability issues
	E5. The company claim to have an ISO 14000 certification or any industry specific certification
	E6. The company invest annually in climate-related infrastructure, resilience, and product development
	E7. The company report on air emission/water discharge information
	E8. The company participate in sustainability's campaigns and charitable activities
Social	S1. The company adopt a strategy for employment or job creation
	S2. The company follow a sexual harassment and/or non-discrimination policy
	S3. The company follow an occupational health and/or global health & safety policy (including Covid-19 protocols)
	S4. The company support gender equality and equal opportunities
	S5. The company follow a human rights policy and protection against forced labor, human trafficking or child labor
	S6. The company offer training and development opportunities for employees and students
	S7. The company claim to have an ISO 9000 certification or any industry specific certification
	S8. The company received an award for its social, ethical, community, or environmental activities or performance
Governance	G1. The company publish a sustainable information or report
	G2. The company have a CSR committee or team
	G3. The company follow an Ethics and/or Anti-Corruption policy (whistleblowing)
	G4. The company follow a Data Privacy policy (confidentiality of the internal information)
	G5. The company follow a Code of Conduct
	G6. Executives formally rewarded for sustainability performance (incentives)
	G7. The company have a policy regarding the independence of its board
	G8. The company have a policy regarding the diversity of its board

Source: KNDP (2017)

3.4 Measurement of control variables

In this study, we include a set of control variables that can influence managerial opportunism (see Table 4). First, we control for firm size (SIZE), measured as the natural logarithm of total assets, since executives of larger firms have more technical expertise and more consistent and strive to avoid political pressures and costs, are more likely to engage in EM activities by making voluntary CSR disclosures following prior studies (Ananzeh, 2022; Gerged *et al.*, 2020; Velte, 2019). Given its possible impact on EM and ESG reporting procedures, various sizes of businesses may have various capacities, resources, and organizational setups, which may have an impact on how likely they are to participate in earnings management activities. We hope to reduce any erroneous correlations that might emerge between ESG reporting and earnings management because of variations in firm scale by accounting for firm size.

Second, since it is thought to play an important role in controlling the behavior of self-interested managers, the level of debt has been frequently addressed in previous studies of EM (Ananzeh, 2022; Grougiou *et al.*, 2014; Velte, 2019). Managers increase earnings to avoid breaching debt covenants (DeFond & Jiambalvo, 1994). Thus, we assume a significant relationship between (**LEV**), measured as the total debt divided by total assets, and EM. Therefore, higher leveraged companies may be subject to particular financial challenges, which could raise the motivation for earnings management in order to pay down debt or preserve financial stability. Leverage can also affect a company's strategic ambitions and, consequently, its commitment to ESG reporting standards. We may reduce the possibility of confounding effects and more clearly distinguish the connection between ESG reporting and earnings management by accounting for leverage, which will improve the precision of our research.

In addition, researchers found firm growth to be significantly associated with EM activities (Collins *et al.*, 2017; Kim *et al.*, 2012; Roychowdhury, 2006; Zang, 2012). Growing companies have more incentive to meet their earnings targets because, in turn, this will allow them to attract more investors, which gives them more flexibility to deceive current and potential shareholders. Hence, we add (**GROWTH**), measured as a percentage change in sales, to account for how much sales vary within companies and how this affects EM practices. To draw investors and keep their competitive edge, high-growth companies should give top priority to long-term sustainability projects, such as thorough ESG reporting procedures. On the other hand, businesses that are expanding quickly could potentially be under more pressure to control profits in order to satisfy investors. We can separate the effects of ESG reporting on earnings management while taking into account variations in growth trajectories amongst firms by controlling for company growth.

The majority of previous studies support the idea that the presence of high-quality audit firms helps prevent unethical practices such as AEM (Sial *et al.*, 2019; Velte, 2019; Zang, 2012). Companies audited by large audit firms have lower managed earnings than those audited by smaller audit firms (Kim *et al.*, 2012). Accordingly, we introduce (**BIG4**), measured as an indicator variable that receives (1) if the firm is audited by one of the Big4 audit firms and (0) otherwise, to control for the impact of large audit firms on EM activities. Therefore, higher degrees of audit scrutiny and experience generally links to Big 4 audit firms, which may have an impact on the caliber of ESG reporting as well as the possibility of earnings management. We can more clearly identify the independent effect of ESG reporting on earnings management practices while considering audit firm characteristics by incorporating the Big 4 variable as a control.

Finally, companies that use more sustainable practices are less likely to avoid revenue losses (Chih *et al.*, 2008). Hence, incorporating the loss variable as a control is essential to account for the financial performance of firms. In contrast to thriving organizations, financial distress or loss-making firms could be subject to distinct incentives and constraints for profits management. We can identify the precise effect of ESG reporting on earnings management methods without taking into account the firm's financial condition when we control for the presence of loss. Therefore, we include an additional variable (**LOSS**), measured as an indicator variable that indicates (1) whether the firm's net income before extraordinary items is negative and (0) otherwise, to control for the impact of negative earnings on the relationship between ESG and EM over the study period.

Table 4. Definitions and measurement of variables

Acronym	Variable name	Type	Explanation	Source of data
DA	Discretionary accruals	Dependent variable	Measured following the Kothari *et al.* (2005) model	Measured using data from DataStream database
ESGD	Environmental, social, governance	Independent variable	The total ESG disclosure score measured by using the Intensity Degree equation, which combines the environmental, social, and governance observed items and divides them by the total number of items expected to be reported in a company's annual report (The intensity ratio varies from zero to one) (Ananzeh, 2022)	Measured using hand collected data

Acronym	Variable name	Type	Explanation	Source of data
SIZE	Firm's size	Control variable	Measured by the natural logarithm of total assets	DataStream
LEV	Leverage	Control variable	Total debt scaled by total assets	DataStream
GROWTH	Company growth	Control variable	Change in sales percentage (%)	DataStream
LOSS	Company loss	Control variable	An indicator variable that shows 1 if the company is net income before extraordinary items is negative and 0 otherwise.	DataStream
BIG4	BIG 4 Audit Firm	Control variable	Type of audit firm. If the company is audited by one of the Big Four audit firms, an indicator variable will take the value 1, otherwise it will take 0	DataStream

3.5 Empirical model

A regression model must be used in quantitative research to determine the relationship between the employed variables. In line with earlier studies, we test the extent to which sustainability disclosures (ESG) can affect the level of EM by using the accrual earnings management as a dependent variable in our regression model (Belgacem & Omri, 2015; Gerged *et al.*, 2020). The latter model therefore contains five variables: ESGD, SIZE, LEV, GROWTH, LOSS and BIG4. We expect a positive connection between ESG and EM practices from an agency (stakeholder/legitimacy) perspective. However, to test our main hypothesis, we construct the following regression model (equation 3):

$$DA_{it} = \alpha_0 + \beta_1 ESGD_{it} + \beta_2 SIZE_{it} + \beta_3 LEV_{it} + \beta_4 GROWTH_{it} + \beta_5 LOSS_{it} + \beta_6 BIG4_{it} + \beta_7 Industry\ fixed\ effects + \beta_8 Year\ fixed\ effects + \varepsilon_{it} \quad (3)$$

where:
DA = discretionary accruals;
ESGD = the total environmental, social, and governance disclosure score;
SIZE = firm size, measured as the nature logarithm of total assets;
LEV = debt ratio, measured as the total debt scaled by total assets;
GROWTH = firm's percentage change in sales;
LOSS = company loss (indicator variable) and
BIG4= the firm is audited by one of the Big4 audit firms.

Following previous studies, we introduced industry and year fixed effects, alongside our independent variable and control variables, to check for endogeneity issues (Al-Shaer, 2020; Al-Shaer & Hussainey, 2022; Rezaee *et al.*, 2020; Wu & Zhou, 2022).

In order to assess which modeling strategy would be best for our research, we started by utilizing a Hausman test to compare fixed-effects and random-effects models. The random-effects estimator was better appropriate for our investigation, according to the Hausman test results, which showed a preference for the random-effects model over the fixed-effects model. To look for autocorrelation in the panel data, we next ran the Wooldridge test. The Wooldridge test statistic verifies that the model's residuals lacked considerable autocorrelation.

In order to investigate the existence of heteroskedasticity, we ran the Breusch-Pagan test. The test findings show that the error terms have high heteroskedasticity. Our solution was to use the feasible generalized least squares (FGLS) approach. Our hypothesis that organizations with greater ESG disclosure rates are less likely to engage in earnings management actions was robustly tested using the FGLS model, which corrects for heteroskedasticity and possibly serial correlation. Our findings about the connection between ESG disclosure and earnings management were deemed reliable thanks to this research technique.

4. Data analysis and results

4.1 Descriptive statistics

Table 5 offers an overview of the descriptive statistics concerning our variables. According to our data set, firms tend to engage in minor accrual manipulation. The mean value of DA is -0.001, with a range of -0.195 to a maximum of 0.115. This indicates that there is limited variability of data points.

As for our independent variable, the "ESG disclosure score," it spans a range from 38% to 100%, with an average value of 70%. It also highlights a significant diversity in ESG disclosure scores within our sample, with a wide range from a minimum of 0.38 to a maximum of one.

Regarding the control variables, the average firm size stands at 12. Furthermore, over the study period, 21% of the sample reported negative net income. In addition, around 28% of the included firms are debt-financed. Moreover, the average rate of growth for the company is approximately 4%. Lastly, large audit firms, on average, conduct audits for 73% of the companies in our sample.

Table 5. Descriptive statistics

Variable	Obs	Min	Max	Mean	Std dev
DA	185	-0.195	0.115	-0.001	0.057
ESGD	185	0.38	1	0.704	0.121
SIZE	185	8.829	15.387	12.004	1.365
LOSS	185	0	1	0.211	0.409

Variable	Obs	Min	Max	Mean	Std dev
LEV	185	0	0.726	0.271	0.196
GROWTH	185	-0.752	1.014	0.033	0.317
BIG4	185	0	1	0.73	0.445

Note: All variables are defined in Table 3

4.2 Pairwise correlation matrix

Table 6 presents the Pearson coefficients' results, assessing multicollinearity among our explanatory variables. The analysis reveals that all variables exhibit correlations below the commonly accepted threshold of 0.7 (Kenneddy, 2003). As a result, there is no indication of problematic multicollinearity among our variables. Additionally, when applying the variance inflation factor (VIF) to conduct a secondary check for multicollinearity, the findings in Table 6 indicate that the mean VIF is 1.39, with the highest value being 1.93, both well below the critical value of 10. This confirms the absence of multicollinearity in our dataset.

Table 6. Pairwise correlation matrix

Variables	DA	ESGD	SIZE	LOSS	LEV	GROWTH	BIG4
DA	1.000						
ESGD	-0.212*	1.000					
SIZE	-0.069	0.550*	1.000				
LOSS	-0.207*	-0.328*	-0.248*	1.000			
LEV	0.143*	0.040	0.371*	0.114	1.000		
GROWTH	-0.070	0.027	0.148*	-0.304*	0.083	1.000	
BIG4	-0.034	0.091	0.217*	0.016	0.013	0.010	1.000

Note: *** ***p<0.01,*** ** ***p<0.05,*** * ***p<0.1***

Table 7. Variance inflation factor

Variables	VIF	1/VIF
ESGD	1.564	0.639
SIZE	1.934	0.517
LOSS	1.313	0.762
LEV	1.311	0.763
GROWTH	1.156	0.865
BIG4	1.062	0.941
Mean VIF	1.39	

4.3 Empirical results

Within this investigation, the time-feasible Generalized Least Squares (FGLS) regression approach served as the concluding step to assess the association between

ESG and EM. Outcomes derived from the Hausman test suggest that the utilization of the random-effects model is a preferable choice when compared to the fixed-effects model. Table 8 presents the findings of the multivariate panel regression model. Our model exhibits statistical significance at the 1% level (P = 0.000), with an R^2 of 44.2%.

At a 1% significance level, the regression results reveal a noteworthy and negative association between DA and ESG Disclosure. This illustrates how well it explains and forecasts the results. Our regression results show a statistically significant negative connection between DA and ESGD at the 1% significance level. This result implies that responsible Kuwaiti firms are less likely to engage in EM through DA within our selected sample. This suggests that businesses that support sustainable business practices typically engage with their stakeholders in an ethical manner, preventing dishonest behavior in the process. Consequently, we infer that socially responsible Kuwaiti companies are less inclined to engage in earnings management through discretionary accruals, suggesting that firms committed to sustainable business practices tend to exhibit responsible stakeholder behavior, thereby discouraging managerial discretion. This adverse relationship has been substantiated by various prior studies (Amar & Chakroun, 2018; García-Sánchez *et al.*, 2020; Gerged *et al.*, 2020; Gerged *et al.*, 2021; Kumala & Siregar, 2020; Palacios-Manzano *et al.*, 2021), whereas it has not been supported by others (Garfatta, 2021; Jordaan *et al.*, 2018; Muttakin *et al.*, 2015; Prior *et al.*, 2008). Consequently, drawing from stakeholder and legitimacy theories, our hypothesis finds empirical support.

Table 8. Regression results

Discretionary accruals				
Variables	Coef	St Err	P-value	Sig
ESGD	-0.094	0.026	0.000	***
SIZE	-0.003	0.003	0.398	
LOSS	-0.035	0.006	0.000	***
LEV	-0.032	0.017	0.060	*
GROWTH	-0.018	0.007	0.013	**
BIG4	-0.005	0.006	0.411	*
Number of obs		185		
Industry fixed effects		Yes		
Year fixed effects		Yes		
R^2		44.2%		
Prob > chi2		0.000		

Note: *** *$p<0.01$*, ** *$p<0.05$*, * *$p<0.1$*

Regarding control variables, the findings suggest that leverage, company growth, and company losses exert a noteworthy influence on the magnitude of accruals within our dataset. We observed a statistically significant, negative association between losses and DA at the 1% significance level. This suggests that there may be limited avenues for earnings management when companies incur losses due to managerial constraints in accessing cash flows. This finding is inconsistent with previous studies (Muttakin *et al.*, 2015).

We observe a statistically significant, negative correlation between leverage and DA at the 10% significance level. Companies could attribute this to adopting debt strategies that accurately reflect their financial standing, aimed at reducing the cost of financing, as suggested by prior research (Ghosh & Moon, 2010; Kumala & Siregar, 2020). These finding contrasts with various studies that propose debt-financed firms tend to engage in earnings management through discretionary accruals to meet their debt covenants (Amar & Chakroun, 2018; García-Sánchez *et al.*, 2020; Palacios-Manzano *et al.*, 2021).

Moreover, the findings reveal a statistically significant, negative association at the 5% significance level between firms characterized by growth and discretionary accruals. This outcome aligns with the argument made by Kim *et al.* (2012), which suggests that socially responsible firms tend to exhibit higher growth potential and, as a result, achieve better financial performance, characterized by reduced earnings management.

Lastly, we found that, within our sample, major audit firms at the 10% significance level negatively and significantly affect DA. This outcome elucidates the company's robust business network, which may provide it with competitive benefits (Cahyono *et al.*, 2023). Large audit firms unquestionably have superior accrual quality because of their proficiency in identifying DA (Kent *et al.*, 2010).

5. Conclusion

This study endeavors to investigate the connection between sustainability reporting and the accruals-earnings management strategy, with a focus on a less developed stock market, namely the Kuwait Stock Exchange. However, we employed a combination of univariate, bivariate, and multivariate analyses to gather robust evidence pertaining to the primary relationship under scrutiny. The sample for this study encompasses 37 publicly listed Kuwaiti companies, comprising 185 firm-year observations spanning from 2017 to 2021.

The regression findings demonstrate a notable and adverse correlation between sustainability reporting and earnings management practices. This suggests that the management of socially responsible Kuwaiti companies prioritizes building strong, mutually beneficial relationships with their stakeholders rather than engaging in deceptive practices.

Our research makes a valuable addition to the current body of literature by assessing how sustainability-reporting practices influence earnings management. Furthermore, to the best of our knowledge, only two prior studies (Gerged *et al.*, 2020; Gerged *et al.*, 2021) have examined the environmental dimension in the context of Kuwait, without a specific focus on social or governance aspects. This has spurred our interest in investigating the combined impact of all these factors. However, by extending the research on the connection between EM and ESG disclosure in the Kuwaiti context, the study adds to the body of knowledge already in existence. It should be highlighted that while this study examines the effects of ESG overall on EM, the majority of earlier research has mostly concentrated on the environmental part of ESG.

Our research offers significant practical insights with relevance to investors, companies, and policymakers. Firstly, it stands to bolster investor confidence, enabling them to make more informed and fruitful investment choices. Secondly, considering the growing demand for sustainability reporting from stakeholders, policymakers should aim to progressively standardize sustainability practices, promoting the integration of social responsibility into Kuwaiti culture, aligning with the 'New Kuwait 2035' vision. Lastly, this endeavor may facilitate companies in attracting more shareholders that are discerning, enhancing their public image, and inspiring a greater commitment to social responsibility by integrating sustainability reporting into their core business operations.

The empirical findings of our study necessitate a cautious interpretation, and it is essential to acknowledge several limitations that could pave the way for future research directions. Firstly, the development of the checklist of items may not be universally applicable to all industries, particularly the service sector, which may not prioritize environmental reporting to the same extent. Secondly, the reliance on a non-random sampling method, prompted by the limited number of companies offering ESG information in their annual reports, raises concerns about the generalizability of our results to the broader population. In the future, it would be valuable to explore the comparative impact of ESG guideline adoption on earnings management in Kuwait, consider the moderating role of corporate governance mechanisms, and potentially expand the study to encompass MENA or Gulf countries, enhancing the overall generalizability and robustness of empirical findings.

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