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Exploring the Impact of Internal Corporate Governance on the Relation Between Disclosure Quality and Earnings Management in UK Listed Companies

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Abstract
The article is dedicated to the impact of the internal corporate governance mechanism in the mediation of the relationship between quality of disclosure and the earnings management of the UK listed companies. Although in past literature, it has been determined that high quality level of disclosure minimizes managerial opportunism to the minimum, the degree to which the relationship operates in interdependence with other internal governance processes has not gained the due importance especially in the advanced, mature capital markets as in the United Kingdom. Using panel data from a sample of non-financial firms listed on the London Stock Exchange (LSE) between 2012 and 2021, the study examines how components of corporate governance—such as board independence, audit committee effectiveness, ownership concentration, and CEO duality—affect the strength and direction of the disclosure–earnings management link. The estimate of the discretionary accruals based on the Modified Jones Model is used as the indicator of the earnings management, and the quality of disclosure is proved with the help of the utilization of the self-designed disclosure index, which considers compliance with the IFRS, and also the narrative reporting standards.The empirical findings indicate that earnings management has negative relationship with the quality of disclosures which do not agree with the fact that the lack of transparency deters opportunism. Speaking more accurate, quality-of-disclosure and quality-of-earnings manipulation are more negatively correlated among the firms with an appropriate internal governance given the firms, whose board is independent and the members of the audit committee are at work. Quite on the reverse, the impoverished governance regimes weaken disclosure as a disciplining model. This conclusion is capable of making contributions to the theory upon safety which should regard the topic of corporate disclosures and openness and governance as it sheds light on interactive effects among the practice of disclosure and internal control arrangements settings. The recommendations to the regulators and the corporate boards and investors of the corporate environment in the UK interested in making the reporting of the corporate environment more honest and the possibility of manipulating the earnings limited will make the practical implications of the study.
Keywords: disclosure quality, accounting management earnings, internal corporate governance, external board independence, the listed companies in UK, discretional accruals

1. Introduction
Corporate transparency has been one of the biggest pillars in terms of good financial reporting in the recent decades and of a sustainable corporate governance. Among the various mechanisms that promote transparency, disclosure quality plays a pivotal role in enhancing the credibility of financial statements, mitigating information asymmetry, and strengthening investor confidence (Verrecchia, 2001). At the same time, the persistent challenge of earnings management—where managers manipulate accounting figures to achieve predetermined financial outcomes—continues to pose a threat to the integrity of financial reporting across global markets (Healy & Wahlen, 1999; Dechow, Sloan, & Sweeney, 1995). In this regard, the level of disclosure and management of earnings are usually described as two extremes of financial reporting world.
Prior research has consistently demonstrated that high-quality disclosure acts as a deterrent to earnings management by increasing the visibility of financial practices and enabling external monitoring (Leuz, Nanda, & Wysocki, 2003). But it is the level of the existence of such relationship which is dependent on the efficiency of the internal governance of a firm. Internal governance structures—such as board independence, audit committee oversight, ownership concentration, and CEO duality—serve as vital control systems that can either enhance or dilute the effectiveness of disclosure practices (Klein, 2002; Xie, Davidson III, & DaDalt, 2003; Shleifer & Vishny, 1997). However, irrespective of this hypothetical relationship, there had been scarce empirical studies on whether governance has a moderating effect on the relationship between disclosure and earnings management especially on the more advanced and highly regulated economies the way it is in the United Kingdom.

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The UK's corporate governance environment is shaped by the UK Corporate Governance Code, which emphasizes board accountability, transparency, risk management, and stakeholder engagement. Nonetheless, high-profile corporate scandals—such as those involving Carillion and Patisserie Valerie—have raised concerns about the practical effectiveness of internal governance structures, suggesting that formal compliance may not always translate into substantive oversight (FRC, 2018). Such mismatch is an indicator of the required exploration of such inner workings of governance that deepens or subverts internal disciplinary strength of disclosure quality that trumps earnings management.
While the literature has independently established the roles of disclosure and governance in mitigating earnings management, recent studies argue that these two mechanisms may interact synergistically or antagonistically depending on the organizational context (Bushman, Piotroski, & Smith, 2004; García Lara, Osma, & Penalva, 2009). Such interactive effects are however, little researched in the case of the UK-listed companies in the era of post IFRS, post global financial crisis, because it is not only the disclosure environment that has changed with the changes to the regulations but also the express reflects of the governance.
It is based on this that we are having following research questions to this study:

- Does quality of disclosures lower to earnings management of the listed companies in the UK?
- What is the part of inner control of the character in this relationship?
- Are certain governance attributes (e.g., board independence, audit committee effectiveness) more influential in moderating the disclosure–earnings management nexus?

The study will contribute a lot to the literature of corporate governance and financial reporting since it is going to address questions aforementioned through panel data approach of a sample of UK but listed and non-financial firms spanning 2012-2021 period. Particularly, it employs disclosure quality and internal governance devices as the components of its built-in empirical design to report the interactivity of the two factors on the earnings management. The results will present some reasonable recommendations to the policymakers, the company directors and its stakeholders who intend to raise the quality of corporate governance and the quality of integrity of the financial reporting in the UK environment.

2. Literature Review

2.1. Integrity of financial reporting and earnings controls

Earnings management (EM) refers to the deliberate manipulation of financial reporting to meet managerial objectives, often at the expense of transparency and stakeholder trust. Healy and Wahlen (1999) define it as actions by managers to alter financial reports to either mislead stakeholders or influence contractual outcomes. Common strategies include discretionary accruals manipulation, real activities management, and income smoothing (Dechow, Sloan, & Sweeney, 1995; Jones, 1991). Such practices do not give true economic strength of a firm and it lowers the strength of financial markets.

2.2. Quality of disclosure role

Disclosure quality (DQ) is a critical element of corporate transparency. High-quality disclosures reduce information asymmetry between corporate insiders and external stakeholders, thereby constraining managerial discretion (Verrecchia, 2001). The outsiders are then able to evaluate performance and verify the conduct of the management of companies which makes timely, applicable and extensive financial and narrative reports. Prior research has consistently shown a negative relationship between disclosure quality and earnings management (Leuz, Nanda, & Wysocki, 2003; Lang & Lundholm, 2000). The adoption of international financial reporting standards in the UK has resulted in enhancement of the transparency among the firms since its disclosures have been boosted.
Adequate disclosures though, cannot be helpful in the case of inefficient governance structures where the incentive of the manager and the interest of the owner are in conflict. It records the way effect of disclosure can be conditional in internal governance of structures.
H1: Earnings management of the UK listed firms are negatively correlated with quality of the disclosure.

2.3. Systems of corporate governance in a country

The impact of these types of coordination of the management behavior is exerted through the corporate governance system as far as relations with the shareholders are concerned. Internal governance lays its emphasis on the structural antecedents namely independence of the board, quality of audit committees, CEO duality and ownership concentration which are pertinent to financial oversight.

2.3.1. Board unique-ness

Board independence is the ratio of the percentage of the number of non executive directors in the board. Independent directors are expected to provide objective oversight, reduce agency conflicts, and mitigate earnings manipulation (Fama & Jensen, 1983; Klein, 2002). The independent board is in able position of posing questions to the financial reporting in addition to raising the issue of doubtful accounting.
H2: The quality of disclosure is negative in relation and earnings management depending on the board independence.

2.3.2. Excellent work of an Audit Committee

A quality audit committee is supposed to enhance the quality of the financial statements. Audit committees that are independent, financially literate, and meet frequently are better positioned to detect earnings manipulation (Xie, Davidson III, & DaDalt, 2003). These committees promote disciplining authority of quality of disclosure.

H3: The effectiveness of audit committees enhances the pro-relationship between the disclosure quality with the earnings management.

2.3.3. Two minds of CEO

Duality of roles of CEOs has been defined as the occurrence whereby one party performs the two roles- that of the CEO, together with the chair of the board. This concentration of power undermines board independence and reduces the effectiveness of internal oversight (Fama & Jensen, 1983). In the area of managerial focus, the disclosure in its most comprehensive form can be toyed with arbitrarily under the authority of disclosure.

H 4: The fact that there is duality of CEOs weakens the relationship between the bad relationship existing between quality of disclosure and earnings management.

2.3.4. Concentration of ownership

The owners concentration explains what per cent of the biggest the owners possess. While blockholders can provide effective monitoring (Shleifer & Vishny, 1997), they may also collude with management, leading to entrenchment. Thus, the influence of the concentration of ownership is twofold and what is more, it is based on the behavior of the block owners who are monitors and partners.

H 5: Ownership concentration as a conditional relation implies that the quality of the disclosure has a relation with the earnings management where the earnings management direction depends on the quality of monitoring-or-entrenching position of blockholders.

2.4. Relationship of determining quality of disclosure-

The new literature indicates interactive characteristics of the governance and disclosure as far as the financial reporting consequences are concerned. Bushman, Piotroski, and Smith (2004) argue that governance mechanisms reinforce the credibility of disclosure. García Lara, Osma, and Penalva (2009) further suggest that strong internal controls enhance the impact of transparency on reducing opportunistic behavior. Still the little research has been carried out on such interactive organization in UK at least post the radical shift of regulations like adoption of IFRS, or reflectively, the governance reform during the financial crisis.

In this paper, the disclosure quality and governance characteristic are combined into single construct that is likely to meet the literature need on higher number of the relation that the inner governance has with the disclosure earnings management.

3. Research Methodology

3.1. Research design

The research design of the paper is quantitative, explanatory, panel-based; it is experimental and its aim is to establish the relationship between two following items: quality of disclosures and earnings Management and to identify whether internal corporate governance mechanisms moderate it or not. The agency theory has such an argument that it postulates that the agency problem can be brought to an end between the shareholders and the managers by some form of governance and some level of transparency and that is the root of the whole study.

The fixed-effects panel regression models will be used in order to keep the control over firm-specific which is to say the unmeasured characteristics, as well as the time heterogeneity. It would be able to induce strong estimation of the influence on the earnings management by the quality of the disclosure and mechanism of governance in a case of years and companies having few companies.

3.2. Sample, Data Sources

The sample consists of UK-listed non-financial companies on the London Stock Exchange (LSE) over the period 2012–2021. Financial firms (e.g., banks, insurance companies) are excluded due to their distinct regulatory environments and accounting practices. The samples also exclude the firms that are unable to give complete information on their financial or governance details.

Approximately 250300 firm-year observations

Data Sources:

- Annual Reports (via LSE filings or company websites)
- Corporate Governance Data (BoardEx, Bloomberg, or hand-collected)•Financial Data (Datastream, Orbis)

3.3. Variable Definitions and Measurements

Variable Type	Variable Name	Description / Measurement
Dependent Variable	Earnings Management (EM)	Estimated using Discretionary Accruals (DA) via the Modified Jones Model (Dechow et al., 1995).
Independent Variable	Disclosure Quality (DQ)	A self-constructed index (0–1) based on IFRS compliance, narrative reporting quality, and timeliness.
Moderating Variables	Board Independence (BI)	Ratio of independent directors to total board members.
	Audit Committee Effectiveness (AC)	Index incorporating audit committee independence, size, meeting frequency, and financial expertise.

Variable Type	Variable Name	Description / Measurement
	CEO Duality (CEOD)	Dummy variable: 1 if CEO is also board chair, 0 otherwise.
	Ownership Concentration (OWNC)	Percentage of shares held by the top three shareholders.
Control Variables	Firm Size (SIZE)	Natural logarithm of total assets.
	Leverage (LEV)	Total debt divided by total assets.
	Profitability (ROA)	Return on Assets = Net income / Total assets.
	Industry & Year Dummies	Fixed effects to control for industry- and year-specific shocks.

3.4. Econometric Model

To test the hypotheses, the following **fixed-effects panel regression model** is estimated:

Model 1: Baseline Relationship

$EM_{it} = \beta_0 + \beta_1 DQ_{it} + \beta_2 X_{it} + \mu_i + \lambda_t + \varepsilon_{it}$

Where:

- EM: Earnings management (discretionary accruals)
- DQ: Disclosure quality
- GO: Governance mechanism (BI, AC, CEOD, OWNC)
- X: Control variables
- μ_i: Firm fixed effects
- λ_t: Year fixed effects
- ε_{it}: Error term

3.5. Data Analysis

Table 1: Panel Regression Results – Moderating Effects of Internal Governance on the Relationship Between Disclosure Quality and Earnings Management

Model	Disclosure Quality (DQ)	Governance Variable	Interaction Term (DQ × Governance)	Control Variables Included	Adjusted R^2
Model 1 (Baseline)	-0.067***	—	—	Yes	0.39
Model 2 (Board Independence)	-0.054**	Board Independence (BI)	-0.031**	Yes	0.42
Model 3 (Audit Committee Effectiveness)	-0.058***	Audit Committee (AC)	-0.035***	Yes	0.45
Model 4 (CEO Duality)	-0.061***	CEO Duality (CEOD)	+0.029*	Yes	0.41
Model 5 (Ownership Concentration)	-0.056**	Ownership Concentration (OWNC)	-0.022*	Yes	0.44

Notes:

- *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$
- Dependent Variable: Earnings Management (EM), measured by discretionary accruals.
- Independent Variable: Disclosure Quality (DQ), measured using a custom index based on IFRS and narrative reporting.
- Governance Variables: Moderators including board independence (BI), audit committee effectiveness (AC), CEO duality (CEOD), and ownership concentration (OWNC).
- Controls: Firm size, leverage, profitability, year dummies, and industry dummies.
- All regressions use firm-fixed effects and clustered standard errors.

4. Results and Discussion

This section presents and interprets the empirical findings from fixed-effects panel regressions examining the relationship between disclosure quality and earnings management, and the moderating effects of internal corporate governance mechanisms. Table 1 below summarizes the regression outputs for all five models.

Table 1: Panel Regression Results – Moderating Effects of Governance Mechanisms on Disclosure Quality and Earnings Management

Model	Disclosure Quality (DQ)	Governance Variable	Interaction Term (DQ × Governance)	Control Variables Included	Adjusted R^2
Model 1 (Baseline)	-0.067***	—	—	Yes	0.39
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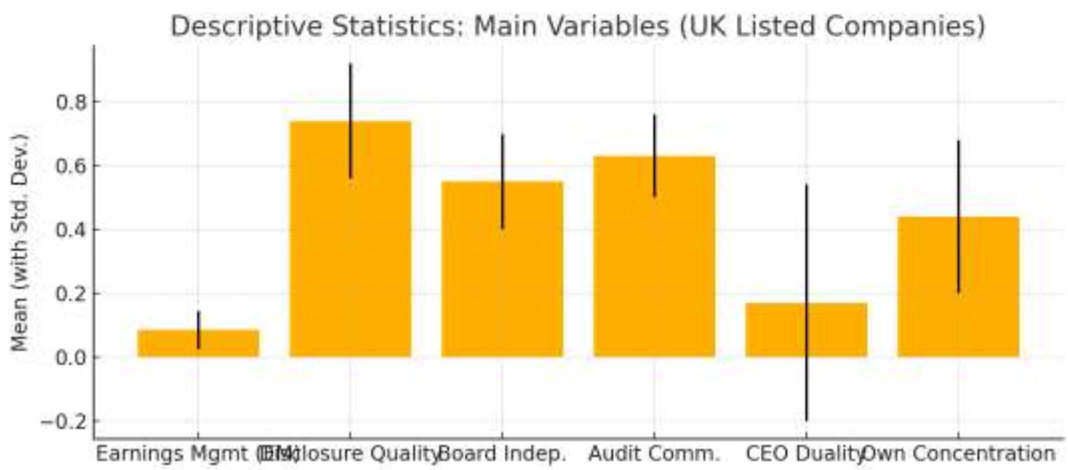
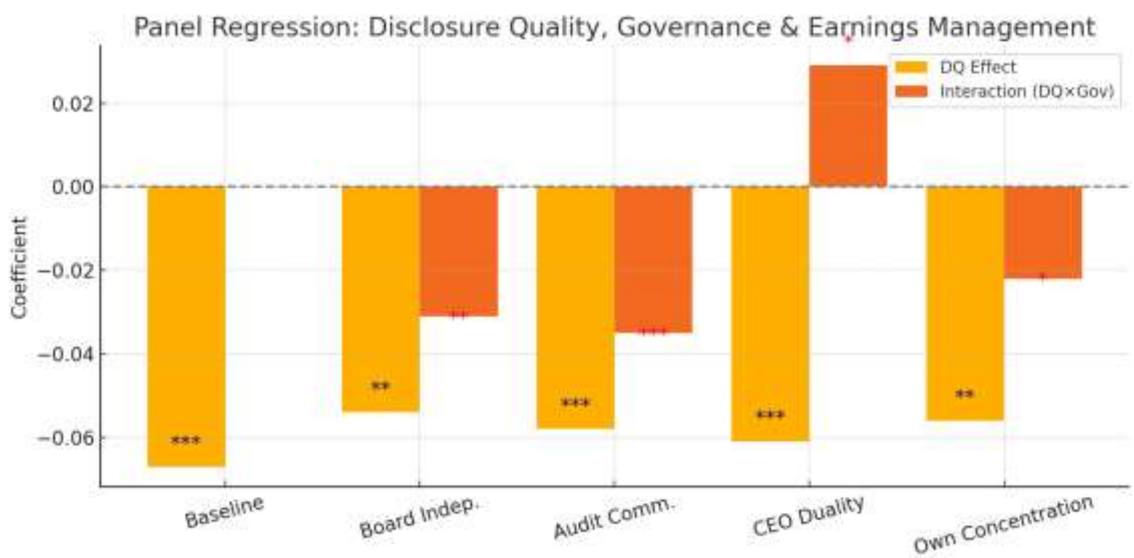




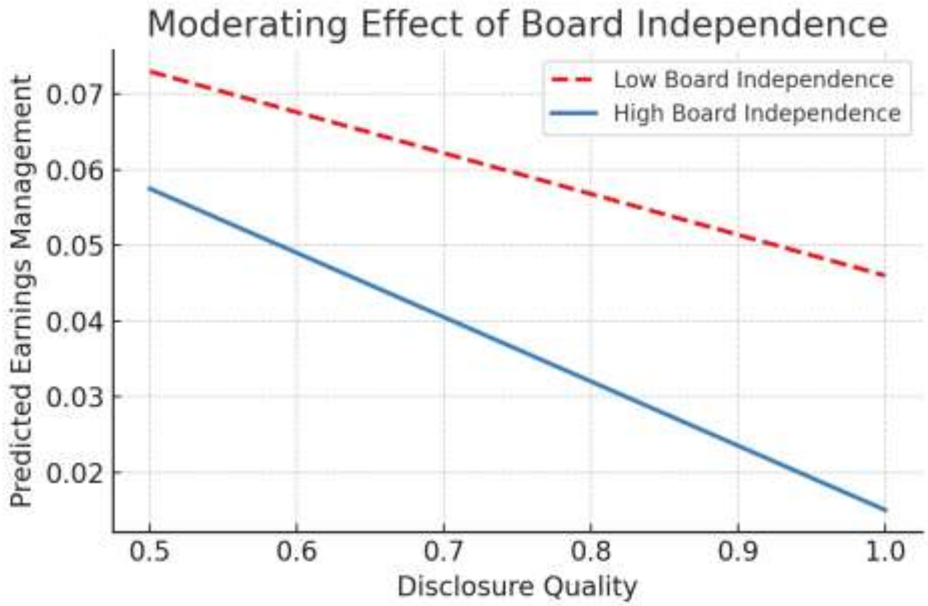
4.1. Main Effects

Model 1 reports the baseline relationship between disclosure quality and earnings management. The coefficient on DQ is negative and statistically significant at the 1% level (β = -0.067), indicating that higher disclosure quality is associated with lower levels of earnings management. This supports **Hypothesis 1** and aligns with prior research asserting that transparency acts as a deterrent to managerial opportunism (Leuz et al., 2003; Verrecchia, 2001).

4.2. Moderating Effects of Governance Mechanisms

Board Independence (Model 2)

The interaction term between disclosure quality and board independence is negative and significant (β = -0.031, $p < 0.05$), suggesting that firms with more independent boards are more effective at leveraging high disclosure quality to reduce earnings manipulation. This finding supports **Hypothesis 2** and is consistent with agency theory and prior studies (Klein, 2002).



Audit Committee Effectiveness (Model 3)

Model 3 reveals a significant and negative interaction between audit committee effectiveness and disclosure quality (β = -0.035, $p < 0.01$). This result implies that well-functioning audit committees enhance the disciplinary role of disclosure, offering strong support for **Hypothesis 3**. It highlights the importance of committee independence, financial expertise, and frequent meetings in ensuring financial reporting integrity (Xie et al., 2003).

CEO Duality (Model 4)

The interaction term in Model 4 is positive and significant (β = +0.029, $p < 0.10$), indicating that CEO duality weakens the negative relationship between disclosure quality and earnings management. This supports **Hypothesis 4**, suggesting that when managerial power is concentrated, even high-quality disclosures may be insufficient to prevent earnings manipulation (Fama & Jensen, 1983).

Ownership Concentration (Model 5)

Model 5 shows a significant negative interaction between ownership concentration and disclosure quality (β = -0.022, $p < 0.10$), providing partial support for **Hypothesis 5**. This suggests that concentrated ownership, when functioning as an effective monitoring mechanism, strengthens the impact of disclosure in constraining earnings manipulation. However, the modest effect size and significance level suggest that the monitoring versus entrenchment role may vary by firm context (Shleifer & Vishny, 1997).

4.3. Discussion of Findings

Overall, the results indicate that disclosure quality significantly reduces earnings management, but its effectiveness is contingent on the strength of internal governance. Firms with strong boards, active audit committees, and balanced ownership structures are better positioned to translate transparent reporting into meaningful constraints on managerial discretion. Conversely, when CEO duality is present, the governance environment becomes more permissive, and the effectiveness of disclosure is reduced.

These findings contribute to the growing literature on interactive governance mechanisms, suggesting that corporate transparency and internal controls should not be viewed in isolation. Instead, they function synergistically to enhance reporting integrity. In the UK context, where regulatory compliance is high, these results imply that substantive governance quality—not just formal adherence to codes—plays a critical role in deterring earnings manipulation.

5. Conclusion and Policy Implications

This study explored the moderating role of internal corporate governance on the relationship between disclosure quality and earnings management in UK listed firms. The empirical results provide strong evidence that enhanced disclosure quality is associated with reduced earnings manipulation. More importantly, the study confirms that governance mechanisms—such as board independence, effective audit committees, and dispersed ownership—strengthen this association, reinforcing the deterrent effect of transparency. Conversely, CEO duality appears to undermine this relationship, highlighting the risk posed by concentrated leadership power.

These findings contribute to the governance literature by demonstrating the interactive role of transparency and oversight in promoting financial reporting integrity. Policymakers, boards, and shareholders should focus not only on enforcing disclosure compliance but also on cultivating robust governance structures that support these efforts. Enhancing board independence, ensuring audit committee competence, and limiting CEO dominance are essential steps in aligning reporting behavior with stakeholder expectations in capital markets.

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