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The Influence of Earnings Management on Earnings Quality and Corporate Sustainability in GCC Companies

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Abstract

In the dynamic and evolving economies of the Gulf Cooperation Council (GCC), financial transparency and sustainability have become paramount to long-term development goals. However, the persistent practice of earnings management threatens both the quality of reported earnings and the broader corporate sustainability agenda. This study explores the relationship between earnings management, earnings quality, and corporate sustainability in listed GCC companies. By distinguishing between accrual-based and real earnings manipulation techniques, we assess their impact on earnings informativeness, reliability, and long-term strategic performance. The findings reveal that excessive earnings management undermines earnings quality, distorts financial signals to stakeholders, and detracts from environmental, social, and governance (ESG) commitments. The paper calls for stronger governance mechanisms and harmonized regulatory frameworks to promote sustainable financial reporting across the region.

Keywords: Earnings Management, Earnings Quality, Corporate Sustainability, GCC Companies, Financial Transparency, ESG, Accrual Manipulation, Real Activities Manipulation, Governance, Sustainable Reporting

Introduction

As the economies of the Gulf Cooperation Council (GCC) undergo strategic transformation, the focus on financial transparency and corporate sustainability has intensified. With countries like Saudi Arabia and the United Arab Emirates spearheading long-term economic visions such as

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Pages: 36-43
Volume-II, Issue-I, 2025

Vision 2030, private sector participation and investor confidence have become critical drivers of growth. In this context, corporate reporting plays a vital role in communicating a firm's performance and long-term viability to stakeholders. However, the prevalence of earnings management (EM) within listed companies raises significant concerns about the quality of reported earnings and their alignment with sustainable business practices[1].

Earnings management is broadly defined as the manipulation of financial statements by management to either mislead stakeholders or influence contractual outcomes. While some forms of EM may be considered legitimate under generally accepted accounting principles (GAAP), excessive manipulation—especially for opportunistic or short-term gains—can severely impair the credibility of financial reporting. Firms may engage in either accrual-based earnings management (AEM), which involves altering accounting estimates and timing (e.g., bad debt provisions, revenue recognition), or real earnings management (REM), which changes actual business operations (e.g., reducing R&D, overproduction) to achieve target earnings[2].

Earnings quality refers to the degree to which reported earnings reflect a firm's actual economic performance. High-quality earnings are consistent, sustainable, and provide an accurate basis for forecasting future cash flows. When EM distorts financial reports, earnings lose their predictive value, misinform investors, and compromise corporate governance mechanisms. This issue is particularly relevant in the GCC, where many companies are family-owned, markets are developing, and regulatory oversight varies in rigor and scope.

The broader implications of EM extend beyond financial misreporting. In today's business environment, corporate sustainability—encompassing environmental, social, and governance (ESG) dimensions—is a cornerstone of long-term strategy. Sustainable firms are expected not only to generate profits but to do so in a manner that minimizes environmental harm, promotes social equity, and upholds governance standards. When companies manipulate earnings to inflate short-term performance, they may defer essential investments in sustainability, distort ESG disclosures, and erode stakeholder trust[3].

In the GCC context, this tension between financial performance and sustainable development is especially critical. Governments across the region are investing heavily in green energy, digital

Pages: 36-43
Volume-II, Issue-I, 2025

transformation, and inclusive growth. At the same time, they are encouraging private firms to adopt integrated reporting and ESG frameworks. Yet, if firms are engaged in EM, the reliability of their sustainability claims is questionable. For example, a firm that cuts environmental investments to meet earnings targets may appear financially strong in the short run but is actually compromising its long-term resilience and stakeholder alignment.

Moreover, investors are increasingly prioritizing ESG-conscious investments and demanding greater accountability from firms. International ratings agencies, financial institutions, and regulators are closely scrutinizing both financial reports and ESG disclosures. In such a climate, EM can be detrimental not only to individual firms but to national economic reputation and investor appeal[4].

This study aims to explore how EM influences earnings quality and undermines corporate sustainability in the GCC. We analyze financial data from a representative sample of listed companies, assess the prevalence and types of EM, and evaluate their correlation with indicators of earnings quality and sustainability performance. The study further discusses the role of governance structures, audit quality, and regulatory initiatives in mitigating EM and enhancing reporting integrity. Ultimately, the research seeks to inform policy and corporate practices that can reconcile financial performance with sustainability objectives in the GCC's evolving economic landscape.

Impact of Earnings Management on Earnings Quality

Earnings quality is a fundamental attribute of reliable financial reporting. It reflects the degree to which earnings reported in the financial statements reflect true and recurring performance rather than managerial discretion or manipulation. In the context of the GCC, where investor confidence is still maturing and financial markets are undergoing transformation, maintaining high earnings quality is essential. However, the practice of earnings management—both accrual-based and real—poses a significant threat to this objective[5].

Accrual-based earnings management (AEM) involves altering accounting estimates and judgments to achieve a desired financial outcome. For example, firms may overstate revenues by recognizing them prematurely or understate expenses by delaying provisions for doubtful

Pages: 36-43
Volume-II, Issue-I, 2025

debts or impairments. While such actions may be legal under existing accounting frameworks, they introduce noise into the earnings figure and obscure underlying performance. In GCC companies, AEM is often more prevalent among firms under financial stress, particularly in industries affected by oil price volatility, such as construction, logistics, and energy services.

Real earnings management (REM), on the other hand, affects actual business decisions. Firms might reduce discretionary spending on advertising or research and development to improve short-term profits, even if it negatively affects future growth. Alternatively, they may overproduce goods to spread fixed costs over a larger volume, artificially reducing the cost of goods sold. These actions can be harder to detect and often have more damaging long-term effects. In the GCC, REM is frequently observed in firms that are trying to meet market expectations or secure continued financing from institutional investors or state-linked entities[6].

The consequence of both AEM and REM is a distortion in the informativeness of earnings. Investors and analysts rely on financial statements to evaluate firm value, make predictions, and assess risks. When these statements are manipulated, it leads to inefficient capital allocation, increased cost of capital, and ultimately, market disillusionment. Empirical evidence suggests that GCC firms with high levels of discretionary accruals tend to have less persistent earnings, lower return predictability, and greater volatility in stock prices—hallmarks of poor earnings quality.

Furthermore, poor earnings quality undermines internal decision-making processes. Management decisions regarding capital investment, dividend distribution, and strategic planning depend on accurate financial insights. If these insights are skewed by EM, it can lead to overexpansion, underinvestment, or misalignment with market conditions. This issue is exacerbated in GCC markets where board oversight may be limited, and audit committees may lack independence or financial expertise[7].

In firms where EM is pervasive, the link between earnings and economic performance is weakened. Investors lose the ability to differentiate between genuinely high-performing firms and those simply painting a favorable picture. This creates a dangerous environment where misreporting is incentivized, honest reporting is penalized, and the credibility of the market is diminished.

To combat these challenges, governance mechanisms must be strengthened. Studies show that GCC firms with strong boards, higher audit quality, and more foreign ownership exhibit lower levels of EM and higher earnings quality. Regulatory bodies must also play an active role in enforcing transparent reporting, penalizing egregious manipulation, and incentivizing honest disclosures[8].

Ultimately, the integrity of earnings reports is foundational to sustainable economic growth. If earnings are managed to the extent that they no longer represent economic reality, it compromises not just firm performance but also market efficiency and public trust. The fight for earnings quality in the GCC is, therefore, a fight for the region's economic credibility in the global financial ecosystem.

Earnings Management and Its Implications for Corporate Sustainability

Corporate sustainability in the 21st century extends far beyond financial profitability. It encompasses a firm's ability to operate responsibly within environmental, social, and governance (ESG) frameworks, ensuring long-term value creation for all stakeholders. As GCC countries seek to align with global sustainability agendas, such as the United Nations Sustainable Development Goals (SDGs), firms are under increasing pressure to report not only financial results but also their social and environmental impacts. However, earnings management can significantly distort this sustainability narrative, masking underlying issues and presenting an inflated picture of long-term viability[9].

One of the key tensions between earnings management and sustainability lies in short-termism versus long-term value creation. When companies manipulate earnings to meet quarterly targets or satisfy market expectations, they may defer essential expenditures in sustainability initiatives. For example, cutting R&D or environmental compliance costs to inflate margins can generate immediate gains at the cost of innovation and long-term risk mitigation. In the GCC, where firms often operate in resource-intensive industries, these trade-offs can have significant consequences for environmental sustainability.

Earnings management can also affect social sustainability. Firms that reduce employee training budgets or delay community engagement programs to preserve earnings may harm workforce morale and stakeholder relations. These practices, though subtle, are increasingly scrutinized in the ESG evaluation processes of institutional investors. Moreover, firms that inflate earnings through manipulative practices often present misleading ESG disclosures, creating a disconnect between reported sustainability performance and actual impact[10].

The manipulation of earnings can also undermine governance sustainability. A transparent governance structure is crucial for ethical decision-making, stakeholder trust, and regulatory compliance. However, firms that engage in EM often operate with weak internal controls, lack board independence, or rely on non-independent auditors. These characteristics not only facilitate manipulation but also indicate broader governance deficiencies. In the GCC, where ownership is often concentrated and family-owned businesses dominate, the entrenchment of management can further exacerbate these issues.

A particularly troubling consequence of EM in the sustainability context is the greenwashing effect. Companies may report selectively on ESG achievements while simultaneously manipulating earnings to hide financial underperformance. This dual distortion undermines both financial and non-financial reporting and erodes the integrity of integrated reporting frameworks. In response, global rating agencies and sustainability indices have begun incorporating earnings quality into their ESG scoring models, recognizing that a firm's financial ethics are inseparable from its sustainability credibility[11].

On a macro level, the prevalence of earnings manipulation impedes national efforts toward sustainable economic reform. GCC countries are investing heavily in sustainable infrastructure, green finance, and responsible investment initiatives. If the private sector fails to align with these efforts through credible financial and sustainability reporting, it risks undermining national reputation, discouraging foreign investment, and slowing progress toward development goals.

To mitigate these risks, policymakers and regulators must ensure convergence between financial and ESG reporting standards. Mandating integrated reporting, enforcing sustainability audits, and promoting transparency in both earnings and ESG metrics can help align incentives. In

Pages: 36-43
Volume-II, Issue-I, 2025

addition, firms should be encouraged to adopt long-term performance-based compensation schemes for executives, reducing the temptation to manage earnings for short-term gains[12].

Educational initiatives and stakeholder engagement are also critical. Boards must be trained to oversee both financial integrity and sustainability performance. Investors must be equipped to interrogate financial and ESG disclosures critically. And civil society must be empowered to demand corporate accountability.

Conclusion

Earnings management, though often rationalized as a strategic financial tool, poses a serious threat to both earnings quality and corporate sustainability in the GCC. By distorting the true economic performance of firms, it erodes stakeholder trust, undermines ESG goals, and jeopardizes the region's broader development objectives. To uphold transparency and sustainability, GCC companies must strengthen governance, embrace ethical reporting, and align financial practices with long-term value creation. Only then can they foster credible, resilient, and future-ready economies.

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Pages: 36-43
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