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Original Article

Investigation of Relationship between some Corporate Governance Mechanisms and Earning Quality

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ABSTRACT

The main objective of this study was to investigate the relationship between corporate governance mechanisms and earning quality. In this study, the size of board of directors, number of non-bound managers in the board and institutional investors are used as corporate governance system mechanisms. Earning quality is also measured based on the relationship between earnings and accruals. Required data collected from the selected sample including 90 companies listed in Tehran Stock Exchange from 2008 to 2012. Hypotheses' testing was conducted using multiple regression and Eviews software. The overall result of the study shows that there is a significant relationship between corporate governance and earnings quality.

Keywords: Corporate Governance, Size Of The Board Of Directors, Non-Duty Managers, Institutional Investors, Earning Quality.

Introduction

More attention has been paid to system of corporate governance with development of enterprises and increased duties and powers of the board of directors. Corporate governance is a set of control mechanisms within and outside the company that creates an appropriate balance between equity of shareholders on the one hand, and needs and authority of board of directors on the other hand. Finally, these reasonable mechanisms provide a reasonable assurance for shareholders, finance providers and other stakeholders according to which the return on their investments and their benefits will be considered (Zainuddini Meymand, 2012).

Conflict of interest between managers and shareholders along with factors such as managers' retention and reward paves the way for earning management. Recently, researchers and financial analysts focused on the earning quality rather than exclusive emphasis on profit figure. Most countries have made efforts to obtain necessary mechanisms to achieve the desired earning quality due their importance. Among these mechanisms is existence of a good governance system in enterprises and businesses (Arab Salehi and Ziaee, 2011).

Reduction in earning quality means difference between reported net profit and results of economic unit performance. In such situations, the information content of earnings is reduced and users are less able to focus on this important element of financial statements in their decision models. According to investors view, the low quality of earnings is not desirable because it leads to non-optimal allocation of resources. Earnings quality assessment helps users of financial statements to judge about reliability of current profits and predict the future. According to what mentioned above, in this study the researcher aims to answer this question: What is the impact of corporate governance on earning quality?

Research theories

In this section, we introduce the concept of corporate governance and selected mechanisms of this stud. Next, theories related to earnings will be introduced.

Corporate governance

Corporate governance mechanism is a set of governing and controlling mechanisms for corporations. It determines distribution of rights and responsibilities of the various stakeholders of companies including directors, employees, shareholders, and other real or legal entities that has influenced and influence the company activities. This system determines rules and procedures for decision processes in the company including setting goals, determining tools to achieve goals and designs for control systems. This system is closely related to methods used by suppliers of financial resources to ensure their return on investment. Corporate governance system is a set of guidelines, structures , processes and cultural norms used by corporate to achieve their objectives including transparency in business processes, accountability to stakeholders and meeting their rights. Corporate governance mechanisms will reduce the agency problems of the company. Quality of these mechanisms is relative and varies from company to company (Karimipoor Ardekani,2013).

Corporate governance mechanisms used in this study

Size of board of directors

Theoretical literature has provided two opposite views of the role of board of directors size on firm performance. In the first view, it is stated that smaller board of directors would improve the company's performance. When board of directors is composed of many members, agency problems can be increased because a number of the board of directors' members may act as self-interested individuals. Also, when the number of board of directors' members is excessive, control and monitoring of the Managing Director will not be effective. Meanwhile, planning, team coordination, decision making, and regular meetings are difficult for a large board of directors. Too large board of directors loses its ability to perform duties efficientlyand is placed in a more symbolic place.

On the other hand, the second view states that the smaller board of directors lacks specialized and varied advantages and benefits in a larger board. Moreover, advantages of larger board of director are in areas such as experience, skills, gender, nationality and etc. Meanwhile, smaller board of directors have less non-bound manager as their members and they have little time to perform regulatory duties and decisions (Nikbakht et al,2011).

Non-bound members of the board of directors

In order to control agency problems, agency costs (monitoring, contracting, remaining losses) can be tolerated to reduce conflicts of

interest between shareholder and agent. One of the costs of monitoring to control the agency problem is the use of non- bound members (independent) to monitor the behavior of managers. Non-bound members are professional managers with expertise in the decisions management that are responsible for controlling the activities associated with serious agency problems between members and shareholders such as state of reward for executives and inspection for replacement of senior executives. Moreover, the academic literature suggests that non-bound members better protect the interests of shareholders and are better agents for them. Accordingly, the independent members control agency problem and reduce information asymmetry between managers and shareholders by providing better disclosure and better quality (Lem et al, 2007) .

From the theoretical perspective of agency, the presence of independent non-bound managers in the board of directors in corporate and their controlling performance as an independent people contributed to a remarkable reduction of conflicts of interest between shareholders and corporate managers in meetings of board of directors. However, it should be noted that corporate executives play a major role in creating the right combination of bound and non-bound managers among the members of the board of directors.

Institutional Investors

Institutional investors play an important role in corporate governance system. They can monitor the company management with appropriate knowledge and experience in related financial and professional fields. This can be considered as the basis for aligning the interests of management and interests of the group of stakeholders in order to maximize shareholders' wealth. Nevertheless, ownership of institutional shareholders can have negative effects such as access to confidential information that creates information asymmetry between them and smaller shareholders.

Institutional shareholders can also increase agency conflicts due to their existence as major shareholders. They can solve agency problems due to economic advantage of savings scale and diversification. Therefore, it appears that institutional shareholders cause the separation of ownership and control while their increasing involvement in companies and focused ownership provides a way to monitor the firm's management (Solomon et al, 2003). Shareholders, particularly institutional investors play an important role in corporate governance system. Institutional investors can focus on the company management and their influence on the management of the company can be the basis for aligning the interests of management and interests of the group in order to maximize the wealth of shareholders (Izadinia and Rsayian,2011).

Earning quality

Earning quality is a multifaceted concept and analysts and researchers use both financial and non-financial data to assess the quality of earning. There are some features identified in financial and accounting texts representing the high quality of profit, which can be named as follows:

Stable, conservative accounting methods,

Pre-tax profit flow caused by operating and reproducible activities,

Obtaining a level of net profit and growth rate, independent of tax considerations (such as tax rate reductions that causes tax breaks)

Having an appropriate level of debt;

Having appropriate capital structure,

Corporate profits which are not result of inflationary.

Generally, it can be said that when reported earnings help users make better decisions, then its profit has a better quality. However,

it is not possible to provide a comprehensive definition of quality because individuals use information for different decisions (Khoshtinat and Ismaili,2007).

Role of accruals

One of the important roles of accruals is to transfer or modify identification of cash flows over time so that the adjusted numbers (earnings) better evaluate the company's performance (statement number (1), accounting concepts, 1978). Accruals are often based on assumptions and estimates that should be corrected in future benefit accruals, if to be incorrect. Therefore, the quality of accruals and earnings will be reduced when encounters estimation error. Accrual accounting encompasses exchanges between features of relevance and reliability. While accrual-based information is about the expected future benefits and related obligations in order to provide related information to users, at the same time, this information is less reliable than received or paid cash. Accruals are defined as the difference between net income and cash flow obtained from operating activities. (According to this definition, there are lower accruals on higher earnings quality). It can be stated that one of accounting adjustments that make the difference between net income and cash flows is derived from accrual accounting (Aboyi Mehrizi, 2012).

Review of literature

Niu (2006) investigated the relationship between corporate governance and accounting earnings quality. The research sample consisted 5189 observations of Canadian companies during 2001-2004. The results showed that there is a negative relationship between earnings quality of companies, abnormal return and income returns. Jiang et al (2008) investigated the relationship between corporate governance and earnings quality using 4311 observations of U.S. companies during 2002-2004. Results of this study indicate that the more increased levels of corporate governance shows the less decreased discretionary accruals and more increased earnings quality. Machuga and Teitel (2009) examined relationship between the characteristics of board of directors and improved quality of earnings in Mexican corporations during 1998 - 2002. Earnings quality was measured using earnings smoothing, timely loss recognition and accruals. Results showed that do not have concentrated family ownership or share directors have greater increases in earnings quality than firms that have concentrated family ownership or share directors. Chang and sun (2010) investigated the effect of disclosure of corporate governance on corporate profits using 2977 observations from 2001 to 2003. Results indicated that the market value of the earnings was higher for firms with stronger disclosure of corporate governance.

Methodology

This study was aimed at examining the relationship between corporate governance, earnings quality and information content. Therefore, the research method was applied in terms of purpose, Ex-*Post* Facto (via past information) in terms of performance and correlational in terms of examination of variables relationships. In order to collect data on theoretical topics such as literature review of the research subject, library method was used. Various sources and databases, especially Rahavard Novin software, Tehran Stock Exchange databases and financial statements of companies were used to collect data on the research variables. Statistical population of this study included all companies listed in Tehran Stock Exchange that have been active in the stock market from early 2008 to late 2012. Systematic elimination method was used to select an appropriate sample as

representative of the relevant population. 5 criteria were considered for this purpose, and companies were selected if had met all 5 criteria. Mentioned criteria included:

Companies listed as accepted members from 2008 to 2012

Company financial year to be ended to March.

No trading halt more than 70 days

A company not to be considered as investment company or financial intermediation company.

Company required information to be available.

After taking into consideration all the above criteria, the desired sample size was included 90 participants.

In this study, descriptive statistics, including measures of central tendency and dispersion was used to describe the study sample and population. Moreover, Regression method based on combined data was used to analyze the data related to hypotheses. Excel software was used to prepare data and Eviews software was used to perform statistical tests. One main hypotheses and three subsidiary ones have been designed and tested:

Main hypotheses

There is a significant relationship between corporate governance and earning quality.

Sub-hypotheses

There is a significant relationship between the size of board of directors and earning quality.

There is a significant relationship between the number of non-boundmanagers and earning quality.

There is a significant relationship between institutional investors and earning quality.

Research model (Abnormal accruals and corporate governance)

According to Jones (1991) study, earning quality can be measured using abnormal accruals. Accordingly, following model was developed.

$$ABS - DAC_{it} = c_0 + c_1 EPS_{it} + c_2 BDSIZE_{it} + c_3 OUTDIR_{it} + c_4 INI_{it} + c_5 LEV_{it} + c_6 SIZE_{it} + c_7 GROWTH_{it} + e_{it}$$

There: ABS – DAC: Absolute discretionary accruals, EPS : Earnings per share

BDSIZE : Board of directors size, OUTDIR: Number of non-bound directors, INI: Institutional investors, LEV: Financial leverage, SIZE: Company size, GROWTH: Opportunities to grow, e : The amount of error of the regression equation.

Descriptive Statistics

Table 1 shows the descriptive statistics of the study variables. Considering this table, we can see the overall status of the corporate governance mechanisms. Therefore, according to the median of the size of board of directors(6), it can be found that half of the sample companies have a board of director with more than six members. Moreover, median of institutional investor's variable (81), indicates that 50% of the sample companies are owned by institutional investors with at least 81 percent ownership. .Also the same situation can be observed among sample companies in terms of number of non- bound managers or the amount of independency of the board of directors. It means that 50% of companies have less than 3 non-bound managers and other 50 percent has more than three non-bound managers.

Findings

First hypothesis

Table 2 presents the results of the first hypothesis testing. According to obtained table data and Durbin - Watson statistics (2/06), it can be stated that there is no serial

correlation between the model errors. Moreover, according to the amount of the adjusted coefficient of determination, it can be stated that the independent variables in this model can explain 22% of variations of dependent variable.

Table 1. Descriptive statistics

Variable	Average	Median	Maximum	Minimum	Standard deviation
P_{it}	3879/03	2589/5	26757	150	3978/49
EPS_{it}	348/55	304	4525	-2114	590/01
ABS-DAC $_{it}$	323833/4	38759/5	8160667	0	1008749
$BDSIZE_{it}$	6/09	6	9	4	0/73
INI_{it}	77/41	81	100	0	17/71
$OUTDIR_{it}$	2/55	3	6	0	1/36
R_{it}	24/43	5/2	734/14	- 78/46	68/42
LEV_{it}	1/48	0/62	350/14	12/0	16/71
$SIZE_{it}$	5/88	5/79	8/52	4/29	0/69
$GROWTH_{it}$	0/997	1/27	70/96	- 154/32	9/74

Table 2. Obtained results of the regression model performance for first hypothesis

$$ABS\text{-}DAC_{it} = c_0 + c_1 EPS_{it} + c_2 BDSIZE_{it} + c_3 LEV_{it} + c_4 SIZE_{it} + c_5 GROWTH_{it} + e_{it}$$

Variable	Variable coefficient	T statistics	Significance
Intercept	-4625718 *	-8/67	0/000
EPS	-137/84***	-1/86	0/064
BDSIZE	3115/94	0/06	0/95
LEV	-298/57	-0/14	0/89
SIZE	847012/4*	11/24	0/000
GROWTH	-127/19	-0/05	0/96
F statistics : 25/52	Adjusted R^2: 0/22		
Significance: 0/000	Durbin - Watson: 2/06		
* P <0.01, ** P <0.05, *** P <0.10			

As the table above indicates, coefficient of the size of the board of directors variable is 3115/94 and according to obtained t statistics (0/06) and its significance level (0/95), the calculated regression coefficient for this variable is not significant at error level lower than 5%. Therefore, statistical H_0 cannot be rejected at the 95% significance level. Therefore, according to the results, the first hypothesis of significant relationship between the size of the board of directors and earning quality at error level lower than 5% cannot be confirmed.

Second hypothesis

Table (3) provides the results of second hypothesis testing. According to obtained table data and Durbin - Watson statistics (2/06), it can be stated that there is no correlation between the independent variables. Moreover, according to the amount of the adjusted coefficient of determination, it can be stated that the independent variables in this model can explain 22% of variations of dependent variable.

Table 3. Obtained results of the regression model performance for second hypothesis

$ABS\text{-}DAC_{it} = c_0 + c_1 EPS_{it} + c_2 OUTDIR_{it} + c_3 LEV_{it} + c_4 SIZE_{it} + c_5 GROWTH_{it} + e_{it}$			
Variable	**Variable coefficient**	**T statistics**	**Significance**
Intercept	-4498073*	-10/09	0/000
EPS	-143/48	-1/94	0/05
OUTDIR	-40453/11	-1/49	0/14
LEV	5/62	0/002	0/99
SIZE	846128/6*	11/36	0/000
GROWTH	-257-/78	-0/07	0/94
F statistics F : 26/45		Adjusted R^2: 0/22	
Significance: 0/000		Durbin - Watson: 2/06	
* P <0.01, ** P <0.05, *** P <0.10			

As the table above indicates, coefficient of non-bound managers variable is -40453/11 and according to obtained t statistics (-1/49) and its significance level (0/14), the calculated regression coefficient for this variable is not significant at error level lower than 5%. Therefore, statistical H_0 cannot be rejected at the 95% significance level. Therefore, according to the results, the second hypothesis of significant relationship between number of non-boundmanagers and earning quality at error level lower than 5% cannot be confirmed.

Third hypothesis

Table (4) provides the results of third hypothesis testing. According to obtained table data and Durbin - Watson statistics (2/06), it can be stated that there is no auto correlation between independent variables. Moreover, according to the amount of the adjusted coefficient of determination, it can be stated that the independent variables in this model can explain 22% of variations of dependent variable.

Table 4. Obtained results of the regression model performance for third hypothesis

$ABS\text{-}DAC_{it} = c_0 + c_1 EPS_{it} + c_2 INI_{it} + c_3 LEV_{it} + c_4 SIZE_{it} + c_5 GROWTH_{it} + e_{it}$			
Variable	**Variable coefficient**	**T statistics**	**Significance**
Intercept	-4484746 *	-9/69	0/000
EPS	-133/39 *	-1/8	0/072
INI	-2577/65	-0/98	0/33
LEV	-305 /26	-0/14	0/89
SIZE	859,791*	11/38	0/000
GROWTH	-328/46	-0/09	0/93
F statistics : 26/14		Adjusted R^2: 0/22	
Significance: 0/000		Durbin - Watson: 2/06	
* P <0.01, ** P <0.05, *** P <0.10			

As the table above indicates, coefficient of institutional investors is -2577/65 and according to obtained t statistics (-0/98) and its significance level (0/33), the calculated regression coefficient for this variable is not significant at error level lower than 5%. Therefore, statistical H_0 cannot be rejected at the 95% significance level. Therefore, according to the results, the third hypothesis of significant relationship between

institutional investors and earning quality at error level lower than 5% cannot be confirmed.

Results

The first hypothesis was discussed and examined about the relationship between size of board of directors and earning quality. Results indicated no statistically significant relationship between the two variables. Arabs Salehi & Ziayi (2006) and Nikoomaram & Mohammadzadeh Saleteh (2011) studies found a significant relationship between these two variables. Significant relation between size of board of directors and earning quality may indicate that the more number of boards makes complicated the consensus on decisions affecting company's financial condition and company operations because each member is trying to benefit the investment company or group of shareholders selected as a board member. However, no relationship was observed between the number of board of directors members and earning quality in the present study. In this regard, this was a reason for improper role playing of board members.

The second hypothesis was suggested and tested about the relationship between numbers of non-bound managers earning quality. Results showed that there was no significant relationship between numbers of non-bound managers earning quality. Probably, it was because of lack of knowledge of non-bound managers about organizational responsibilities or lack of their expected role playing. Often these managers do not consider themselves responsible for accountability of institutions requesting responses. Therefore, they do not perform their monitoring duties properly and their presence in composition of the board of directors has a formality form (Izadinia and Rasayian, 2012).

Arab Salehi and Ziayi (2011) and Ismail-Zadeh Moghari et al (2011) found a significant relationship between the number of non-boundmanagers and earning quality. Results of studies conducted by Mashayekh and Ismaili (2007), Izadinia and Rasayian (2012) showed no significant relationship between the two variables.

The was discussed and investigated third hypothesis about the relationship between institutional investors and earning quality. Results showed no significant relationship between these two variables. Mohammadzadeh Saleteh (2011) found an inverse relationship between institutional investors and earning quality, while Rsayian & Izadinia (2011) and Firth et al (2007) showed a direct relationship between the two variables. Direct relationship means that institutional investors own the bulk of the company's shares and they cannot supply their stock share at once and go out of the company's because wholesale supply in high volume will decrease stock price.Therefore, they play a better controlling role to protect their interest. In addition, the lack of relationship between institutional investors and earning quality, based on outcome of the study, can be attributed to the weakness of institutional shareholders in the controlling role.

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