The Correlation between Corporate Governance Mechanisms and Earnings Quality in Listed Companies in Tehran Stock Exchange

Fereshteh Tamaskani¹*, Ebrahim Abbasi²

¹Department of Management, Aliabad Katoul Branch, Islamic Azad University, Aliabad Katoul, Iran
²Associate Professor at Alzahra University

* Corresponding Author: Fereshteh Tamaskani

ABSTRACT: In recent years corporate governance has been discussed as one of the effective strategies for increasing the quality of financial (earnings) reporting. Corporate governance refers to a set of relationships between shareholders, directors, and accountants of the company and it contains establishing a control system in order to reserve the rights of minority shareholders and proper implementation of assembly acts and preventing any possible abuse. The current research aim is to survey the correlation between corporate governance mechanisms and earnings management in listed companies of Tehran stock exchange. From the point of aim the current research is an applied research. In this research the amount of changes in one or a few factors based on the changes of one or a few other factors through correlation coefficient is considered. Also based on the category of researches due to the collecting data method (research design) this research is a descriptive research. Regarding the imposed conditions the sampling was conducted from 492 companies listed in stock exchange up to the end of 2012 and 98 companies were chosen as the sample. Required data were collected through corporates data collecting from their financial statements and Rahavard Noven software, and in order to analyze data and extract the descriptive and inferential statistics Eviews software was used. Results showed that there is a positive and significant correlation between the size of corporate auditor, amount of non-bound directors among the board of directors, and ownership percentage of institutional investors and the earnings quality, while there is a positive but insignificant correlation between the component of lack of CEO as the chairman or the vice-chairman of board of directors (CEO duality of responsibilities) and block number of major shareholders and earnings quality. At the end a few practical research suggestions are provided.

Keywords: Corporate governance, Earnings quality, Stock exchange.

INTRODUCTION

Corporate governance is a set of tools for guidance and controls that by the use of laws, regulations, structures, processes, cultures and systems results in achieving the objectives of response, clarity, justice and respecting the rights of stakeholders. The more effective the corporate governance and the more it results in decreasing the agency problems the better the corporate performance will look from the perspective of a shareholder and the earnings quality will be something smaller than a problematic issue. During the recent years corporate governance has been discussed as an effective strategy for increasing the quality of financial (earnings) reporting. Corporate governance refers to a set of relationships between shareholders, directors, and accountants of the company and it contains establishing a control system in order to reserve the rights of individual shareholders and proper implementation of assembly acts and preventing any possible abuse (Aghaei et al., 2009). The initial objective of establishment of board of directors in corporates is protecting the shareholders’ interests and board of directors is in charge of formulating and authorizing goals and programs that in long term result in maximum wealth for the corporate and shareholders. One of the indicators that has caught the attention of researchers during last 3 decades is earnings quality. Also efforts have been
made in order to reach a reasonable and valid method for evaluating earnings quality and detecting the factors affecting it (Desaye et al., 2009). Shareholders are one of the biggest players of corporate governance system, because they are the supplies of corporate capital, and it is very important to keep their trust. By choosing the board of directors, shareholders directly or indirectly play roles in corporate decision makings, and since institutional and main shareholders have the ability to choose one or a few members of board of directors they could be effective in reducing the agency costs (Raeisi, 2008). In an optimal corporate governance system directors are responsive to the board of directors and board of directors is responsive to shareholders and other stakeholders, because the necessity and importance of the current research is detecting strategies that could result in increasing the earnings quality of shareholders and decreasing the existing conflict of interest among the stakeholders, and this could be done only through an optimal corporate governance.

Quality of reporting refers to the expression and detection of economic status of a company through financial statements and its performance during financial period. Directors have no willingness to provide shareholders with unrealistic corporate status only if their motivations are along with the shareholders’ interest or if there is no conflict of interest between them (Sivaramakrishnan et al., 2008). The basic financial statements are the most important information resources of the users and shareholders are the most important group of users of financial statements and mainly they make their decisions related to their investments based on the accounting profit, thus the earnings quality has high importance for the users. Many organizations use the combination of incentive and regulatory mechanisms such as incentive plans (incentive) function-conditional, regulatory and non-regulatory systems, monitoring by board of directors and confirmation of independent auditor in order to solve the agency problems. As long as these mechanisms are successful in aligning the motivation we expect to see improvement in financial statements (Jalali, 2010). Earnings quality is discussed when the financial analysts determine that to what extent the reported earnings reflect the real benefit. Generally the investors think that the concept of real benefit means the benefit resulted from normal operation which is repeatable in the future fiscal years and creates cash flows. The concept of earnings quality refers to two features of 1) usefulness in decision making, 2) relationship between earnings quality and economic benefit. Created trust from the quality of financial reporting is considered as a management behavior (duty) and it is one of the mechanisms of corporate governance (Mashayekh & Esmaeili, 2006). Stock Exchange is one of the 3 types of exchange (commodities, rates and currencies, and stock exchange) that is subject to corporate governance. In the corporate bylaws it is predicted that the stock companies (subject to the corporate governance bylaw) should have electronic information center and they should provide all the shareholders with all the news, statistics, and financial information, and also in the board assembly and corporate board of directors there should be a representative of minority shareholders in order to decrease the possibility of violation. Also the corporate governance is in fact a kind of limitation for the majority shareholders and minority shareholders’ access to the information and management control (Setayesh et al., 2010).

In a research named surveying the effect of corporate governance on the earnings management in Tehran stock exchange Esmaeilzadeh Maghari in 2010 stated that during recent years corporate governance has been discussed as an effective strategy for increasing the quality of financial reporting, and different empirical research results show that an optimal corporate governance results in increased earnings quality. Results showed that there is a positive significant correlation between the ownership percentage of institutional shareholders, block number of majority shareholders, percentage of non-bound directors among the board of directors, lack of CEO as the chairman or the vice-chairman of board of directors, and the size of corporate auditor and the earnings quality. In an article named institutional shareholders and earnings quality Burns et al (2006) concluded that, companies with bigger institutional ownership and more majority shareholders have less discretionary accruals thus higher earnings quality. Empirical evidences show that the regulatory role of majority shareholders results in improvement of reporting process and decrease of conflict between directors and shareholders. In an article named correlation between institutional and majority shareholders and earnings quality Chung and Zhang in 2009 concluded that presence of institutional shareholders results in increase of quality of ownership structure, and they not only cause to increase the quality of governance but also act as the trustee and reduce the agency costs. In an article named surveying the correlation between CEO duality of duty and earnings quality Chang and Sun (2008) concluded that CEO duality of duty may endanger the effectiveness of regulatory duty of board of directors on the financial reporting. Ultimately they concluded that there is a positive and significant correlation between CEO duality of duty and earnings quality. Chtouroua, Bedard and Courteau (2001) concluded that there is a positive correlation between discretionary accruals and existence of CEO as the chairman of board of directors.
Regarding the matter that in corporate governance bylaw there is a special emphasis on the establishment of internal audit system and audit committee and the relationship between the directors and independent auditors takes form through audit committee, and there is an emphasis on the benefits of corporate governance bylaw, information transparency, consideration of equal equity, establishing internal control systems, and enhancing the relationship of independent auditors with the corporate (Doyle et al., 2007). The current research main issue is that through corporate mechanisms shareholders could have access to the financial statements and evaluate its relationship with earnings quality, and this is achieved through controlling and monitoring the directors’ performance in order to find strategies to increase the quality of financial reporting or corporate earnings. The current research aim is to survey the correlation between corporate governance mechanisms and the earnings management in companies listed in Tehran stock exchange, and to observe that to what extent a correlation exists between the corporate governance and earnings quality of companies listed in Tehran stock exchange.

METHODOLOGY

From the point of aim this research is an applied research. In this research the changes of one or a few factors based on the changes of one or a few other factors through achieving the correlation coefficient are being discussed. Also based on the category of researches due to the collecting data method (research design) this research is considered as a descriptive research. The researcher’s aim to conduct this research is to provide an objective, real and regular description of a situation or a subject matter. In other words in such kind of researches the researcher tries to report what it really is without any interfering or mental deduction, and to have objective results of the situation. Regarding the fact that the only reliable reference for collecting the financial data in the current situation of Iran is Tehran stock exchange thus the companies listed in Tehran stock exchange were considered as the population. For sampling the purposive sampling (systematic elimination) method was used: to this aim all the companies in the population having the below requirements will be considered as the sample and the rest will be eliminated:

1. Companies being accepted in Tehran stock exchange up to 2008 (according to the research time domain).
2. Companies being active in stock exchange in financial period of 2008 to 2012 (according to the research time domain).
3. Companies that did not have any loss during the mentioned years.
4. Companies having accessible required information especially the financial statements note in order to extract the required data such as the discretionairy accruals.
5. In order to increase the possibility of comparison their financial period should be ended at the end of February.
6. These companies should not be a part of banks and financial institutions (investment companies, financial intermediation companies, holdings, banks and leasing) because the disclosure of financial information and corporate governance structures are different in such companies.

Regarding the above mentioned conditions and through sampling from 492 companies listed in Tehran stock exchange up to the end of 2012, 98 companies were chosen as the sample. Data were collected through library and field method, and its first part includes subject literature, defining and detecting the concept of independent and dependent variables, and discussing and surveying their effects on each other through the theories of financial scholars and the second part is the field method in which the required data were collected through corporate data collection of their financial statements and Rahavard Novin software. Also in order to analyze data and extract the descriptive and inferential statistics the Eviews software was used. In the current research for estimating the regression models the combined data were used. In this method the time series data and cross-sectional data are combined and when there is no possibility of surveying the problems through time series or cross-sectional method or when the number of data is small this method is used. In the present research the modified Jones model (provided by Dechow, Sloan and Sweeney, 1995) was used for measuring the earnings quality, because this model is able to solve the current research problem.

RESULTS

The research 1st hypothesis:
There is a significant correlation between institutional investors’ ownership percentage and corporate earnings quality. For testing this hypothesis the below model was estimated:

\[
DAC_{it} = \beta_0 + \beta_1 INST_{it} + \beta_2 SIZE_{it} + \beta_3 LEV_{it} + \beta_4 GWTH_{it} + e_{it}
\]

Results achieved from estimation of above model in table 1 are as followed:

**Table 1. Summary of statistical results of testing 1st hypothesis.**

<table>
<thead>
<tr>
<th>Explanatory variable</th>
<th>Coefficient</th>
<th>t-statistic</th>
<th>Probability</th>
<th>Significance level</th>
</tr>
</thead>
<tbody>
<tr>
<td>y-intercept</td>
<td>0.110751</td>
<td>0.486971</td>
<td>0.6267</td>
<td>Insignificant</td>
</tr>
<tr>
<td>INST</td>
<td>0.273123</td>
<td>2.042919</td>
<td>0.0420</td>
<td>95%</td>
</tr>
<tr>
<td>SIZE</td>
<td>0.004251</td>
<td>0.106344</td>
<td>0.9154</td>
<td>Insignificant</td>
</tr>
<tr>
<td>LEV</td>
<td>-0.003372</td>
<td>-0.636547</td>
<td>0.5249</td>
<td>Insignificant</td>
</tr>
<tr>
<td>GWTH</td>
<td>0.018877</td>
<td>2.384210</td>
<td>0.0178</td>
<td>95%</td>
</tr>
</tbody>
</table>

Before testing the research hypothesis based on the achieved results we have to make sure about the accuracy of results. To this aim F test was used to survey the significance of whole model. Regarding the probability of calculated F-statistic (0.000) it could be stated that the fitted regression model is significant. Based on the coefficient of determination of fitted model it could be claimed that almost 41% of changes in the model dependent variable (earnings quality) are explained by the independent variables. The estimation coefficient of independent variable INST shown in table 1 indicates a positive and significant correlation between institutional investors’ ownership percentage and corporate earnings quality in error level 0.05, because the calculated t-statistic for research independent variable coefficient equaled 2.042 which is bigger than t-table 1.96 (area of rejecting H0 or critical area). Research 2nd hypothesis states that: There is a significant correlation between block number of major shareholders and corporate earnings quality. For testing this hypothesis the below model is estimate:

\[
DAC_{it} = \beta_0 + \beta_1 BLOCK_{it} + \beta_2 SIZE_{it} + \beta_3 LEV_{it} + \beta_4 GWTH_{it} + e_{it}
\]

Results achieved from the estimation of above model are provided in table 2:

**Table 2. Summary of statistical results of testing 2nd hypothesis.**

<table>
<thead>
<tr>
<th>Explanatory variable</th>
<th>Coefficient</th>
<th>t-statistic</th>
<th>Probability</th>
<th>Significance level</th>
</tr>
</thead>
<tbody>
<tr>
<td>y-intercept</td>
<td>0.213759</td>
<td>0.921389</td>
<td>0.3576</td>
<td>Insignificant</td>
</tr>
<tr>
<td>BLOCK</td>
<td>0.024277</td>
<td>1.764576</td>
<td>0.0787</td>
<td>Insignificant</td>
</tr>
<tr>
<td>SIZE</td>
<td>0.028791</td>
<td>0.748291</td>
<td>0.4549</td>
<td>Insignificant</td>
</tr>
<tr>
<td>LEV</td>
<td>-0.004519</td>
<td>-0.843759</td>
<td>0.3995</td>
<td>Insignificant</td>
</tr>
<tr>
<td>GWTH</td>
<td>0.019625</td>
<td>2.460815</td>
<td>0.0145</td>
<td>Insignificant</td>
</tr>
</tbody>
</table>

Observing the calculated F-statistic (8.722) in table 2 and probability amount related to F Prob(F-Statistic)< 0.05 indicate the overall significance of fitted regression model in confidence level 95%. The amount of coefficient of determination of this model also indicates that model independent variables can explain 45% of dependent variables. Estimation coefficient of research main independent variable (BLOCK) also indicates the existence of a positive correlation between number of blocks of major shareholders and the corporate earnings quality. But regarding the fact that the calculated t-statistic 1.7645 is in acceptance area of H0 it could be understood that statistically this correlation
is insignificant. Thus it could be said that in confidence level 95% there is no significant correlation between the block number of major shareholders and corporate earnings quality, and the 2nd hypothesis is rejected. Other research findings showed that the 3rd and 5th research hypotheses were confirmed. In other words it could be said that there is a significant correlation between the number of non-bound directors among the board of directors and the corporate earnings quality, and also there is a significant correlation between the size of corporate auditor and earnings quality, but the 4th hypothesis was rejected, which means that it could be said that in confidence level 95% there is no significant correlation between CEO duality of duty and corporate earnings quality.

**DISCUSSION AND CONCLUSION**

The current research aim is to survey the correlation between corporate governance mechanisms and earnings quality in companies listed in Tehran stock exchange. Two statistical methods being used were implementing the multiple regression models by the use of (PLS) and panel data. In the current research there was a positive and significant correlation between the size of corporate auditor, number of non-bound directors among the board of directors and institutional investors’ ownership percentage with earnings quality, while there is a positive but insignificant correlation between the component of lack of CEO as the chairman or the vice-chairman of board of directors (CEO duality of responsibilities) and block number of major shareholders and earnings quality. Results showed that by the increase of institutional shareholders ratio to the total shareholders (under the condition of fixing three control variables) the earnings quality increases. This result is consistent with and supported by the research findings of Yu (2006), and Francis et al (2008). They concluded that corporates with bigger institutional ownership have less discretionary accruals and thus higher earnings quality. The current research results are not consistent with the research findings of Machuga et al (2009). They concluded that corporates having more major shareholders have less discretionary accruals and thus higher earnings quality. Regarding the fact that this was a new subject and it has been around for only two decades there are few researches available about it and also there is the possibility that the results of conducted researches do not have consistency with each other and there is the possibility to have different results in different countries. Results showed that there is a significant correlation between the amount of non-bound directors among the board of directors and the corporate earnings quality. This result is consistent with and supported by the research findings of Sivaramakrishnan (2008), Wang et al (2006), Klein (2002), Ramasay (2005). They concluded that when the number of non-bound directors among the board of directors increases the discretionary accruals decrease and non-bound directors result in increase of earnings quality. Another research finding was that there is no significant correlation between lack of CEO as the chairman or the vice-chairman of board of directors (CEO duality of responsibilities) and the corporate earnings quality. The research result was inconsistent with the findings of Chang (2008). They concluded that there is a positive and significant correlation between CEO duality of responsibilities and earnings quality. The research result was also inconsistent with the research findings of Chtourau, Bedard and Courteau (2001). They concluded that there is a positive correlation between discretionary accruals and existence of CEO as the chairman of board of directors. Regarding the fact that this was a new subject and it has been around for only two decades there are few researches available about it and also there is the possibility that the results of conducted researches do not have consistency with each other and there is the possibility to have different results in different countries. The current research result showed that there is a significant correlation between the size of corporate auditor and the earnings quality. The current research result was consistent with and supported by the research findings of De Angelo (1981) and Setayesh et al (2010). In their researches about the size of audit institute they concluded that bigger audit institutes have more tendencies toward honest reporting and they offer better quality audit services, because they are interested in having more reputation in the market and since they have many customers they are not worried about losing them.

Results achieved from surveying the ownership structure showed that institutional and major shareholders have a significant role in financial reporting. This could be due to the regulatory role and professionalism of this group of shareholders. Along with emphasizing on the regulatory role of this group of shareholders it is recommended that in order to preserve the rights of minority shareholders, laws and regulations and bylaws should be formulated and authorized in a way that they provide the legal rights of this group of shareholders. According to the research results it was determined that corporates being audited by the audit organization had better earnings quality, thus it is recommended to formulate and authorize laws and regulations of official audit community and stock exchange in a way that they result in formation and integration of big audit institutions. According to the incidence of earnings quality by corporates and increasing familiarity of directors with this subject they may lead to confusion of shareholders and users
of financial information, on the other hand regarding the lack of existence of complete and codified rules and regulation on controlling and monitoring this phenomenon the Securities and Exchange Organization could use the results of such researchers and impose monitoring and control on the performance of corporates by the help of shareholders and users and play a very vital role. Future researchers could survey factors encouraging the Iranian corporate directors toward imposing the corporate governance and earnings quality or they could survey the goals and tools such as directors’ performance or governmental agencies or the effect of political and social state behaviors in this field and the effect of earnings quality and they could also survey other factors affecting corporate governance such as the experience of board of directors, number of individuals having financial education, gender of board of directors, number of independent individuals of board of directors, factors of designing reward and fees and shareholders’ satisfaction rate. Also it is suggested to study the effect of capital structure and the growth opportunities on the corporate earnings quality.

REFERENCES

Yu Frank. 2006. Corporate Governance and Earnings Management. working paper of Minnesota, University of Oregon, University of Toronto, WFA.