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Study of the Relationship between Corporate Governance and Earnings Quality in TSE

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ABSTRACT: In this research, it is tried to determine the relation between governance system components and earnings quality in listed companies in Tehran stock exchange. These components include the proportion of non-executive member's board of directors, the level of ownership concentration and the percentage of changes in companies' board of director's members. This research examines 130 companies in the period of (2007-2012). The results show that in the 95 percent of confidence level, there is no relationship between the quality of earnings and proportion of non-executive members' board of directors, the level of ownership concentration, and the percentage of changes in members of board of directors. Generally, the testing of the research hypotheses showed that the components of system governance which had been discussed in this research has not any significant effect on earning quality of listed companies in Tehran Stock Exchange.
Key words: Earnings Quality, Corporate Governance Components

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INTRODUCTION

Basic Financial statements are the most important information resources for users and shareholders who are the most important group of users of financial statements. They make their decisions based on account earning. So earning quality is very important for the users. Moreover, to identify mechanisms which can increase the earning quality and decrease opposition of the available benefits between beneficiaries are very important; these goals can be reached through a well governance company system (MqryIsmail-Zadeh et al., 2010).

Since the main goal of investors is to gain more profit rather than controlling the company, it is expected from the managers to be responsible for achieving the corporate goals and to manage and monitor the corporation towards achieving more profits for its investors. As there is no ways left for the

Financial markets but to rely on the managers to predict the companies' true future, an appropriate method of corporate governance could be a useful solution for efficient management and control of businesses (Sharifi et al., 2013).

A Review on Research Literature: In recent years and following the bankruptcy of world major companies, researchers and financial analysts, shifted their attention from solely on profit figure to the quality of earning. Because of the important mechanisms and necessary actions for reaching the desired quality of earning, most of the countries have made efforts to obtain it. Among these mechanisms, being a suitable governance system in companies and economic enterprises are very important (Bvlv, 2006).

Mohamdabady and Mashayekh (2010) studied the Relationship between Corporate Governance and Earnings Quality in TSE. They found that there is no relationship between accruals quality, earnings quality as items with the corporate governance mechanisms.

Ramasay and Mather (2005) examined the impact of "Earnings quality and its relationship with aspects of corporate governance "there is aspects of a nonlinear relationship between board ownership and earnings quality. Also found that there is no relationship between the number of board members and the earnings quality

Buzak and Buzak (2007) study of 224 companies listed on Canadian stock exchange (ISX) concluded that there was an inverse relationship between ownership concentration and corporate governance.

Research Hypothesis

1. There is a significant relationship between proportion of non-executive board of directors and earning quality

2. There is a significant relationship between ownership concentration and earning quality

3. There is a significant relationship between percentage of changes in the board of directors and earnings quality (earning stability coefficient) of accepted companies in Teheran stock exchange.

MATERIALS AND METHODS

The time period of research is the study of a period of 6 years from 2007 until 2012.Tehran Stock Exchange is the place of research the statistical population consists of all companies listed in the

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Tehran Stock Exchange. The statistical sample in this research is selected using systematic removal and must have the following conditions:

1. The companies which are not investment companies, insurance companies or banks.

2. The companies whose data is available in the Time period.

3. The companies which ended their fiscal year at the end of March. Applying the above conditions, 130 companies

Were selected to estimate the models and test the hypotheses of the research.

Variables of the research: The necessitated data is provided through the application of Tehran Stock Exchange Information Center, from the financial statements of listed companies in Tehran Stock Exchange. In the present study, first the original data, from PDF files, are conveyed into Microsoft Excel. Then, the necessitated data is provided through Microsoft Excel for placement in the model. In order to analyzing data and testing hypothesis, SPSS statistical software and Excel software are used.

Dependent variable: Earnings quality: There is no general definition of earnings quality, universally accepted definition of most financial analysts is that the quality of their profits as dividends to ordinary continuous, repeatable and cash flow knows. This model had designed and presented,

$EARN_{i,t} = \alpha_0 + \alpha_1 EARN_{i,t-1} + \varepsilon_{i,t}$

$EARN_{i,t}$: Current period before Extraordinary Item sin come Items

$EARN_{i,t-1}$: Profit before prior period items Unexpected

$\varepsilon_{i,t}$: The remaining regression model

This examination for all years of study period is done by modeling companies data and a1 (coefficient of independent variable) is the level of earning stability during the research period. (In this study equations coefficient is also called earning reaction coefficient (ERC).

Independent variable: Independent variables in this research include: Non-executive board manager members. Based on the Commercial Law of Iran outside, director is any member of a company's board of directors who is not an employee or stockholder in the companies. According to this law, they aren't full-time in the Company and they are paid to get in return attend meetings of Board. Outside director's ratio is deliberated by dividing the number of Outside directors on the total number of the board of directors. This information shall be disclosed income panies' reports (Abdoli and Bahadori, 2013).

To calculate the non-executive - board manager members' variable, we have found the number of non-executive board mangers and divided it by the overall members of directors. And this variable, have shown in the form of zero and one.

Ownership Concentration: Owner ship concentration means a certain number of stockholders controlling management and all company policies including financial and operational policies. According to Iran trade law, board of directors in each company is selected by General Assembly stockholders and the number of votes of each stockholder is obtained through multiplying the number of suffrages for the number of shares by the number of directors .Thus, the stockholders with more shares will be able to select board of directors, including executive and nonexecutive board. In Iran, shares of most companies are mainly possessed by investment firms, banks, pension funds and insurance. Therefore, small stockholders do not play a major role. In this study, "Herfindahl -Hirschman" Index (HHI (has been used in order to calculate the owner ship concentration. The mentioned index is obtained from the total squared percentage of shares owned by stockholders of the companies. The index flagship increases along with increase in the owner ship concentration and when all shares are owned by one person, it reaches to the maximum value calculated by10, 000 units. If the ownership structure is dispersed and all stockholders have equal ratios, HHI index reaches to the minimum value calculated by N/10000

HHI = Σ (pi /p *100(2 (Abdoli and Bahadori, 2013). Change percentage of board director: To calculate we obtained change of the board directors and divided it on the whole members of board managers. This variable also described as zero and one.

Controllable variables: In this research, it is used three controllable variables (return on assets, operating risk and financial leverage). The amount of assets returning is obtained by ratio of operating profit before tax on the total investment. This ratio calculates the amount of company's shares per each Rial of company's whole investment. The larger this ratio shows the better company's incoming profits. Operating risk is the standard deviation of the company's sales during the period of investigation. It's expected that companies with firm risks have a lower sustained profitability. Financial leverage is calculated from divided companies' total debate on the companies' whole assets. For investigating the relationship between components of governance system and earnings quality of companies the model 1 has been used: $EARN_{i\,t} = \alpha_0 + \beta_1$ Out board + β_2 own conc+ β_3 (board change) +$\beta_4$control variable + $\acute{\varepsilon}$

Out board: proportion of non-executive members' board of directors. Ownconc: Level of ownership concentration board change: the percentage of changes in companies' board members of directors.

Unpredictable error: Outboard: proportion of non-executive -board director member and own conc.: level of companies' ownership concentration. Change board: changes percentage of director members and e unpredictable error.

RESULTS

Descriptive characteristics are examined as the table 1. Descriptive results of the research variables show that the mean of dependent variables, that's to say the quality of company earnings Is 0.3479 and standard deviations of it is 0.3720 Also, the independent variables mean Proportion of non –executive members board of directors, level of ownership concentration , the percentage of changes board members of directors 0.6795, 3833.6560 and 0.2193 respectively.

Hypotheses testing: The examination of result of the statistical summary and Anova table 2, 3 show that non-executive board directors' variables, level of ownership concentration and changing percentage of managers are the major variables researches which could obtain 3% of whole earnings quality changes of companies.

Table 1. Descriptive statistics of study variables

Variables	Earning quality	ownership concentration	percentage of changes board	percentage of changes board
N	125	125	125	125
Mean	.3479	3833.6560	0.6795	0.2193
SD	.56407	1988.53956	0.16164	0.12500
Variance	0.318	3954289.598	0.026	0.016
Skewness	0.070	0.773	-0.729	0.140
Kurtosis	0.158	0.584	-0.256	-0.750
Minimum	-1.13	80.00	0.20	0
Maximum	1.83	10000.00	0.91	0.47

These results show that nearly one percent of earning quality company changes in the sample of this research explained by independent variable of non-executive board directors' proportion ownership concentration level and the percent of managers changes. And the rest of the changes (99.7%) is the portion of other reasons and random events that are out of the sample. given the coverage of F is larger than 5%(sing=0.952) so we can expect H0 and reject H1 with more than 99 % certainly . It means that the theory of linear regression model could not be accepted. This means that there is no relationship between governance system components and earnings quality index in accepted companies in Tehran Stock exchange. Also investigation of the coefficient show that mangers percentage changes had a positive impact and non-board directors and ownership concentration level have bad effects, even they are very little.

And The examination of the result of the statistical summary and Anova table 4,5 show that: about control variables: a ratio of dependent variables variance that obtained with help of independent variables by control variable is calculated only 0.007 in other words , non –board director proportion variables ,ownership concentration level , and managers percentage changes , financial lever , performance risk and assets output could only explain 0.7% of the whole earning quality and the others are the portions of other reasons and accidental events . Given that coverage of F (0.126) in error level of 5% (Sig=0.993) is obtained larger than 5% so the linear theory of regression model is rejected and we can accept H0 and reject H1 with 99% of certainty. It means that there is no significant correlation between independent variables with companies' earnings quality. Also investigation of coefficient in controllable variables Entrance shows that financial lever and assets output have negative effect and performance risk has positive impacts.

Table 2. Model Summary b

Model	R	R^2	Adjusted R^2	Std. Error of the Estimate	Durbin-Watson
1	0.052[a]	0.003	-0.023	0.50547	1.589

a. Predictors: (Constant), X3. Percentage of changes board, X1. , ownership concentration X2. Percentage of changes board b. Dependent Variable: Earning quality

Table 3.ANOVAb

Model	Source	SS	DF	MS	F	Sig.
1	**Regression**	.087	3	0.029	0.113	0.952[a]
	Residual	29.638	116	0.256		
	Total	29.725	119			

a. Predictors: (Constant), X3. Percentage of changes board, X1. , ownership concentration X2. Percentage of changes board b. Dependent Variable: Earning quality

Table 4. Model Summary b

Model	R	R^2	Adjusted R^2	Std. Error of the Estimate	Durbin-Watson
1	0.082[a]	0.007	-0.046	0.51118	1.602

a. non –executive board, ownership concentration, percentage of changes board, financial leverage, operating risk and return on assets, b. Dependent Variable, Earning quality.

Table 5.ANOVAb

Model	Source	SS	DF	MS	F	Sig.
1	**Regression**	0.198	6	0.033	0.126	0.993[a]
	Residual	29.527	113	0.261		
	Total	29.725	119			

a. non –executive board, ownership concentration, percentage of changes board, financial leverage, operating risk and return on assets

DISCUSSION

The results of the main theory with 3 sub-theories show that there is no significant correlation between governance systems ability (proportion of non-executive - board directors, ownership, and concentration level and managers percentage changes) and the indexes of earning quality.

Suggestions:

Recommendations resulting from the research:

1- Given that there is no significant relationship between non -executive – board of directors proportion and earnings quality, so it suggested that analysts consider this criterion in their investigations.

2- Given that there is no significant relationship between ownership concentration and earnings quality, therefore it recommended that analysts consider the criterion in their evaluations

3- Given that there is no significant relationship between percentages of changes board members of director and earnings quality, so it recommended that analysts consider this criterion in their evaluations.

Suggestions for future researches: According to the results of the research, following suggestions are offered: a)Influential factors on corporate governance such as internal factors, government policy and external factors such as capital flows from outside to inside should be discussed .b) in order to do research from unlisted companies of stock exchange we should use them too. c) in a similar research, effects of other variables such as proportion of shares to assets, company size, return on assets, balanced assets output, shares output, ownership concentration, percentage of changes in board of directors, proportion of non-executive board of managers, profitability, size of board of directors and etc., on earnings quality for a longer period of time and extended statistical samples should be investigated and should be compared with this researcher results.

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