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The relationship between corporate governance and earnings management in banks listed on Tehran Stock Exchange

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Abstract
This study, in order to provide evidence about the effectiveness of corporate governance tools (content management stock ownership, institutional ownership and the percentage of non-duty members of the Board of Directors) on earnings management in banks was listed on Tehran Stock Exchange during 2009-2013.The sample consisted of 10 banks (all banks listed) were selected as sample data obtained through library research and application of new outcomes were collected.
In this study, three variables of management stock ownership, institutional ownership and the percentage of non-duty members of the Board of Directors as independent variables used tools of corporate governance. Also, to measure earnings management the modified Jones model and to test hypotheses of multivariate regression was used and significance was determined using t and F statistics. Finally, it was determined that between three characteristics of corporate governance (institutional ownership percentage of share ownership required for managers and other members of the board) and there was no profit management.
Keywords: Earnings management, institutional ownership percentage of share ownership management, the percentage of non-duty members of the Board of Directors

1. Introduction

The primary objective of financial statements is to provide users with information relating to the uncertainty and timing of future cash flows. Relevance of accounting numbers creates powerful incentives for managers to manipulate earnings to their advantages (Abdul Rahman & Ali, 2006). Healy and Wahlen (1999) stated two competing reasons for managers to manipulate their income. The first is the capital market pressure which states that the widespread use of accounting information by investors and financial analysts for stock valuation creates incentives for executives to manage earnings in order to influence short-term stock performance. The second reason is contracting motivation which stresses the use of accounting data to monitor and regulate contracts between firms and their stakeholders. Managers can manipulate earnings in order to maximize their income or to signal their private information, thus influencing the formativeness of earnings (Gul et al., 2003). Schipper (1989) and Healy and Wahlen (1999) declared that earnings management is the alternation of performance by insiders to either mislead some stakeholders or to influence contractual outcomes. In other words, managers can work opportunistically for their advantage and disadvantage for their companies.

Dechow et al. (1996) highlighted that accounting earnings are more reliable and more informative when managers' opportunistic behavior is controlled through a variety of monitoring systems. The bankrupt of large companies has raised serious questions about the effectiveness of different monitoring devices such as external examiner, voluntary disclosure and corporate governance mechanism (Ebrahim, 2007). There has been debate in the literature about the effectiveness of corporate governance factors. Corporate governance implies an explicit responsibility for boards in the financial reporting process. In doing so, it raises the expectation that boards will constrain opportunistic earnings management activities (Epps & Ismail, 2008). Fama and Jensen (1983) stated that board of directors has important role in protecting shareholder interests by monitoring firm's management team. Based on agency theory framework, outside directors have an incentive to avoid colluding with managers because the value of independent directors'

Human capital is partially determined by the effectiveness of their monitoring performance (Fama and Jensen, 1983). Otherwise, the value of their human capital as outside directors may diminish. Therefore, outside directors are widely believed to protect the interests of shareholders more effectively.

Also, the internal mechanisms of corporate governance in a company, including a variety of organizational arrangements and procedures used by companies to the balance of power and responsibilities between shareholders, board members, executives and employees of the company (Beasley et al., 2000, Flo et al., 2001). The ownership structure, board structure, the board, the board members are outside directors, managing director and chairman of the board of the same characteristics of the audit committee and the determinants and impact the ongoing corporate governance mechanisms (Karselo and Neil, 2000; Cohen et al., 2002; Liu and Sun, 2005). Many studies in the field of corporate governance mechanisms in corporate focus on this that weakness in the mechanisms of corporate governance in a company with low quality reporting of financial statements, profit and earnings manipulation and fraud, as well as the low level of transparency of information and poor communication. (Beasley et al., 2000, Karselo and Neil, 2000, Flo et al., 2001). Uncertainty and lack of transparency in financial information released by the company are Because of weakness in the company's corporate governance mechanisms established , allow the controlling shareholders that their own interests at the expense of other shareholders in the company have maintained their own wealth. There are important mechanisms that influence it and achieve the desired quality of earnings; most communities are struggling to provide these mechanisms have done. One of these mechanisms, there is a good system of corporate governance in companies and enterprises that most countries have put efforts to strengthen and improve it. Most previous studies carried out in Iran in the field of earnings management in general, corporate governance and its impact on all companies listed on the stock exchange by ignoring investment companies, financial intermediaries and banks due to the specific nature of it.

2.Literature Review

2.1 Earnings management

This is generally believed by the regulators and the public that managers manipulate reported earnings (Levitt (1998); Loomis (1999)). A large body of academic research has examined the existence of earnings management, in particular, around specific corporate events in which agency problem is most likely to occur. Perry and Williams (1994) provides evidence of managers' manipulation of earnings in the predicted direction in the year preceding the public announcement of management's buyout intention. Erickson and Wang (1999) find that acquiring firms manipulate accounting earnings upward prior to stock for stock corporate mergers. Teoh et al (1998a and 1998b) find that managers raise reported earnings before initial public offerings and seasoned equity offerings.

Managers have various incentives to manipulate earnings. Some incentives are provided by contractual arrangements based on accounting earnings such as bonus plan, debt and dividend covenants, etc. For example, DeFond and Jiambalvo (1994) find that sample firms accelerate earnings prior to lending covenants, and Holthausen, Larcker and Sloan (1995) find that managers manipulate earnings downwards when their bonus are at their maximum. In some cases, earnings management is motivated by regulatory reasons. Previous studies find that managers would manipulate earnings to circumvent industry regulations and reduce the risk of investigation by anti-trust regulators (Collins et al (1995); Cahan (1992)). However, recent research has been focus more on incentives provided by the capital market. Dechow and Skinner (2000) suggest that accounting information such as earnings is important for capital market to value the firm, and the increased stock market valuations and stock-based compensation during 1990's make managers have more incentives to manage earnings. The results of empirical researches are generally supportive to this assertion. Some recent studies show that firms "overstate" earnings prior to seasoned equity offering (SEO), initial public offering (IPO) and stock for stock mergers (Teoh et al (1998a, b); Erickson and Wang (1999)) in order to get favorable valuation by capital markets. Moreover Perry and Williams (1994) find evidence of earnings understatement problem prior to a management buyout.

Earnings management is different from accounting frauds which violate Generally Accepted Accounting Principles, because the opportunities of earnings management are inherent in the current financial reporting system. Xie et al (2003) argue that the nature of accrual accounting gives managers considerable discretion in determining the earnings in any given period. According to Teoh et al (1998a), within the boundary of GAAP, managers have several sources to manipulate earnings. They can choose an accounting method to advance or delay the recognition of revenues and expenses, use discretionary aspects of the application of the chosen accounting method, or adjust the timing of asset acquisitions and dispositions to alter reported earnings.

Although Schipper (1989) suggests that earnings management could possibly be beneficial by providing a means for management to convey their private information on firm performance, there is a potential danger of wealth loss for shareholders when the interests of mangers and shareholders conflict. Since the managers are compensated explicitly (salary, bonus, stock option, etc) and implicitly (job security, reputation, etc) on the firm's earnings. Managers may conceal the true performance by earnings management to get a higher compensation or keep their jobs at the cost of shareholder's interest. Moreover, the earnings management increases the information asymmetry between managers and shareholders, thus investors may make wrong decisions based on misleading earnings information. For example, Teoh et al (1998) find that IPO issuers who manage earnings aggressively perform relatively bad after IPO compared to those manage earnings conservatively and demonstrate the wealth of outside shareholders can be harmed by earnings management.

A number of prior studies examine the existence of earnings management by identifying a situation where earnings management is likely to occur and estimating discretionary accruals. However, some recent papers test earnings management by examining the distribution of reported earnings (Burgstahler and Dichev (1997); Degeorge et al (1999); Brown (2001)). These studies find that the frequency of firms with small positive earnings (positive earnings changes or earnings surprise) is higher than expected, while the frequency of firms with small negative earnings (negative earnings changes or earnings surprises) is less than expected. These results are explained as the evidence of income-increasing earnings management and support the hypothesis that managers have incentives to avoid reporting loss, earnings declines, and earnings missing analysts' forecasts. The reason why meeting such simple benchmarks is so important to managers is probably due to the capital market reaction. According to Barth et al (1999) and Skinner and Sloan (2000), failure to meet these earnings benchmarks will cause a dramatic drop of stock price. Since the personal wealth of top managers is tied more closely to their firms' stock price in form of stock-based compensation plan in recent years, it is reasonable to argue that managers have strong incentives to manipulate earnings to avoid missing earnings benchmarks. Thus, in this thesis, I identify the firms which are in danger of missing some earnings benchmarks and test whether the board of directors and audit committee could constrain earnings management behavior when managers have strong incentives to do so. However, managers may also adjust earnings downward in some situations. Degeorge et al (1999) argue that earnings far beyond the thresholds will be reined in to make future earning thresholds more attainable. Therefore I will also examine the ability of board and audit committee in reducing income-decreasing earnings management.

2-2.Corporate governance mechanism

- ***Percent of Independent outside Directors on the Board***

There is a considerable literature regarding the effect of the composition of the board of directors (i.e., inside versus outside directors). Agency theory supports the idea that board independence should be denominated by outside director. Dunn (1987) highlighted that board dominated by outsiders is in a better position to monitor and control managers. Fama and Jensen (1983) argued that the role of the board of directors is to protect shareholder interests by monitoring managers. An important factor that may affect the board's ability to monitor the firm's managers is its composition and the percentage of independent directors on the board.

A number of studies have linked the proportion of outside directors to financial performance and shareholder wealth (e.i., Brickley et al., 1994). Moreover, the dominance of non-executive directors is more effective in monitoring management. Klein (2002), Xie et al. (2003), Sonda et al. (2003) and Peasnell et al. (2005) provided evidence concerning board independence and earnings manipulation and found that companies with independent boards are less likely to report abnormal accruals. Conversely, Park and Shin (2003), Abdul Rahman and Ali (2006) and Osama and Noguer (2007) found no relationship between outsider directors and earnings management. On the other hand, other studies proposing that completely independent boards may not be effective in monitoring management. For example, Agrawal and Knoeber (1996) found a negative relationship between independent board and firm performance, leading them to conclude that boards that have too many outsiders lose the expertise associated with officers serving on the board.

- ***Board Size***

Board size is viewed as an important element of board characteristics that may affect earnings management (Abdul Rahman and Ali, 2006). The Jordanian code of corporate governance documents that the number of board members has been left to the internal system of the company, although in all cases it should not be less than 5 members and not more than 13 members. Previous studies failed to provide empirical evidence between board size and the effectiveness of monitoring managers. For example, studies of Yermack (1996), Huther (1997) and Andres et al. (2005) indicated that larger board size might be less effective in monitoring management activities. Nevertheless, Dalton et al. (1999) showed that larger board members provide more advantages for their companies through sharing alternative experience which might decrease the incidence of earnings management. Previous studies have used board size as a determinant of earnings management, but the influence of board size has received mixed results in previous studies. For example, Abdul Rahman and Ali (2006) found a positive relation between earnings management and board size. However, Xie et al. (2003) and Peasnell et al. (2005) found a negative association between earnings management and board size. Interestingly, Abbott et al. (2000) found no relation between quality of earnings and board size.

- ***Role Duality***

Consistent with agency theory, the Jordanian corporate governance codes recommend that the role of the chairman should be separated from that of the CEO to ensure that the later would not be in a position with too much power to handle daily business operations. That is, CEO with excessive power over board could easily manipulate income. The dual office structure also permits the CEO to effectively control information available to other board members and thus impede effective monitoring (Jensen, 1993).However, stewardship theory argues that role duality improve firm performance, because management's compensation is tied to the firm performance. Previous studies examined the relation between earnings management and role duality. For example, Klein (2002) found that discretionary accrual is positively related to the CEO duality. In contrast, Beasley (1996) documented no significant relation between the likelihood of financial statements fraud and CEO duality. In the same manner, Abdul Rahman and Ali (2006) found that separation between the role of CEO and chairman has no effect on earnings management.

- ***Concentrated Ownership***

Agency theory suggests that shareholdings held by managers help align their interests with those of shareholders (Jensen and Meckling, 1976). Furthermore, under the convergence-of-interest hypothesis, insider ownership can be seen as a mechanism to constrain the opportunistic behavior of managers and, therefore, earnings management is predicted to be negatively associated with insider ownership (Warfield et al., 1995). Unlike the UK and the US which have dispersed ownership, ownership in Jordanian public listed companies are much more concentrated or owned by family or identifiable group (Al-Fayoumi et al., 2010). Previous studies on earnings management found a negative association between earnings management and insider ownership (Warfield et al., 1995; Chtourou et al., 2001; Abdul Rahman and Ali, 2006). In contrast, Al-Fayoumi et al. (2010) indicated that insiders' ownership is significantly and positively affect earnings management.

3. Research hypotheses

Given that the purpose of this study was to investigate the relationship between corporate governance and management characteristics of interest in the bank is listed in the Tehran Stock Exchange, the research hypotheses are as follows:

- First hypothesis: the percentage of share ownership interest in the bank's executive management listed on Tehran Stock Exchange there is a significant relationship.
- The second hypothesis: the ownership interest in an entity with the management of the banks listed in the Tehran Stock Exchange, there is a significant relationship.
- The third hypothesis: the percentage of non-duty members of the management board gains in banks listed in the Tehran Stock Exchange, there is a significant relationship.

4 -variables and how to measure them

Variable earnings management (accrual accounting unusual) as the dependent variable is. In this study, an adjusted version of Jones's model was developed by Dechow and others, which are used to estimate abnormal accruals accounting is calculated as follows:

$$CACC_{it} = (\Delta CA_{it} - \Delta CASH_{it}) - (\Delta CL_{it} - \Delta CLD_{it}) \tag{1}$$

Where in:
$CACC_{it}$: total current accruals (working capital) for the firm i in year t;
ΔCA_{it}: Change in current assets for firm I in year t;
$\Delta CASH_{it}$: change in cash for the firm I in year t;
ΔCL_{it}: Change in current liabilities for the firm I in year t;
ΔCLD_{it}: Change in current portion of long-term debt for the firm I in year t;

$$CACC_{it} / TA_{it-1} = \beta_{0i} + \beta_{1i} [(\Delta REV_{it} - \Delta REC_{it}) / TA_{it-1}] + \beta_{2i} [(\Delta COGS_{it} + \Delta INV_{it}) / TA_{it-1}] + \beta_{3i} (\Delta OCF_{it} / TA_{it-1}) + \varepsilon_{it} \tag{2}$$

$CACC_{it}$: the accrual accounting for the firm I in year t, according to the model number (1);
ΔREV_{it}: changes in revenues for the firm i in year t to year t-1;
ΔREC_{it}: Change in accounts receivable for the firm I in year t to year t-1;
$\Delta COGS_{it}$: changes in the cost of goods sold for the firm I in year t to year t-1;
ΔINV_{it}: change in inventories of goods in year t minus the change in inventories of goods in year t-1;
ΔOCF_{it}: change in operating cash flow for the firm I in year t to year t-1;
TA_{it-1}: Total assets of firm I in year t;
e_{it}: the error for firm I in year t (an indicator of abnormal accruals)

Independent variable

In this study, four independent variables to be considered are as follows:

• The percentage of shares owned by directors:

The percentage of ownership of the board members shall receive a fixed salary from the company and their family members in the shares of companies that are the responsibility of the board members must often or managing director or managing director are closely related.

• Institutional ownership

Is equal to the stock in the hands of big investors such as banks, insurance companies, pension funds, investment companies and other public companies (Bvshy, 1998: 306). This variable Avgarlv research (2000), Didmen (2000), Charv et al. (2005), Lang and Saho (2008) and Alsayd (2010) is used in the same sense.

• The percentage of outside board members:

Outside members of the Board of Directors refers to persons whose part-time member of the Board of Directors and the firm does not receive a fixed salary (Ghaemi and Shahriari, 2009: 120). According to Lee (1994), Denis and Sarin (1999), periost (2002), Charv et al. (2005), Donnelly and Kelly (2005), Boone et al. (2007), Goust

(2008), Cools et al. (2008), link et al. (2008), evasaky (2008), Chayn (2008), Lee and Harrison (2008), Atmaja et al (2009), Lyhn et al (2009), Chaizma and Kim (2010) and Hey and Sumer (2010) and Pathan and School (2010), a study of outside board members to the total number of board members is used.

5 - Sample statistics

The population of this research has been accepted by all banks in the Tehran Stock Exchange (currently 10 banks) during 2009 to 2013 is formed.

6. Methods

Since this study is to investigate the relationship between corporate governance and management features in bank profits is accepted in Tehran Stock Exchange; research for the study, correlation and multiple regression to test the relationship between these variables is used to stepwise.

Following regression model was used to test the hypotheses:

$$AA_{it,} = \beta_0 + \beta 1\ OCit + \beta 2\ BSitt + \beta 3\ CEOit + \acute{\varepsilon}_{i,t} \qquad (3)$$

Row	Symbol	شرح
1	AA_{it}	Management Earnings (abnormal accruals) of the remaining model number (2) (the dependent variable)
2	OC_{it}	Institutional ownership i at time t (independent variable)
3	BS_{it}	Percent share ownership in the Company i t (independent variable)
4	CEO_{it}	Percent of the members corporate executives outside i in period t independent

7. Data collection method and scope of spatial and temporal

The required data through observation and review of documents such as financial data banks collected. In this study, to develop research literature library method has been used to test research hypotheses financial statements of companies listed on the stock exchange and application of the outcomes of the new site, have been used. The research on the banks listed in the Tehran Stock Exchange is done and the period in question, from the beginning to the end of 2009 to 2013.

8. Data analysis

In this study, the Pearson correlation coefficient and multiple regression was used to analyze the data. Preliminary data in the Excel spreadsheet file format in software design was completed and data to statistical analysis, SPSS software was used.

9. The results of the test the research hypothesis

Table 1: The incoming variables

The variables entering	method	Enter regression model
Possession shareholders	Enter	1
The percentage of non-duty members of the Board of Directors	Enter	2
The percentage of institutional ownership	Enter	3

As the table (1) can be seen, the results of the test variables are entered into the model using regression. This test can be optimized using the regression model and independent variables, which can be entered into the regression model, to determine. The results indicate that the independent variables were entered into the model.

Table 2: Summary of regression

Regression model	R	R^2	Adjusted R^2	The estimated standard deviation
1	0.311	0.097	0.672	0.0125

Coefficient of determination as well as measure the strength of the relationship between independent variables and the dependent variable and describes the control. The value of this parameter indicates that the percentage of variability explained by the independent variables and control .As the Table 2 can be seen in this model, the coefficient of determination is equal to 0.097. I.e. 9.7% of the variability is explained by the independent variables and control.

9-1-test the significance of the regression model assumptions:

Table 3: Test the significance of the regression model using ANOVA

Multivariate regression model		Total squares	Significance level	Degrees of freedom	Mean square	F statistics
1	Regression	0.001	0.0	3	0	1.647
	Residuals	0.007		46	0	
	Total	0.008		49		

In a multivariable regression equation, if any relationship between independent variables and the dependent variable and there is no control, we control all the parameters and independent variables in the equation equal to zero. Therefore, the significance of the regression tested. This is done using F statistics. As shown in Table (3) observed, the F-statistics and the significance of this statistic indicates that statistical null hypothesis that the meaningless of the whole model (all zero coefficients) is rejected and regression the estimated total is significant.

9-2-sample t-test to evaluate significant regression coefficients minor

Using a t-test to evaluate the significance Student factors described above. If the confidence level of the absolute value of α is smaller than expected, there will prove to be a factor in the model.

Table (4): Results of t-test to assess partial regression coefficients are significant

Regression model	Not standardized coefficients		standardized coefficients	T-Test	significant
	standard deviation	coefficient	Beta		
constant	0.005	0.010		2.032	0.048
Institutional ownership	0.018	0.009	0.095	2.432	0.632
Percent share ownership	0.011	0.014	0.242	1.352	0.183
Percent of the members outside	0.010	0.0	0.06	0.0039	0.969

• First hypothesis: an institution to manage the impact of interest listed in the Tehran Stock Exchange.

As shown in Table (4) Therefore, the level of institutional ownership of the independent variables shows that there is a positive relationship between institutional ownership and earnings management. Also, given that the level of significance of the relationship between earnings management and institutional ownership of more than 5 percent, so this is meaningless. Therefore, the first hypothesis of the study will not be accepted.

• The second hypothesis: the percentage of shares owned by directors of listed banks in Tehran Stock Exchange on earnings management influence.

As shown in Table (4) is significant, positive relationship between the percentage of share ownership and earnings management executives there. However, given that the significant levels of share ownership and earnings management executives (sig = 0.183> 0.05). So this is not significant. Therefore, the second hypothesis is not accepted.

The third hypothesis: the percentage of non-Earnings management shall affect banks listed in Tehran Stock Exchange.

As shown in Table (4) is considered the percentage of non-duty members of the board and there is a positive relationship between earnings management. Also, given that the level of significance required in the relationship between earnings management and the percentage of non-members (Sig = 0.969> 0.05). So, it is not significant in this regard. Therefore, the hypothesis that the third sub-study will not be accepted.

10. Conclusion recommendations based on the results

The results showed that all banks listed in the Tehran Stock Exchange, the three characteristics of corporate governance (institutional ownership percentage of share ownership required for managers and other members of the board) in earnings management incentives with Earnings management association do not meaningful. In other words, three features of corporate governance in the management of Earnings or motivation, time management, high profit and low-Earnings management at the time did not have the motivation. Finally, we can conclude that three corporate governance features examined in the present study can impact on earnings management in banks is accepted in Tehran Stock Exchange. Thus, according to the results of research in order to protect the rights of minority shareholders, increasing the reliability of profit and contribute to the development and growth of the stock market, be other mechanisms of corporate governance, such as the independence of the Board of Directors, the Board of Directors, the Audit and Audit Committee in order to reduce the incentive for earnings management by executives of the bank to protect the rights of shareholders to be considered.

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