Evaluating Effect of Corporate Governance Mechanisms on Financial Reporting Quality

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Abstract
The present study aims at evaluating effects of some of the most important corporate governance mechanisms on improvement of financial reporting quality in Tehran stock exchange. Therefore, it studies corporate governance mechanisms including ownership percentage of institutional investors, ownership centralization, type of auditor, and independency of members of board of directors and their effect on financial reporting quality (Barth, 2001). Also, the research uses control variables, e.g. firm size, financial leverage, and market to book value ratio. This is an applied and causal research considering its type and method. Tehran stock exchange listed firms constitute statistical population of the research. The sample was selected using systematic exclusion sampling method and imposing conditions of the research variables to 75 firms of 17 industries during 2012-2017. Statistical technique of panel data regression was used to analyze data and test the hypotheses. According to the results, there is a positive and meaningful relation between ownership centralization, and financial reporting quality. Additionally, there is not any relation between variables of ownership percentage of institutional investors, type of auditor, independency of members of board of directors and financial reporting quality.

Keywords: Institutional investors’ ownership, Ownership centralization, Type of auditor, Independency of members of board of directors, Financial reporting quality
Introduction

“Corporation governance system” is a response to agency problem arising from “separation of control from ownership”. Before 1970s when “Agency theory” and “conflict of interests” were introduced, “firms’ governance structure” was less focused on. Following agency theory, agency relations widely affected different subjects of financial literature. Firms’ governance gradually attracted more attentions especially through appearing of financial disrepute, bankruptcy, and financial corruption of companies during late of 20th century (Rezaei & Dousti, 2011). In fact, separation of stock ownership and management control on firm operation may lead to conflict of interests and agency expenses resulting from the conflict of interests between managers and stockholders. Ignoring the agency problem, reporting quality will not suffer any special problem since managers have not any motivation to distort the financial reports or conceal the information.

Corporate governance is a mechanism to mitigate agency problems. Based on some laws, e.g. Sarbanes-Oxley (2002), the USA legislative organizations required the managers to guarantee financial reports, empowerment of corporation governance, and improvement of auditor independency in order to improve financial reporting quality (Nikoumaram & Mohammadzadeh Saleteh, 2010).

Conceptual Framework

Corporate Governance

According to available literature, there is not any determinate definition about corporate governance. The definitions are placed in wide spectrum beginning with limited perspectives and ending with the extensive ones. In limited perspectives, corporate governance is limited to relation between firm and stockholders. The pattern is stated as agency theory. At the other end of the spectrum, corporate governance is considered as a network of relations between firm and their owners (stockholders) as well as several beneficiaries including staff, customers, sellers, bond holders, and etc. The perspective is regarded as stakeholder theory (Aghaei et al, 2009). Corporate governance mechanisms affect quality of information disclosed by firms. Disclosure of transparent financial information minimizes agency problems through lessening of informational asymmetry between management and stockholders. In contrast, disclosure of unclear financial information often misleads stockholders and, therefore, adversely affects their wealth. According to prior studies, corporate governance mechanisms including properties of board of directors, ownership structures, and audit quality affect financial information disclosure procedure. Thus, corporate governance is introduced as a factor improving quality of information provided by the management (Sabzalipour et al, 2012).
Corporate governance mechanisms and their role in financial reporting quality

Structure of Board of Directors

A. Role of non-executive directors in financial reporting quality

From agency theory viewpoint, presence of non-executive independent managers in firms’ board of directors and their supervising function as independent persons is really helpful in reducing conflict of interests between stockholders and managers. Corporate governance literature significantly emphasizes on role of non-executive managers in solving agency problem through developing appropriate employment contracts and supervising on managers’ behavior. According to the researches, effect of board of directors in supporting from stockholders interests is a positive function of non-executive managers’ ratio in board of directors (Ahmadpour et al, 2009). To quantify the index, most accounting researches used non-executive managers to all members of board of directors’ ratio.

Firms’ ownership structure

A. Role of institutional stockholders in financial reporting quality

Institutional investors are another mechanism of corporate governance supervising the firm management since they may both significantly affect the firm management and coordinate interests of stockholders. The ways used by stockholders to supervise on management are generally introduced in the frame of agency theory. There are two ideologies about role of institutional investors in firms: 1) institutional investors are inherently short-termism. They are temporary investors mainly consider running yield rather than long-term interests in determining share price, and 2) if stocks are owned by few investors (especially institutional ones), there will be less problems considering separating ownership from control. Therefore, it supposes a supervisor role for institutional investors and states that their presence lessens probability of profit management and motivation of managers to do so (Ahmadpour et al, 2009).

B. Ownership Centralization

It is defined as a condition where significant rate of stocks belong to major stockholders and indicates to percentage of stocks hold by limited number of persons. According to Mahdavi and Heidari (2005), there was very high rate of ownership centralization in Tehran stock exchange in 2005 such that shares of five major stockholders of firms of Tehran stock exchange were averagely estimated as 74%. Also, shares of 10 main stockholders as well as 20 stockholders were more than 79% and 9%, respectively. According to Herfindahl index and three other indexes (shares of 5, 10, and 20 major stockholders), machinery manufacturing industry and mining industry experienced the highest rate of ownership centralization (Etemadi et al, 2009).

Empirical researches offered different approaches to measure ownership centralization. For example, Demsetz and Lehn (1985) define ownership centralization as sum of shares hold by 5 or 20
main stockholders and Rock (1989) and Telgoli et al (2003) explain ownership centralization as sum of percentages of major stockholders holding more than 5% of shares (Baradaran et al, 2012).

Role of audit authority in financial reporting quality

As an important hypothesis, agency theory states that confirmation of the broker affairs is difficult and complex for the employer. Independence audit is regarded as one of the most important and effective methods to coordinate interests of stockholders and managers. On the other hand, reputation of audit organization significantly affects validity and reliability of accounting data. Theoretically, size of audit organization directly affects reliability and reputation of the firm. Francis and Simon (1987), Day (1993), Yang Jonathan and Line (1993), and Hogan and Jotter (1997) suggested that major audit organizations offer high quality audit in comparison with the minor ones (Baradaran et al, 2012).

Financial reporting quality

Firms use financial statements to disclose information related to their performance and financial status. Disclosure is defined as providing and transferring economical information including financial, non-financial, quantitative, or other forms related to financial status and performance of the firms. If disclosure is required by regulations, it is called compulsory disclosure; otherwise, it is voluntary one (Lashgari & Mahmoudi, 2007).

Quality of financial reporting and disclosure is a necessity. Financial reporting quality leads to better prediction of future cash flows of firm for investors and other users of financial statements. Evidently, quality level of financial reporting has economical effects since there is a mutual interaction between accounting and economy. Usefulness of financial statements or other financial reports is influenced by financial reporting quality where procedure stability and information accuracy are regarded as key aspects of quality. Financial reporting quality is standard separating useful information from other ones and promotes usefulness of financial information (Nourvash, 1998).

Although it may be expected that better corporate governance leads to improvement of financial reporting, it is not the fact. There is not any general agreement on what should be covered by financial reporting quality. Instead of defining financial reporting quality, prior studies emphasized on hindering factors such as profit management, re-presenting of financial statements, and forge. They regarded a financial reporting process unsuccessful once they observed the above-mentioned factors. On the other hand, prior studies dealt with role of different actors of corporate governance scene (board of directors, audit committee, independent auditors, and internal auditors) and the range where the mentioned actors may individually or collectively affect the process of sincere and just presentation of financial reports (Hassas Yeganeh & Baghoumian, 2005). Several factors may affect financial reporting quality. The research questions whether corporate governance mechanisms affect financial reporting quality of firms.
Research History

Levitt (1996) studied the relation found between corporate governance and financial reporting quality and concluded that there is a positive relation between properties of corporate governance and financial reporting procedures.

Goodwin and Lin Seow (2002) evaluated effect of corporate governance mechanisms on financial reporting quality in Singapore. According to their findings, there is a relation between potency of audit committee, availability of internal auditor, potency of law of corporations, and financial reporting quality.

In their study, Ramasay and Mather (2005) found a nonlinear relation between ownership percentage of members of board of directors and profit quality and a positive relation between independent managers and profit quality ratio. Additionally, they noticed that there is not any relation between number of members of board of directors and profit quality level.

Cheng & Courtenay (2006) demonstrated that firms with high ratio of independent members of board of directors take benefit of high levels of voluntary disclosure. Therefore, there is a direct relation between number of independent members of board of directors and high quality financial disclosure.

Beekes & Brown (2006) studied the relation between corporate governance index and several indexes of disclosure quality including accuracy, deviation, and difference rate in profit prediction by analyzers. They concluded that disclosure of firms with efficient corporate governance is more accurate. Also, they found that size of board of directors is another property of board of directors which is in direct relation with disclosure quality.

Nasrollahi and Arefmanesh (2010) studied the relation between ownership and profit quality. To evaluate profit quality, they used qualitative features of accounting information in accordance with theoretical concepts of Iran Accounting Standards. According to their research, presence of institutional investors in ownership structure of firms leads to more sincere, relevant, fair, and on-time presentation of information and profit quality is reduced through centralization of institutional investors ownership.

Ebrahimi Kordlar and Arabi (2010) studied the relation between ownership centralization and profit quality. To evaluate profit quality, they used qualitative features of accounting information in accordance with theoretical concepts of Iran Accounting Standards (relevance and reliability). According to the results, inter-organizational ownership centralization leads to improvement of profit quality. However, there is not any persuasive evidence considering effect of intra-organizational block-holders on profit quality.

In their study, Aghaei and Chalaki (2009) evaluated the relation between properties of corporate governance and profit management in Tehran stock exchange listed firms. They found that there is a negative meaningful relation between institutional ownership and independency of board of directors, and profit management. Additionally, there is not any meaningful relation between other properties
of corporate governance (ownership centralization, managing director influence, duality of managing director duties, reliance of debt, and duration of occupying the post of managing director) and profit management.

Hadavi (2008) studied the relation between profit quality and corporate governance and indicated to lack of any meaningful correlation between ownership percentage of members of board of directors and number of non-executive members of board of directors, and profit quality.

Mashaiekh and Esmaeili (2006) studied the relation between profit quality and some aspects of strategic principles of Tehran stock exchange listed firms and found that there is not any relation between profit quality, ownership percentage of members of board of directors, and number of non-executive members of board of directors. However, there was a nonlinear relation between accrual items and ownership percentage of members of board of directors. Generally, number of non-executive managers and ownership percentage of members of board of directors regarded as corporate governance mechanisms do not play an important role in promoting profit quality of stock exchange listed firms.

**Research hypothesis**
Corporate governance mechanisms affect financial reporting quality.

**Research method**
**Type of research method**
This an applied research conducted using multivariable regression method and econometrics models for 6 years from 2012 to 2017. The research hypothesis was tested based on integrated data and Eviews-6 software was used to analyze the data statistically. Tehran stock exchange listed firms constitute statistical population of the research. Statistical sample of the research was consisted of stock exchange listed firms if:

1. They are listed at Tehran stock exchange until 19 Mar., 2012
2. They do not suffer from transactional shutdown for more than 6 months
3. Their required data are available
4. Investment firms, insurance companies, banks, and financial institutes are excluded from the study considering different nature and classification of financial statements items of investment and intermediation firms in comparison with the manufacturing ones
5. There is a positive book value for their equities
6. They do not change their financial year during the research
7. Their financial year ends up to 19 March

Considering the above limitations, 75 Tehran stock exchange listed firms of 17 industries were selected as the sample.

**Research Variables**
Independent Variables

**CGit**: Corporate governance mechanism

The present research used four mechanisms including:

1. **Ownership percentage of institutional stockholders**: According to definition 27, Article 1 of Securities Law of Islamic Republic of Iran, every real or legal person purchasing more than 5% or Five Billion Rials of nominal value of securities in press is regarded as an institutional investor. Evaluating notes attached to financial statements, ownership percentage of the investors of the firm shares are specified.

2. **Ownership centralization**: The research uses Herfindahl-Hirshman index which is an economical index to measure exclusivity rate in market. Using the index, percentage of market share of every supplier is squared and added and a digit is obtained which varies between zero and one. The closer to one, the more centralization and vice versa.

3. **Type of auditor**: Numbers one and zero will be used to indicate to type of auditor if financial statements are reckoned by a governmental (audit organization) or private authority, respectively.

4. **Independency of members of board of directors**: The present study uses non-executive managers of board of directors to all members ratio to measure independency rate of members of board of directors.

Dependent variables

**Financial reporting quality**: Accuracy of financial information is regarded as a criterion to measure its quality. Using components of accounting operational profit of the last period, residuals of regression equation of future cash flows prediction are used to empirically measure accuracy of financial information (Barth et al, 2001).

\[
\text{CFO}_{it+1} = \alpha_0 + \beta_1 \text{CFO}_it + \beta_2 \Delta\text{AR}_{it} + \beta_3 \Delta\text{INV}_{it} + \beta_4 \Delta\text{AP}_{it} + \beta_5 \text{DEPR}_{it} + \beta_6 \text{OTHER}_{it} + \varepsilon_{it}
\]

Where

- CFO: Cash flow of operation
- ΔAR: Variation of accounts receivable
- ΔINV: Variation of inventories
- ΔAP: Variation of accounts payable and deferred liabilities
- DEPR: Depreciation expense of fixed tangible and intangible assets
- OTHER: Other accrual items calculated as follows:
  \[
  \text{OTHER} = \text{OP} - (\text{CFO} + \Delta\text{AR} + \Delta\text{INV} - \Delta\text{AP} - \text{DEPR})
  \]
- OP: Operational profit
- ε: Supposed error with the average of zero and fixed variance

Absolute value of residuals, i.e. \(|\varepsilon_{i,t+1}|\) is an empirical criterion to measure financial reporting quality. The smaller the absolute value, the higher the accuracy of financial information and quality of financial reporting will be. Median of residuals is regarded as separation line of information.
quality, i.e. if equation residuals are equal or smaller than median of residuals absolute value, financial reporting will be a high quality one; otherwise, it will be assumed as low quality.

**Control variables**

$\text{SIZE}_{it}$: Size of the firm resulted from logarithm of all assets  
$\text{LEV}_{it}$: Financial leverage of the firm which is equal to total liabilities of the firm divided by its assets  
$\text{MBV}_{it}$: Market to book value ratio

**Model assertion and estimation**

Using panel method, the present study evaluates effect of corporate governance mechanisms on financial reporting quality. The pattern was estimated using potent panel technique\(^1\). Chow test and Hausman test were used to select from least integrated squares, fixed effect (FE), and random effect (RE) methods.

Models used to test the hypotheses are as follows:

$$FQ_{it} = \beta_1 + \beta_2 \text{INSTOWN}_{it} + \beta_3 \text{OWN}_{it} + \beta_4 \text{AUDIT}_{it} + \beta_5 \text{IND}_{it} + \beta_6 \text{SIZE}_{it} + \beta_7 \text{LEV}_{it} + \beta_8 \text{MBV}_{it} + \epsilon_{it}$$

The model variables are defined as:

$FQ_{it}$: Financial reporting quality  
$\text{INSTOWN}_{it}$: Ownership percentage of institutional stockholders  
$\text{OWN}_{it}$: Ownership centralization  
$\text{AUDIT}_{it}$: Type of auditor  
$\text{IND}_{it}$: Independency of members of board of directors  
$\text{SIZE}_{it}$: Size of company  
$\text{LEV}_{it}$: Financial leverage  
$\text{MBV}_{it}$: Market to book value ratio

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\(^1\) Refer to Baltagi (2008), Hsiao (2005), Greene (2008), and Gujarati (2004) for further information about details and advantages of panel method.
According to Table 1, fixed effect model was selected as the research model. Table 2 refers to results of the model estimation. Considering probability of statistic (F), \( P<0.05 \), according to Table 2. Thus, the model is meaningful and regression equation is confirmed. Probability of statistic (T) used to evaluate meaningfulness of variables menstruates that ownership centralization of the firm is positive and statistically meaningful. Therefore, the relation between this variable and the dependent variable is confirmed. However, there is not any relation between variables of ownership percentage of institutional investors, type of audit, independency of members of board of directors, and financial reporting quality. In the selected method, \( R^2=0.35 \) indicating to the fact that the desired descriptive variables explain about 35% of variations of the dependent variable.
Conclusion & Suggests

Establishment of appropriate structures of corporate governance may lead to less conflict of interest of owners and managers, appropriate interaction between them, and improvement of financial reporting quality. Corporate governance structures will suffer from significant defects if management can personally and independently make decisions about investment, operational affairs, and award due to its executive power and unlimited authorities. To improve structures of corporate governance during recent years, codification of corporate governance system bylaw and capital market law was especially concerned. The present study aims at evaluating whether measures taken to improve corporate governance lead to higher quality of financial reporting. For this purpose, ownership percentage of institutional investors, ownership centralization, type of auditor, and independency of members of board of directors- as corporate governance mechanisms- and their effect on reporting quality were studied. According to the findings, there is a positive and meaningful relation between ownership centralization and quality of financial reporting, i.e. relying on owning of main part of the firm ownership, major stockholders will ally and influence firm reporting contrary to interests of minor stockholders. There is not any relation between ownership percentage of institutional investors, type of auditor, independency of members of board of directors, and financial reporting quality. Rules and regulations governing a firm should agree with its legal environment. Considering differences found between Iran and western firms from economical, political, and cultural perspective, it is necessary to localize rules related to corporate strategies. Therefore, it is better to avoid any thoughtless copying or adapting in codification of strategic bylaw of the state stock exchange; otherwise, the case laws will fail. In this regard, it is useful to focus on results of researches conducted in Iran and its economical environment and it is expected that it can help the laws localization.

It is suggested that Tehran stock exchange organization require the firms to disclose more information about their corporate governance conditions.
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