The impact of corporate governance mechanisms on earnings management

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The role of corporate governance is to reduce the divergence of interests between shareholders' and managers. The role of corporate governance is more useful when managers have an incentive to deviate from shareholders' interests. One example of management’s deviation from shareholders’ interests is the management of earnings through the use of accounting accruals. The primary objective of this paper is to examine the association between corporate governance internal mechanisms (ownership concentration, board independence, CEO dominance) and external mechanism (institutional shareholders’) and earnings management. Firm size and leverage are control variables. The population used in this study comprises firms listed on the Tehran Stock Exchange (TSE) between 2004 and 2008, the sample comprises 196 firms. Panel data method is employed as technique to estimate the model. We find that firms with higher ownership concentration and board independence manage earnings less, while firms with higher institutional holdings manage earnings more, there is positive significant association between the existence of CEO-Chairman duality and earnings management. This study also found a positive significant association between firm size and leverage and earnings management.

Key words: Earnings management, institutional shareholders’, board composition, corporate governance.

INTRODUCTION

The role of corporate governance is to reduce the divergence of interests between shareholders’ and managers. The role of corporate governance is more useful when managers have an incentive to deviate from shareholders’ interests (Alam, 2009). One example of management’s deviation from shareholders’ interests is the management of earnings through the use of accounting accruals. Corporate governance is likely to reduce the incidence of earnings management. Corporate governance is also likely to improve investors’ perception of the reliability of a firm’s performance, as measured by the earnings, in situations of earnings management. That is, corporate governance will be value relevant when earnings management exists.

Concerns about corporate governance in East Asian countries emerged as a result of the East Asian financial crisis in 1997/1998. The crisis exposed the consequences of weak governance and poor governance standards were blamed indirectly in part for the crisis that weakened foreign investors’ confidence in the East Asian capital market, including Malaysia (Leng, 2004; Abdul Rahman and Haniffa, 2005). Further, the tragic collapses and losses of giant companies such as Enron corporation, WorldCom and Tyco International in the United States (US), which is known to have the best regulated and most efficient capital market in the world, highlights the critical need to improve the corporate governance system in both developed and developing countries.

These together with other scandals such as Parmalat in Italy, followed by revelations of misrepresentation of financial statements, have drawn attention to corporate governance reform around the world and the need to improve the quality of reported earnings as the capital market needs precise and unbiased financial reporting to value securities and encourage investors’ confidence. In response to the risks posed by corporate governance breakdowns, many countries have taken a proactive action to reform their code on corporate governance to improve and strengthen the corporate governance systems.
In the early 2000, the managers of Tehran Stock Exchange (TSE), Islamic Parliament Research Center, and a specialized committee in Economic and Finance Ministry, started to do some surveys about corporate governance in Iran. Surveying the corporate governance characteristics in Iran shows the approximation of them to the internal control systems. The internal control corporate governance is a system in which all the listed companies in one country are owned and controlled by the minor and main shareholders' (Alam et al., 2010). These shareholders’ can be divided into different group. Some maybe the members of the foundation group, some maybe the creditor banks) which are a small group), some are the other companies or even the government. However, in the past few years the efforts which have been done to expand the capital market, shows that Iran is interested in changing this system to external control corporate governance. For instance, in the third and fourth Economic development plan, privatization of governmental organizations comes into a great deal of importance. It seems in case of reaching this goal (to privatize the governmental organizations) and increasing the shareholders’, corporate governance system in our country with regard to the other countries' experiences, has change its aim to making external control system.

Nevertheless, observing the companies and stock market in Iran shows that nowadays there are some external control mechanisms. For example, I can point out legal the warden because of Trade Law (especially clauses 144-156), stock exchange laws, Audit organization statute, and Iranian official accounting society rules. In fact, the capital market in Iran is very new and somewhat inefficient. The major shareholder’s supervision and motivating, depends on some activities, such as buying controlling stock and the rule of institutional investors. Supervising of minor shareholders’ is not permitted. However, auditing the financial statements of registered companies in stock exchange is compulsory. In addition, there is no ranking institution in Iran.

Unfortunately, there is not any proper supervision system for internal control mechanism. Despite the board of directors' issue and some other issues related to executive management, such as dividing the responsibilities between executive managers, the role of non-executive managers is very weak and there is no care about supervising organizational morality. Fortunately, in the late 2004, TSE Research and development center published the first edition of code of corporate governance in Iran. This code was regulated in 22 clauses and contained some necessary definitions, management board and shareholders’ responsibilities, financial disclosures, accountability and auditing concept. According to the ownership structure, the capital market situation, and the trade Law, this code was edited in the next year (2005). The second edition of code of corporate governance in Iran was regulated in 5 chapters and 37 clauses. This code has been declared via media and has been implemented by many companies. (Mashayekhi and Noravesh, 2008).

Thus, the aim of this study, tests the relationship between corporate governance mechanisms and earnings management. The primary objective of this paper is to show that corporate governance affects the value relevance of earnings in the presence of earnings management.

This paper is organized as follows. The next section followed by a discussion of past studies and development of hypotheses about the expected associations between some corporate governance characteristics and earnings management. Next, the research method and data collecting process are described, followed by a discussion of the empirical results. The paper ends with a conclusion.

PRIOR RESEARCH AND HYPOTHESIS DEVELOPMENT

Ownership concentration

Ownership concentration is a measure of the existence of large shareholders’ in a firm (Thomsen and Pedersen, 2000). Large shareholders’ have greater incentives to monitor management, because the costs associated with monitoring management are less than the expected benefits to their large equity holdings in the firm. Ramsey and Blair (1993) suggest that increased ownership concentration provides large shareholders’ with sufficient incentives to monitor managers. Demsetz and Lehn (1985) and Stiglitz (1985) empirically support this view by finding that large equity holders have incentives to bear the fixed costs of collecting information and to engage in monitoring management. In contrast, dispersed ownership leads to weaker incentives to monitor management (Maher and Andersson, 2000). In situations where shareholders’ hold low stakes in the firm, shareholders’ have little or no incentive to monitor managers (Ramsay and Blair, 1993; Hart, 1995), because monitoring costs will exceed the gains of monitoring managers. Contrary to the view discussed above, other studies (for example, Bebchuk, 1994; Stiglitz, 1985) suggest that ownership concentration may negatively affect the value of the firm, because large shareholders’ have the capacity to abuse their position of dominant control at the expense of minority shareholders’. Bennedsen and Wolfenzon (2000) argue that larger shareholders’ are recognised by minority shareholders’ as a signal of a better monitoring environment. Their argument is consistent with the view that ownership concentration is a monitoring attribute of corporate governance (La Porta et al., 1999) Building on the agency framework developed by Jensen and Meckling (1976), the existence of large shareholders’ is expected to lower opportunistic earnings management.
The justification for this is that managers at publicly traded firms either lose their control to large shareholders’ or are constantly monitored by large shareholders’. If higher ownership concentration increases monitoring over management (Demsetz and Lehn, 1985; Stiglitz, 1985), higher ownership concentration should decrease management’s capacity to alter accounting earnings and increase the reliability earnings. Dempsey et al. (1993) finds that different categories of ownership concentration are related to different levels of opportunistic earnings management.

Earnings management also reflects the strength of management’s incentive to manage earnings. Once managers have no incentive to manage earnings opportunistically, they act according to the interest of shareholders’, and thus ownership concentration should not have an impact on shareholders’ perception of accounting earnings.

Given the impact of ownership concentration on earnings management and earnings reliability, highly concentrated ownership should affect shareholders’ perception of earnings reliability and relevance after conditioning on earnings management. Thus, less reliable earnings associated with high ownership concentration are perceived by shareholders’ to be more value relevant than those associated with lower ownership concentration. Therefore, it is hypothesized that:

\[ H_1: \text{Highly ownership concentration are negatively related to earnings management.} \]

**Board Independence**

The most fundamental notions in corporate governance is that the board of directors should be independent of management and the company (Hermanson, 2003). Independence can be achieved through the inclusion of disinterested parties, that is, outside directors, to increase the boards’ ability to be more efficient in monitoring the top management (Fama and Jensen, 1983). Outside directors have more incentive to effectively monitor management because of a strong need to develop their reputations as expert decision makers. However, the success of these mechanisms depends upon its independence from management. Beasley’s (1996) paper argues that the inclusion of grey directors who have affiliations with management may impair board independence. The independent directors must be solely outside directors who have no other relationship with the company except that of being on the board of directors.

A number of studies have reported a positive role of having a higher proportion of independent non-executive directors sit on the board and financial reporting quality. Beasley’s (1996) paper provides evidence of a strong relationship between the independence of board members and the likelihood of fraud incidence. Larger proportions of outside members on the board of directors provide a better oversight of management to prevent financial statement fraud and effectively monitoring management activity. The results of Beasley’s (1996) study highlight the importance of examining the insight processes of how outside directors exercise control over board activities when evaluating the impact of these corporate governance mechanisms on financial reporting quality.

Other researchers after Beasley’s (1996, 2000) papers continue to address the link between board quality and financial reporting quality, focusing on the issue of earnings management. It is expected that the efficient monitoring from non-executive directors helps to effectively constrain earnings management activity. The study by Peasnell et al. (2000) on the association between board composition and earnings management activity, between the pre- and post-Cadbury period, finds evidence of a significant negative relationship between earnings management and the proportion of non-executive board members in the post-Cadbury period. Their findings suggest that the higher proportion of non-executive directors helps constrain earnings management activity and appropriately structured boards following the issuance of the Cadbury Report has effectively increased the quality of financial reports in the UK. Klein (2002) also reports similar findings for 692 large publicly-traded US firms for which she finds a negative association between board independence and abnormal accruals. Correspondingly, using a sample of 434 listed Australian firms; Davidson et al. (2005) also find a significant negative relationship between earnings management and the presence of a majority of non-executive directors. Their findings support the agency theory claims that independence of the board members is an effective monitoring mechanism to protect shareholders’ interest.

Results from prior studies in developed countries, with a dispersed ownership structure, confirm the agency theory claims of effective monitoring mechanisms by the independent directors. A study by Kao and Chen (2004) provides negative significant evidence between earnings management and a higher proportion of outside directors in the Taiwanese market. Similarly, Jaggi et al. (2007) also reports similar findings for Hong Kong listed companies where family ownership and control is common. However, it is important to note that their paper provides further evidence that the monitoring effectiveness is reduced in family controlled firms. This is evidenced by an insignificant relationship between proportions for non-executive directors in high family-ownership samples. Park and Shin (2004) however fail to find empirical support of the association between earnings management and board independence in Canada where the ownership structure is highly concentrated and a large block holder controls the public traded firms.

Abdullah’s (1999) study finds evidence of a positive and significant role of board independence on earnings
quality proxy by earnings response coefficient and provides support that independent directors are effective control mechanisms in a firms' financial reporting process. In addition, a study by Salleh et al. (2006) also reports a significant finding between a higher proportion of independent directors and a higher audit quality proxy by audit fees. Their study highlights the importance of a board's independence in relation to its monitoring role and strengthening of audit quality. A study by Abdullah (2004), Che Haat (2006) and Vethanayagam et al. (2006), however, did not find any empirical support of an association between board independence and performance.

Additionally, a study by Abdullah and Mohd Nasir and Abdul Rahman and Mohamed Ali (2006) also fails to find any significant evidence between independence of boards and earnings management. A more recent work by Hashim and Susela (2006), using a more recent sample, provides evidence of a significant contrary sign between board independence and earnings management and brings issues of whether Malaysian companies boards are effective and truly independent when performing their duties.

Despite the conflicting results from prior studies, it is hypothesized that:

\[ H_2: \text{Highly independent boards are negatively related to earnings management.} \]

**CEO dominance**

Most corporate practice recommendations strongly suggested the separation between the roles of board chairman and the CEO. Corporate governance regulators recognize that CEO dominance over the board as a source of excessive power (Dedman, 2000). The role of the board chair is to monitor the CEO (Jensen, 1993). Chairman of the board has the power to control the agenda and the running of the board meetings. There is likely to be a lack of independence between management and the board, if the CEO is also the board chair. CEO dominance becomes problematic if the interests of the CEO are different from interests of shareholders'. Using data from the United States, Yermack (1996) and Rechner and Dalton (1991) show that firms with independent chairman outperformed firms with CEO dominance. CEO dominance does not necessarily decrease performance; it is likely to influence the market's perception of the level of control exercised over managerial performance and the financial reporting process. Gul and Leung (2004) find that CEO dominance is associated with lower voluntary corporate disclosure for Hong Kong companies. They argue that CEO dominance combines decision management and decision control, which could erode the board's ability to exercise effective control. Empirical evidence supports the view that CEO dominance is likely to lead to more opportunistic managerial behaviour due to the reduction in effective board monitoring over executives (Finkelstein and D'Aveni, 1994).

Core et al. (1999) find that CEO compensation is lower when the CEO and board chair positions are separate. Thus, it is justifiable to assume a positive association between CEO dominance and earnings management. In the United States, CEO dominance is the norm, while in Australia and the United Kingdom it is not. Therefore there may be cultural difference. Anderson et al. (2003) find that the separation between CEO and board chair positions appear to positively influence the information content of accounting earnings. If CEO dominance decreases monitoring over management (Dechow et al., 1996; Finkelstein and D'Aveni, 1994), CEO dominance should decrease the reliability earnings. Unlike prior studies, this study defines CEO dominance in terms of the independence of the chairman rather than CEO duality. The reason it is defined differently from prior studies is that the chairman is less likely to hold the CEO accountable if the board chair is a person who is not independent of management (that is, current or past executives). Given that CEO dominance should influence earnings management and earnings reliability, CEO dominance is expected to affect shareholders' perception of earnings reliability and relevance after conditioning on earnings management. Thus, reliable earnings associated with CEO dominance are perceived by shareholders' to be less value relevant than those associated with independent chairmen.

As shareholders' perceive that reduction of monitoring caused by CEO dominance increases earnings management and reduces the reliability and relevance of accounting earnings, Therefore, it is hypothesized that:

\[ H_3: \text{CEO dominance is positively related to earnings management} \]

**Institutional shareholders'**

Institutional shareholders' have both the incentive and power to constrain opportunistic behaviour of managers in the form of earnings management. Both the incentive and power of institutional ownership are functions of the degree of ownership by the institutions. McConnell and Servaes (1990), Nesbitt (1994), Smith (1996), Del Guercio and Hawkins (1999) and Hartzell and Starks (2003) have found evidence that corporate monitoring by institutional investors can constrain managers' behaviour.

Large institutional investors have the opportunity, resources, and ability to monitor, discipline, and influence managers. Chung et al. (2002) document a negative association between institutional ownership and income-increasing accruals for US firms while Koh (2003) finds a similar result using a sample of Australian firms. Additionally, consistent with classical agency theory, Ashbaugh
and Warfield (2003) find evidence that the demand for more reliable financial reporting is greater when parties other than management have financial stakes in the company. Barton (2005) finds that among former Andersen clients, firms with greater institutional ownership defected faster than those with lower levels of institutional ownership (Alam et al., 2010b). Therefore, it is hypothesized that:

\[ H_4: \text{Highly institutional ownership are negatively related to earnings management.} \]

**RESEARCH DESIGN**

**Sample selection**

The population used in this study comprises firms listed on the Tehran Stock Exchange (TSE) between 2004 and 2008. All financial firms (including banks) are excluded because this industry is regulated and is likely to have fundamentally different cash flow and accrual processes. Firms with insufficient data to compute discretionary accruals are also eliminated. After adjusting for outliers, the sample comprises 196 firms. Panel data method is employed as technique to estimate the model. Financial and accounting data is collected directly either from annual reports or from company's handbooks.

**Variable definitions**

**Dependent variable: Discretionary accruals (DA)**

There is no consensus on the definition of earnings management (Beneish, 2001). For example, Davidson et al., (1987) in Schipper (1989) defined earnings management as “the process of taking deliberate steps within the constraints of generally accepted accounting principles to bring about a desired level of reported income”. Healy and Wahlen (1999) state that “earnings management occurs when managers use judgment in financial reporting in structuring transactions to alter financial reports, to either mislead investors as to the extent of such accruals because they are out of managers’ control.

Earnings management occurs in three ways: (1) Via the structuring of certain revenue and/or expense transactions; (2) via changes in accounting procedures; and/or (3) via accruals management.

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Equation 2 is estimated for each firm and fiscal year combination thus:

\[ TACC_n/A_{n-1} = \alpha_1(1/A_{n-1}) + \alpha_2[\Delta REV_n - \Delta REC_n]/A_{n-1} + \alpha_3[PPE_n/A_{n-1}] + \varepsilon_{nt} \]  

Where, \( TACC \) is the total accrual, \( \Delta REV \) is the change in operating revenues, \( \Delta REC \) is the change in net receivables, \( PPE \) is gross property, plant and equipment, \( t \) and \( t-1 \) are time subscripts and \( i \) is the firm subscript. Changes in revenues is included to control for the economic circumstances of a firm; whilst gross property, plant and equipment are included to control for the portion of total accruals related to non-discretionary depreciation expenses (Jones, 1991). Dechow et al., (1995) modified the Jones (1991) model by removing the discretionary components of revenues through changes in accounts receivable. Firms are considered to have they engaged in income increasing (decreasing) discretionary accruals if have positive (negative) estimated discretionary accruals. Earnings management occurs when managers use judgment in financial reporting in structuring transactions to alter financial reports, to either mislead investors as to the extent of such accruals because they are out of managers’ control.

**Equation 2**

\[ TACC = NI - OCF \]  

**Equation 2**

\[ T = \Delta RE, \Delta CA \]  

Where, \( T = \Delta RE, \Delta CA \) are the changes in revenues and cash flows from operating activities, respectively.

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Table 1. Descriptive statistics for dependent and independent variables.

<table>
<thead>
<tr>
<th>Statistic</th>
<th>DA</th>
<th>OWNCON (%)</th>
<th>BRDIND</th>
<th>DUL</th>
<th>INOWN (%)</th>
<th>SIZE</th>
<th>LEV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>0.0124</td>
<td>76.70</td>
<td>0.52</td>
<td>0.44</td>
<td>56.20</td>
<td>27.71</td>
<td>0.088</td>
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<tr>
<td>Median</td>
<td>0.002</td>
<td>80.50</td>
<td>0.6</td>
<td>0</td>
<td>60.30</td>
<td>27.8</td>
<td>0.084</td>
</tr>
<tr>
<td>Maximum</td>
<td>0.49</td>
<td>99.80</td>
<td>1</td>
<td>1</td>
<td>98.90</td>
<td>33.26</td>
<td>0.844</td>
</tr>
<tr>
<td>Minimum</td>
<td>-0.26</td>
<td>5.60</td>
<td>0</td>
<td>0</td>
<td>2.00</td>
<td>20.94</td>
<td>0.01</td>
</tr>
<tr>
<td>Std. Dev.</td>
<td>0.0697</td>
<td>18.29</td>
<td>0.217</td>
<td>0.49</td>
<td>27.20</td>
<td>2.21</td>
<td>0.051</td>
</tr>
</tbody>
</table>

DA= discretionary accruals, OWNCON = percentage of shares owned by block holders (more of five percent), BRDIND = proportion of non-executive directors to total board composition. DUL = 1 if CEO is also board chair and 0 otherwise. INOWN = percentage of common shares owned by institutional investors. SIZE= log of total assets. LEV= Leverage ratio calculated by total liabilities over total assets.

All variables are scaled by prior year total assets At-1 to control for heteroscedasticity.

Independent variables

Independent variables argued in section 1, are: Ownership concentration (OWNCON), board independence (BRDIND), CEO dominance (DUL) and Institutional shareholders’ (INOWN).

Control variables

**Firm size (SIZE)**

Additionally, firms' accruals management decisions are likely to be influenced by firms' size. The size hypothesis (Watts and Zimmerman, 1986) posits that large firms are more politically visible and are more likely to manage earnings to reduce their political visibility (Moses, 1987; Hsu and Koh 2005). However, Ashari et al., (1994: 293) has an opposite view and argues that more information is available about larger firms, which are closely scrutinized by analysts and investors. Smoothed income signals from larger firms add little value; accordingly, they have less incentive to smooth income (Atik, 2008). Thus, there is no specific prediction on the association between firm size and discretionary accruals. This study uses the natural logarithm of total assets as a proxy for firm size (SIZE).

**Firm leverage (LEV)**

We also control for leverage. DeFond and Jiambalvo (1994) and Sweeney (1994) report that managers use discretionary accruals to satisfy debt covenant requirements. Because more highly leveraged firms have greater incentives to increase earnings.

Trueman and Titman (1988: 128) argue that managing earnings enables managers to reduce estimates of various claimants of the firm about the volatility of its earnings process and so lowers their assessment of the probability of bankruptcy. As discussed by Atik (2008), this provides an opportunity to borrow at lower interest rates and decreases cost of capital. Consistent with this debt hypothesis, we expect that managers in more leveraged firms are more likely to adopt aggressive earnings management techniques to prevent violation of debt covenants (Watts and Zimmerman, 1986). Firm financial leverage, measured as the ratio of debt to assets, is included, as a proxy for risk, because managers are more likely to exercise their accounting discretion when they are closer to default on debt covenants (Press and Weintrop, 1990).

**Common effect model**

To test the hypothesis common effect model in panel data analysis has been used:

Where: DA = discretionary accruals; OWNCON = percentage of shares owned by block holders (more of five percent); BRDIND = proportion of non-executive directors to total board composition; DUAL = 1 if CEO is also board chair and 0 otherwise; INOWN = percentage of common shares owned by institutional investors; SIZE = log of total assets; LEV = leverage (ratio of total liabilities to total assets)

**RESULTS**

**Descriptive statistics**

As reported in Table 1, the mean and median value of discretionary accruals is 0.0124 and 0.002 respectively. The mean and median value of percentage of block shareholders’ (OWNCON) is 76 and 80% respectively. The maximum and minimum value and the standard deviations of OWNCON are 5.6, 99.8 and 18.29% respectively.

The mean and median value of BRDIND is 76 and 80% respectively the maximum and minimum value and the standard deviations of BRDIND are 2.6, 99.8, and 18.29% respectively.

The mean and median value of INOWN is 56.28 and 60.3% respectively.

The maximum and minimum value and the standard deviations of INOWN are 98.9, 2, and 27.26% respectively.

The mean and median value of SIZE is 27.7 and 27.8% respectively. The maximum and minimum value and the standard deviations of SIZE are 33.2, 20.9 and 2.2% respectively.

The mean and median value of LEV is 8.8 and 8.4% respectively. The maximum and minimum value and the standard deviations of LEV are 84, 1 and 5%, respectively.

**Common effect model results**

As shown in Table 2, since probability of F-Statistics of homogeneity test is more than 0.05, H₀ hypothesis which is based on existing common C for all interrupts is not rejected against H₁ hypothesis is based on existing
Table 2. Regression results.

\[
DA_{it} = \alpha + \beta_{OWNCON} + \beta_{BRDIND} + \beta_{BRDSZE} + \beta_{CEO} + \beta_{INOWN} + \beta_{SIZE} + \beta_{LEV} + \epsilon
\]

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>-3.35</td>
<td>-5.808</td>
<td>0.000</td>
</tr>
<tr>
<td>OWNCON</td>
<td>-6.1</td>
<td>-2.283</td>
<td>0.022</td>
</tr>
<tr>
<td>BRDIND</td>
<td>-4.11</td>
<td>-3.401</td>
<td>0.000</td>
</tr>
<tr>
<td>DUAL</td>
<td>3.87</td>
<td>1.996</td>
<td>0.045</td>
</tr>
<tr>
<td>INOWN</td>
<td>1.14</td>
<td>2.474</td>
<td>0.013</td>
</tr>
<tr>
<td>LGSIZE</td>
<td>1.25</td>
<td>5.815</td>
<td>0.000</td>
</tr>
<tr>
<td>LEV</td>
<td>7.54</td>
<td>5.425</td>
<td>0.000</td>
</tr>
</tbody>
</table>

| F-Statistics      | 580.55      | Durbin-Watson stat | 1.91   |
| R²                | 0.898       | Prob(F-statistic)  | 0.000  |
| Adjusted R²       | 0.897       | Prob (Effects Test F) | 1.000  |

Note: significant at 95% level of confidence.

different C. So preferable model is the model with same C for different interrupts which is reflected its results as following. Regarding the result of F-Statistics, homogeneity test of common effect model is accepted and as is obvious in table, p-value: 0.000 confirm significance of regression in confidence level of 99%. (If was p-value< 0.000 Haasman test used in order to selecting random effect model against fixed effect model). Table 2 shows the results of common effect model applied to find out the impacts of ownership concentration (OWNCON), board independence (BRDIND), CEO dominance (DUL) and Institutional shareholders’ (INOWN), on earnings management, the dependent variable (DA), is significant (p<0.001) and positively correlated with INOWN, DUL, SIZE, LEV, and is significant (p<0.001) and negatively correlated with OWNCON, BRDIND. We found discretionary accruals as a proxy for earnings management is negatively related to ownership concentration. Our findings suggest that the presence of block holders could effectively monitor the management to avoid opportunistic behaviour of the management including earnings management. This result is not consistent with the findings of McConnell and Servaes (1990), Nesbitt (1994), Smith (1996), Del Guercio and Hawkins (1999) and Hartzell and Starks (2003), Chung et al. (2002), Koh (2003). As a result, institutional investors in Iran are not effective in constraining managerial behaviour of earnings management.

Consistent with the argument that institutional investors in Iran are short-term oriented and create incentives for managers of their portfolio firms to manage earnings aggressively, these institutional investors focus excessively on current earnings performance (Koh, 2003). This result is not surprising. The coefficients and signs on the control variables shows a positive relation between firm size and earnings management, this result is consistent with the findings of Moses (1987), Hsu and Koh (2005). We also find a positive significant relation between leverage and earnings management. This result is consistent with the findings of DeFond and Jiambalvo (1994) and Sweeney (1994).

Conclusion

This paper examines the effect of corporate governance mechanisms on earnings management in Iran. This study also extends prior research by focusing on the relationship between earnings management and corporate governance characteristics. We found discretionary accruals as a proxy for earnings management is negatively related to ownership concentration. Our findings suggest that the presence of block holders could effectively monitor the management to avoid opportunistic behaviour of the management including earnings management. In addition, we show that board independence is negatively related to earnings management. Our findings suggest that adding outside
directors to the board may improve in governance practices and they are helpful to the board in monitoring the firm’s management of earnings. In fact, Investors can rely on the information revealed in the financial statements when there are more outside directors in the board. This paper also contributes to institutional ownership literature. Prior studies find that the presence of institutional investors is negatively related to earnings management. We extend these tests and find that firms with higher institutional ownership have higher discretionary accruals. Moreover, this is also the first paper that provides evidence that firms with higher level of dedicated institutional ownership have higher discretionary accruals, suggesting that institutional investors may not monitor managers effectively in terms of accruals quality, also these result suggest that adding institutional investors to the board may not develop corporate governance and help the board in preventing the firm’s management of earnings.

According to our findings, duality is the other corporate governance index that is significantly related to the earnings management. That is, if the CEO is board chair, the likelihood of earnings management will increase. One probable reason is that, the CEO duality may reduce the effectiveness of the board and may create a conflict between management and board that may reduce earnings management. One probable reason is that, the CEO duality may reduce the effectiveness of the board and may create a conflict between management and board that may reduce earnings management (Zahra, 1990; Solomon, 2007). Another probable reason is that duality may have been imposed, rather than adopted in a usual organization practices to consolidate CEOs power (Kang and Zardkoohi, 2005). It may have reduced the board’s ability to exercise the governance function in the context of Iran. This finding captures the agency theory implying that the combined leadership structure does not enhance the firm economic performance in the context of Iran. It is noted that the existing board culture in Iran allows both the executive and the non-executive directors to perform duties together in one organizational layer; therefore there are some incidences of CEO duality. It is suggested to separate the executive function of the board from the monitoring function by splitting the role of Chairperson and CEO, which is also recommended in the United Kingdom ‘Cadbury report 1992’and ‘Higgs report 2003’. This study also found a positive significant association between firm size and leverage and earnings management. Our findings have important policy implications since they suggest the need to encourage applying corporate governance principles by institutions and individual block-holders to provide effective monitoring of earnings management in Iran firms, especially those with a large size.

REFERENCES
