Board Combination and Earnings Management: Evidence from Iran

1Younes Badavar Nahandi, 2Saeed Mahmoudzadeh Baghbani, 3Amin Bolouri
1Assistant Professor, Department of Accounting, Tabriz Branch, Islamic Azad University, Tabriz, Iran
2, 3Young Researchers Club, Tabriz Branch, Islamic Azad University, Tabriz, Iran

ABSTRACT

The purpose of this paper is to examine the influence of the board of directors combination on earnings management for a panel of 480 observations from 2001 to 2008 in Iranian company. While the role of company boards in earnings management has been examined in developed markets setting, particularly the US and UK, understanding their effectiveness in emerging markets like Iran is important due to differences that exist in the structure of business organizations across these markets. Board combination has been measured by board size, board independence, and CEO-duality. The Modified Jones Model (1995) has been used to determine the earnings management. Common effect model indicates the presence of positive relationship between CEO-duality and earnings management while we did not get statistically significant relationship between board size and board independence with earnings management.

KEY WORDS: earnings management; board size; board independence; CEO-duality.

INTRODUCTION

Information asymmetry between managers and shareholders empower the managers to use discretionary behavior while reporting earnings of a company to increase their own utility function. Theoretically, a present value of future cash flows is considered as the value of the company. Thus, any increase in earnings depicts the increase in overall value of company and vice versa (Lev, 1989). Especially in case of losses to company, earnings are managed to show a favorable situation (Hayn, 1995). This presents the idea of earnings management that is the use of accounting choices to amend reported earnings for the sake of managers’ benefits. Alternatively, earnings management can be defined as reasonable as well as legal decision-making and reporting of financial results, by managers, with the intention to achieve stability in earnings.

Earnings can be managed using real transactions such as asset sales and/or accelerating or deferral of revenue and expenses using accounting methods and estimates (Peasnell et al, 2005). The effect of the latter method accumulates in accruals. One advantage of using accruals to manage earnings is that it is difficult and costly for the users to unravel accounting numbers in order to make economic decisions. Therefore, accruals are more likely to be used by managers to manage earnings than structuring actual transactions. We follow recent research studies in earnings management by focusing on accruals manipulation (Klein, 2002; Xie et al, 2003). We use the definition by Healy and Wahlen (1999) throughout the paper that earnings management reflects an opportunistic behavior of the management. Nevertheless, we acknowledge that some accounting choices and estimates may be used to signal private information.

Based on previous literature, Earnings management can be seen as a potential agency cost since managers manipulate earnings to mislead shareholders and fulfill their own interests. Therefore, the board of directors which is responsible for solving the agency conflicts between managers and shareholders should play a role in constraining the level of earnings management. Further more, prior similar researches of financial reporting fraud suggest that effective board monitoring helps to maintain the credibility of financial reports. Thus, it is reasonable to hypothesize that an effective board of directors will help to limit the earnings management.

This study examines the effectiveness of board of directors’ combination on earnings management within the business environments in Iran.

BACKGROUND, LITERATURE AND HYPOTHESIS DEVELOPMENT

According to agency theory, the separation of ownership and control leads to a divergence in the pursuit of managerial interests versus owners’ interests (Jensen and Meckling, 1976), and thus monitoring managerial decisions

*Corresponding Author: Saeed Mahmoudzadeh Baghbani, Member of Young Researchers Club, Tabriz Branch, Islamic Azad University, Tabriz, Iran. P.O.Box: 15655/461 Email: saeed.m1362@gmail.com

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becomes essential for the board of directors in order to protect shareholders’ interests (Fama and Jensen, 1983), and to ensure the integrity of the financial reporting process. Director integrity and board effectiveness play important roles in ensuring the quality and reliability of financial reporting (Cadbury Report, 1992). Therefore, we can expect that board composition will be an important factor in influencing whether or not a firm engages in earnings management. The study investigates third board characteristics (i.e., Board size, board Independence and CEO duality) and evaluates whether these characteristics have any relationship with the earnings management.

EARNINGS MANAGEMENT

Discretionary accruals represent the extent of earnings management. Discretionary accruals reflect subjective accounting choices made by managers (Chung et al, 2002). The magnitude of discretionary accruals is indicated as a percentage of assets of a firm. The higher the value of discretionary accruals, the greater the earnings is manipulated. Earnings management may take the form of either income-increasing or income-decreasing accounting choices. Income-increasing manipulation means positive discretionary accruals whereas income-decreasing indicate negative discretionary accruals.

Managers would like to manage the earnings to increase their private gain. Healey (1985), McNichols and Wilson (1988), Gaver et al. (1995), Houluhasen et al.(1995) and Balsam (1998) provided evidence that manipulations which are contractually bound to achieve target earnings have greater tendencies to manage earnings. Furthermore, managers might use earnings management before or after the period of initial public offering (Aharony et al, 2003; Teoh et al, 1998). The rationale for manipulating earnings is to increase issuing stock price. Jianqiao (1999) shows that a loss-making company is conducted remarkable earnings management.

BOARD SIZE

Board size is the number of directors on the board and an important factor in the effectiveness of the board. Unfortunately, the literature provides no consensus about the direction of the relationship between board size and effectiveness. On the one hand, a smaller board is argued to be more effective because they have less difficulty coordinating efforts (Jensen, 1993; Yermack, 1996; Eisenberg et al, 1998) and smaller board may be less encumbered with bureaucratic problems and may be more functional and provide better financial reporting oversight. On the other hand, a larger board is claimed to have information and expertise advantage over smaller boards (Dalton et al, 1999) and a larger board may be able to draw from a broader range of experience (Xie et al, 2003). Campos et al. (2002) retain that board size mustn’t be neither too big nor too small and suggest that the optimal size is between five and nine members. Kouki et al. (2011) examine the influence of corporate governance mechanisms on earnings management and state board size that should be neither too large nor too small in order to avoid diverting opinions that profit on the manager and allow earnings management. The evidence regarding financial statement reliability is mixed.


Coulton and Taylor (2001) have verified the hypothesis of negative relationship between board size and possible earnings management opportunity.

Xie et al. (2003) find that larger boards are associated with lower levels of discretionary current accruals indicating a larger board is more effective in monitoring such accruals than a smaller board.

Matoussi and Mahfoudh (2010) provide evidence that a high board size is not sufficient to increase financial statements reliability.

Kouki et al. (2011) finds that the board size is positively and significantly correlated with earnings management. Therefore,

Hypothesis1: There is a significant relationship between board size and earnings management.

BOARD INDEPENDENCE

Recommendations from the Cadbury Committee (1992) and the Blue Ribbon Committee (1999) presume that independent directors play more important monitoring roles than non-independent directors. Independent directors also have incentives to develop a reputation as experts in decision control and monitoring (Fama and Jensen, 1983). Prior studies confirm the role of outside directors in the governance of public companies.

For a board to be effective in controlling earnings management, independence of board members has given much importance. Executive directors bring insider knowledge along with them, which is not available to outside directors, and so they can exploit this edge for transferring wealth to themselves on cost of other stockholders. To avoid this
problem, presence of independent directors on board is necessary because they are perceived to be unbiased monitors. Less chances of committing fraud are there for the firms having the higher percentage of independent directors on board.

Beasley (1996) analyses 75 firms that report financial statement frauds, matched with non-fraud firms. Results indicate that the proportion of independent directors on the board has a significant negative impact on the probability of fraudulent financial reporting.

Peasnell et al. (1998) particularly tested association between earnings management and board composition. They found a significantly negative relationship between income increasing accruals and proportion of outside board members.


Uzun et al. (2004) find that a greater proportion of independent directors on the board is significantly associated with a lower occurrence of financial fraud.

Sharma (2004) finds that the probability of fraudulent reporting decreases with the proportion of independent directors on the board.

Park and Shin (2004), studying Canadian companies, and find that outside directors do not induce a reduction in earnings manipulation.

Peasnell et al. (2005) suggest that the likelihood that British managers record income-increasing abnormal accruals is negatively related to the proportion of outsiders on the board. However, they find little evidence that outside directors influence income-decreasing earnings management.

Davidson et al. (2005) find that the presence of a majority of independent directors on the board is found to mitigate earnings management activities in Australia.

Chen et al. (2006), using 169 fraud enforcement in China during 1999-2003, find that percentage of independent directors on the board is negatively associated with financial fraud occurrence.

Cornett et al. (2006) examines whether corporate governance mechanisms affect earnings management at the largest publicly traded bank holding companies in the United States. They find that board independence is negatively related to earnings management.

Ebrahim (2007) finds that the negative relation between board independence and earnings management is more significant for more active boards, as a proxy by annual board meetings frequency.

Larcker et al. (2007) find that board independence is not correlated with signed abnormal accruals, the absolute value of abnormal accruals, or the likelihood of accounting restatements.

Bowen et al. (2008) also find that the proportion of executive directors (a proxy for lack of independence) is negatively correlated with the absolute value of abnormal accruals.

Jaggi et al. (2009) study of Hong Kong companies found that a higher proportion of independent directors is associated with more effective monitoring to constrain earnings management. They conclude that the quality of earnings is higher for firms with a higher proportion of independent directors on the board.

Ali Shah et al. (2009) examines the relationship between board composition and earnings management. They did not get statistically significant relationship between board independence and earnings management in Pakistani company.

Yang et al. (2009) examines the role of outside directors in constraining the earnings management activities and no relationship was observed between the degree of earnings manipulation and the proportion of outside directors.

In this paper, the proportion of non-executive directors on the board is as the proxy for board independence.

Therefore:

Hypothesis 2: There is a significant relationship between the proportion of non-executive directors on the board and earnings management.

CEO DUALITY

Another strand of research examined the role of CEO, who is also the chairman of the firm. Prior research studies such as Gul and Leung (2004), Booth et al. (2002) and Ho and Wong (2001) refers this phenomenon as CEO duality, whereby one person assumes two roles (as a CEO and as a chairman). Agency theory suggests separation of duties may lead to efficient monitoring over the board process (Fama and Jensen 1983; Jensen 1993). In the absence of a separation between the chairman role (as the oversight and governance mechanism) and the CEO role (as decision management) the monitoring function of the board over earnings management may be jeopardized because the CEO has more discretion to manipulate financial reports (Finkelstein and D’Aveni 1994). In such a firm, the CEO has more power over the board and firm without being supervised and evaluated by a chairman.
The issue of CEO duality and earnings management needs careful analysis. As the literature on CEO duality and corporate governance highlights, agency problems could be higher when a CEO also holds the position of the Chairman of a board.

There is little by way of evidence on CEO duality and earnings management. And the evidence on the relation between CEO duality and firm performance is mixed. While some studies find that CEO duality enhances performance in large firms (Brickley et al, 1997), others document higher performance of firms where the positions of CEO and Chairman are split (Pi and Timme, 1993; Baliga et al, 1996). CEO duality essentially weakens the independence of the monitoring role from the executive decision making. A weaker control system indicates opportunistic earnings management can increase.

Similarly, Patton and Baker (1987) state that the combination of CEO and chairman functions creates a climate in which it is easy to the CEO to dominate the board. Besides, a number of studies provide evidence of a negative effect of CEO duality on financial reporting process (Dechow et al, 1996; Abbott et al, 2000; Carcello and Nagy, 2004).

Loebbecke et al. (1989) argue that firms whose CEO is also the chairman are likely to exhibit lower financial reporting quality because the CEO can manipulate financial reporting to achieve their own aims. In 75% of the fraud cases they examine, a single person controls the firm's operating and financial decisions.

Other evidence in the literature indicates that when the positions of CEO and chairman are separated, firms are valued more highly by the market (Yermack, 1996).

Dechow et al. (1996) report greater earnings management by firms with CEO duality.

Abbott et al. (2000) report a weak positive association between CEO duality and the probability of companies attracting SEC sanctions for aggressive reporting or fraud.

Klein (2002), found that earnings management is positively related to the CEO, who holds a position on the board’s nominating and compensation committee.

Carcello and Nagy (2004) find that CEO duality is positively associated with the probability of financial statement fraud.

Mohd Saleh et al. (2005) provide evidence that firms with CEO duality is positively related with earnings management in Malaysian firms.

Sarkar et al. (2006) investigate the impact of board characteristics on opportunistic earnings management in the context of a large emerging economy, India. Their results indicate that CEO-duality and presence of controlling shareholders on the board increases earnings management.

Rahman and Ali (2006) state that a CEO with excessive power over board matters could easily manipulate earnings numbers.

Bowen et al. (2008) indicates that separation of roles between CEO and chairman is important to prevent earnings management activities. In their study, they indicate that earnings smoothing activities are higher for firms with CEO duality.

Johari et al. (2008) examines the roles of a chief executive officer who also serves as a chairman of the company, and their result indicated that combined chairman-CEO roles (CEO duality) do not influence the practice of earning management in Malaysian firms.

Matoussi and Mahfoudh (2010) find that separation really constraints manager’s earnings management.

Therefore: **Hypothesis 3:** There is a significant relationship between CEO dominance and earnings management.

**CONTROL VARIABLES**

Smith and Watts (1992) hypothesize that managerial discretion is greater for high-growth firms. This will result in high-growth firms adopting mechanisms that control for these potential agency problems, through appropriate corporate policies (Smith and Watts, 1992; Gaver and Gaver, 1993). DeFond and Jiambalvo (1994) report that managers of highly leveraged firms have incentives to make income-increasing discretionary accruals, to avoid breaching debt covenants. Firm size is also used in most earnings management studies to control for many factors (e.g., political costs and economies of scale). Following Klein (2002), we use a market to book ratio, leverage ratio and firm size as control variables.
MATERIALS AND METHODS

STATISTICAL POPULATION & SAMPLE
The statistical population studied at this research is the corporation accepted in Tehran Stock Exchange, and the period of research is between the years 2001 to 2008. The systematic omission method has been used in this research in order to achieve the sample, and all criteria used for selecting the sample are as follows:
1. Companies selected must be accepted since the year 2001 in Tehran Stock Exchange.
2. Companies should not be changed the financial period in the study period.
3. Companies should not be members of any financial investment and mediators.
In this way and by applying the above standards, 480 firm-years observation remained which all were chosen as the sample for research.

MEASUREMENT OF EARNINGS MANAGEMENT
A generally used approach in earnings management literature is the Jones model. Conceptually, total accruals (TA) are decomposed into non-discretionary (NDA) and discretionary accruals (DA). The difference between total accruals and non-discretionary accruals is the discretionary component. In other words, discretionary accruals are the prediction error in the Modified Jones accruals model of Dechow et al. (1995).
Jones uses a two-step approach. First, a cross-sectional regression is performed for total accruals (TA). Total accruals (TA) are measured as the change in non-cash working capital plus depreciation and amortization. Jones then regresses to total accruals on the change in sales and property, plant and equipment.

\[
\frac{TA_{i,t}}{A_{i,t-1}} = a_1 \left( \frac{1}{A_{i,t-1}} \right) + a_2 \left( \frac{REV_{i,t}}{A_{i,t-1}} \right) + a_3 \left( \frac{PPE_{i,t}}{A_{i,t-1}} \right) + \epsilon_{i,t}
\]

Where:
- \( TA_{i,t} \) total accruals of the company \( i \) in the year \( t \)
- \( A_{i,t-1} \) total assets of the company \( i \) at the end of the year \( t-1 \)
- \( REV_{i,t} \) revenues of the company \( i \) in the year \( t \) less revenue in the year \( t-1 \)
- \( PPE_{i,t} \) gross property, plant and equipment of the company \( i \) at the end of the year \( t \)
- \( a_1, a_2, a_3 \) firm specific parameters
- \( \epsilon \) the residuals

The second step is to use these firm-specific parameter estimates from the previous equation (i.e., \( a_1, a_2, a_3 \)) to divide the total accruals into a discretionary part (DA) and a non-discretionary part (NDA). Non-discretionary accruals (NDA) are the predicted part of total accruals and discretionary accruals (DA) are the residual resulting from this regression.

\[
\frac{NDA_{i,t}}{A_{i,t-1}} = a_1 \left( \frac{1}{A_{i,t-1}} \right) + a_2 \left( \frac{\Delta REV_{i,t}}{A_{i,t-1}} \right) + a_3 \left( \frac{\Delta PPE_{i,t}}{A_{i,t-1}} \right)
\]

\[
DA_{i,t} = \frac{TA_{i,t}}{A_{i,t-1}} - NDA_{i,t}
\]

Where:
- \( NDA_{i,t} \) is non discretionary accruals of the company \( i \) in the year \( t \)
- \( \Delta REV_{i,t} \) net receivables of the company \( i \) in the year \( t \) less net receivable in the year \( t-1 \)
- \( DA_{i,t} \) is the discretionary component of accruals of the company \( i \) in the year \( t \)

ESTIMATION MODEL
We run one regression on board of director variables controlling for size, leverage and market to book ratio. Hypotheses are tested using a multivariate regression model.
The model is as follows:

\[
DA_{i,t} = \beta_0 + \beta_1 BSIZE_{i,t} + \beta_2 BIND_{i,t} + \beta_3 DUAL_{i,t} + \beta_4 LEV_{i,t} + \beta_5 FSIZE_{i,t} + \beta_6 MTB_{i,t} + \epsilon_{i,t}
\]
Where:
BSIZE (Board size): the actual number of members on the board.
BIND (Board independence): the ratio of non-executive directors to total members on the board.
DUAL (CEO duality): 1 if CEO is also board chair and 0 otherwise.
LEV (Leverage ratio): the debt at the end of the fiscal period divided into the capital market value at the beginning of the fiscal year.
FSIZE (Firm size): the natural logarithm of the capital market value at the end of the fiscal year.
MTB (Market to book ratio): the capital market value divided by the capital book value at the end of the fiscal year.

DATA ANALYSIS AND RESULTS

THE DESCRIPTIVE STATISTICS

In order to test the data, we checked the data type by descriptive statistics, results of which are presented in the following tables:

The descriptive stat below (Table 1) shows the mean values, median, minimum and maximum values of the discretionary accruals data:

Table 1. Descriptive statistics on discretionary accruals

<table>
<thead>
<tr>
<th>Panel A: Accrual measures</th>
<th>Discretionary accruals (DA)</th>
<th>Mean</th>
<th>Minimum</th>
<th>Median</th>
<th>Maximum</th>
<th>Std. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1.12</td>
<td>0.08</td>
<td>0.38</td>
<td>48.93</td>
<td>0.58</td>
<td></td>
</tr>
</tbody>
</table>

Table 2 shows the mean, median and standard deviation values of the series of independent and control variables:

Table 2. Descriptive statistics for independent and control variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Median</th>
<th>Std. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>BSIZE</td>
<td>5.14</td>
<td>5</td>
<td>0.41</td>
</tr>
<tr>
<td>BIND</td>
<td>0.59</td>
<td>0.60</td>
<td>0.18</td>
</tr>
<tr>
<td>DUAL</td>
<td>0.46</td>
<td>0</td>
<td>0.48</td>
</tr>
<tr>
<td>LEV</td>
<td>1.50</td>
<td>0.96</td>
<td>1.65</td>
</tr>
<tr>
<td>FSIZE</td>
<td>10.07</td>
<td>11.48</td>
<td>0.65</td>
</tr>
<tr>
<td>MTB</td>
<td>4.31</td>
<td>2.53</td>
<td>6.14</td>
</tr>
</tbody>
</table>

The descriptive statistics show that the average board size is 5.14 members. Campos et al (2002) noted that board’s size must not be too large or too small and suggested an optimal number of 5 to 9 members. Hence, we expect to have an optimal size for our sample. In Iranian company on average, about 59% of the directors are non-executive. Table 2 also shows that 46% of managers are both managers and Chairman of the board.

CORRELATION ANALYSIS

After descriptive statistics, correlation analysis has been performed to check the relationship between independent and dependent variables. The association between two continuous variables is assessed using Pearson correlation.

Table 3. Correlation analysis for variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>DA</th>
<th>BSIZE</th>
<th>BIND</th>
<th>DUAL</th>
<th>LEV</th>
<th>FSIZE</th>
<th>MTB</th>
</tr>
</thead>
<tbody>
<tr>
<td>DA</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BSIZE</td>
<td>0.09</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIND</td>
<td>-0.12</td>
<td>0.22</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DUAL</td>
<td>0.22</td>
<td>0.18</td>
<td>-0.21</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LEV</td>
<td>-0.25</td>
<td>-0.17</td>
<td>-0.32</td>
<td>-0.17</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FSIZE</td>
<td>0.19</td>
<td>0.12</td>
<td>0.39</td>
<td>0.09</td>
<td>-0.29</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>MTB</td>
<td>-0.14</td>
<td>-0.19</td>
<td>0.25</td>
<td>-0.14</td>
<td>-0.29</td>
<td>0.37</td>
<td>1</td>
</tr>
</tbody>
</table>
The correlation analysis helps to ascertain whether there is any multicollinearity problem among the independent variables. Based on standard criteria, the correlation value of less than 0.7 would not pose any serious multicollinearity problems and affect the validity of the findings. Table 3 shows that none of the correlation values exceed 0.7. Hence, there was no serious multicollinearity problem among the independent variables.

As mentioned in the above table, no other board combination variable is significantly correlated with dependent variable other than CEO duality, which has a positive relationship with dependent variable DA.

COMMON EFFECT MODEL

Table 4 below shows the results of the common effect model applied to find out the impacts of board composition on earnings management.

Normality of the data will be a problem if the value of skewness and kurtosis of the variables are between +2 and –2 (Garson, 2004). To overcome the issue, the dependent variable data were transformed using normalization procedure described in Cooke (1998) and Young (1998).

Table 4. Regression analysis for variables

<table>
<thead>
<tr>
<th>The dependent variable is the discretionary accruals.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Coefficient</strong></td>
</tr>
<tr>
<td>Intercept</td>
</tr>
<tr>
<td>BSIZE</td>
</tr>
<tr>
<td>BIND</td>
</tr>
<tr>
<td>DUAL</td>
</tr>
<tr>
<td>LEV</td>
</tr>
<tr>
<td>FSIZE</td>
</tr>
<tr>
<td>MTB</td>
</tr>
<tr>
<td><strong>F Statistics= 25.41</strong></td>
</tr>
</tbody>
</table>

Significant F statistics i.e 25.41 confirms the validity of the model, and the highest Variance Inflation Factor is only 1.303 suggesting there is no serious multicollinearity problem. Kennedy (1998) suggests, VIF of more than 10 indicates harmful collineairties.

Table 4 shows the results of the common effect model applied to find out the impacts of board combination on earnings management. The value of discretionary accruals in this regression is estimated using the Modified Jones (1995) model. The results present non-significant relationships between board size and earnings management, thus H1 is rejected. Our result is different to Xie et al. (2003) and Coulton and Taylor (2001) who found significantly relationship between board size and earnings management.

The relation between DA and BIND is not significant, thus H2 is rejected too. Findings are different to Klein (2002) and Cornett et al. (2006) who found negatively relationship between board independence and earnings management. However, this result is consistent with the argument by Monks and Minow (1995) that independent non-executive directors have no significant economic ties to the firm beyond their job as directors. This implies that to be an interested and effective director, they should hold shares in the firm. Furthermore, CEO duality is positively associated with the discretionary accruals at a 5% level with a t-statistics of 2.234, thus H3 is not rejected, our findings consistent with the findings of Dechow et al (1996). The coefficients on the control variables show a positive relation between firm size and earnings management. Our finding is consistent with the findings of Moses (1987), Hsu and Koh (2005). We also find a negative relation between leverage and earnings management. This result is different with the findings of DeFond and Jiamhalvo (1994) and Swemey (1994).

The adjusted R2 is 26.3% indicating that only a marginal portion of the variability of DC is explained by the independent variables. This figure is, however, normal for any earnings management studies utilizing discretionary accruals as a proxy (Peasnell et al, 2005).

CONCLUSION

The conflict of interest between the managers of commercial section and other beneficiaries results from the fact that the managers of the corporation effectively control the corporation’s assets while they do not have the ownership
of major shares of that corporate. As a result, it is expected that they impose an opportunistic treatment in the financial reporting, including earlier identification of the earnings.

In this study, a comprehensive analysis was conducted regarding the relation between some characteristics of the board of directors and earnings management regarding financial reporting of the corporations accepted in Tehran Stock Exchange between the years 2002 to 2009. In particular, this paper examines the roles of independent members of the board, CEO duality and size of the board on earnings management. We consider the discretionary accruals of a firm to represent the extent of earnings management. Our estimate of discretionary accruals is based on the Modified Jones (1995) model.

Overall, this study finds no evidence between the degrees of earnings management with the proportion of non-executive directors. There are a few possible explanations for the inefficient monitoring by non-executive directors in curbing the earnings management in Iran. Non-executive directors may lack the financial expertise required to detect the earnings management. Therefore, they would find it difficult to assess or analyze certain information. It means the board’s effectiveness at monitoring the financial reporting process depends on the ability of non-executive directors to understand earnings management methods. In addition, non-executive directors in Iran may not be fully independent in the board. The non-executive directors may be close friends of the non-independent directors or the people in the board. Moreover, the presence of dominant managerial shareholders may make it difficult for non-executive directors to effective constrain the earnings management practices. Furthermore, passive or complacent attitude of directors may, in particular, lead to ineffective monitoring process in a firm. This result is consistent with the argument by Monks and Minow (1995) that independent non-executive directors have no significant economics ties to the firm beyond their job as directors. This implies that to be an interested and effective director, they should hold shares in the firm.

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 the 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 (Zahra, 1990; Solomon, 2007). Another probable reason is that duality may have been imposed, rather than adopted in 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 nonexecutive 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’.

Furthermore, we note a relationship between Board size (BSIZE) and earnings management amplitude. In fact, coefficient of BSIZE is positive but not significant, then we can say that the more board’s size is large, the more earnings management increases. Hence, large size of the board threatens efficient manager’s control and increases manager’s opportunistic behavior and accounting, and financial information is destroyed. This is absolutely evident, because the board’s large size induces opinion diversity, slowness of decision taking that benefits the manager. According to our findings, there is a positive significant association between firm size (FSIZE) 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’s firms, especially those with a large size.

This study paves the ways to investigate the relationship of earnings management and other board characteristics as well. As Iranian corporate governance environment is somewhat different from other countries, there is a possibility that results obtained are not in accordance with the generally believed phenomenon as in case of board composition in Iran.

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