

Earnings Management and Companies Ownership Structure in Iran (A Comparison of Earnings Management between companies with institutional investors and companies with individual investors)

Dr. Sanjar Salajeghe¹; Maryam Nazari Montazer²; Nima Nourollahi³; Jamal Valipour⁴;
Maryam HorMohammadi⁵

¹ Faculty Member and Group Manager of MA & PHD of management sciences, Islamic Azad University, Kerman Branch, Iran

^{2,5} MA Student, Islamic Azad University- Science & Research Kerman Branch

³ PHD student, Islamic Azad University, Kerman Branch

⁴ Faculty member in accounting and finance, Islamic Azad University- Babol Branch

ABSTRACT

The purpose of this study is to investigate the effect of ownership structure on earnings management in companies listed on the Tehran Stock Exchange. In this research companies divided to two groups: 1-companies with institutional investors (INS), 2-companies with individual investors (IND). The basic for dividing is standard No, 20 of Iran that emphasizes low share to direct control in investee companies is 20%. The sample comprises 636 firm-years observations from 212 companies (2006-2008). The results show that: 1) firms with low earnings before accruals have relatively high earnings management than firms with high earnings before accruals, 2) the companies with institutional investors (INS) are involved in more aggressive earnings management practices or in detail, companies with institutional investors (INS) tend to manipulate earnings upward more aggressively when their earnings before discretionary accruals are poor, and they downplay their earnings more than companies with individual investors (IND) when their earnings before discretionary accruals are exceptionally high.

KEY WORDS: earnings management, INS, IND, earnings before accruals, discretionary accruals, total actual.

1. INTRODUCTION

Some investigations have dealt with observed cases of fraud, litigation, SEC enforcement actions or earnings restatements (15; 4; 29; 13; 1). Other works go beyond the scope of these 'extreme' situations to address earnings management, commonly estimated by abnormal accruals (16; 5; 19; 30; 19; 26; 25, 31; 6). Earnings management does not necessarily result in the litigious context of fraudulent financial reporting; it can be defined as the use of managerial discretion to influence the results published to the company's stakeholders (17). Also, some studies investigated the relation between accounting system (accrual and cash) and shareholder protection. Hung (2001) studied the relation between accrual accounting and the value relevance of accounting measures in countries with different levels of shareholder protection. She finds that stronger shareholder protection improves the effectiveness of the accrual system. She argues that accrual accounting provides better matching of revenues and expenses than cash accounting and therefore makes accounting information more value relevant. However, accrual accounting also presents more opportunities for managers to manage earnings and hence may cause accounting information to be less value relevant. She predicts that strong shareholder protection will attenuate this negative impact.

Ownership structure influences the monitoring mechanism a company uses, including the monitoring of earnings-management activity. Balsam et al. (2002) state that institutional investors, who are sophisticated investors, are more capable of detecting earnings management than non-institutional investors because they have more access to timely and relevant information. Existing literature only examines the effect of institutional investors on earnings-management magnitude, while our study will examine the effect of institutional investors on the earnings management before accruals and compare with individual companies.

Institutional investors have a greater monitoring role if the company's ownership structure is widely dispersed. Wide-spread ownership structure only takes place in Anglo- Saxon countries, such as the United States and the United Kingdom. In other developed and developing countries, firms usually are

*Corresponding Author: Maryam Nazari Montazer, MA Student, Islamic Azad University- Science & Research Kerman Branch. Iran

controlled by founding families. La Porta, Lopez-de-Silanes, and Shleifer (1999), report that 85% of Spanish firms have controlling shareholders, compared to United States and the United Kingdom, which have only 10% and 20%, respectively. However, the majority of public firms in developing countries are controlled by families. Arifin (2003) suggests that agency problems in family controlled firms are not as serious as that in publicly-controlled firms or firms without controlling shareholders. In the former, there are fewer agency problems because the conflict between principal and agent is less than that in the latter. However, as Claessens, Djankov, Fan, and Lang (1999) find, family-controlled firms, through pyramid ownership structure and their business group, expropriate minority shareholders (i.e., the public).

This study examines whether ownership structure influence the type of earnings management selected in public firms in Iran, when they have low earnings before accruals. Prior research provides evidence that firms manage earnings for a variety of reasons. But, none of the prior studies have investigated the differences in the levels of earnings management among the different groups of companies.

Even though the purpose of this paper is examine differences in earnings management manners between different levels of companies, and to examine the motivation behind earnings management in these companies, there are many reasons to expect the existence of differences between the competing firm motivations. For example, companies do not tend to miss their big investor (institution ownership). In the other hand, institutional investors have more control to management performance.

If the largest shareholder faces greater contest and his or her control is more disputed, he or she must solicit a consensus with other shareholders to maintain the control necessary to make the main strategic decisions. Therefore, when the position of the largest shareholder is challenged, he or she may form control coalitions with other reference shareholders to reach the majority of the vote rights. Thus, the role of institutional investors and the formation of the controlling coalition within family firms are vital and can have a significant impact on the performance of the firm (7; 8; 11; 21). This study examines if companies with institutional investors have more tend to manage earnings when their earnings before accruals are low than companies with middle or small shareholder (individual investor).

Earnings management in this study is measured using total accruals and discretionary accruals estimated using Haribar and Collins (2002) model and modified Jones Model (13). The sample covers 212 companies from the Iran. Over the period of 2006-2008, there were 636 firm year usable observations of which 432 observations are INS and 204 observations are IND. The results show significant difference in earnings management levels between INS and IND over the sample period. The INS are more aggressive in earnings management measured by total and discretionary accruals. The study uses three methods to test the differences in earnings management levels between the two firms groups. First, a differences test of accruals means, then a regression analysis, and finally a graphic analysis similar to the one described by Burgstahler and Dichev (1997). The results of the three tests indicate that INS are more aggressive in earnings management relative to their IND. INS tend to manage earnings downward more aggressively than the IND when the earnings before discretionary accruals are high. On the other hand, INS tend to manage earnings upward more than IND when they have poor earnings before discretionary accruals.

2. LITERATURE REVIEW

Achieving earnings targets, such as avoiding losses, avoiding earnings decreases and meeting or beating analysts' forecasts, has been extensively studied in the accounting literature (14). In general, the consensus in prior research is that managers care greatly about these earnings benchmarks and are willing to engage in costly earnings management strategies to achieve them (21). Specifically, the survey results provided by Graham *et al.* (2005) report that top executives admitted to such behavior. About 75 percent of respondents agreed that beating earnings benchmarks is important to them.

Leuz, Nanda, and Wysocki (2003) investigate how investor protection affects firms' earnings management practices across countries. They find that earnings management is negatively associated with investor protection and legal enforcement. They conclude that investor protection is a fundamental determinant of the quality of reported accounting earnings across countries¹. This study extends their study, and systematically investigates how accounting standards affect earnings management and the quality of reported financial information. Note they investigate how investor protection affects firms' earnings management practices across countries, and not to investigate the effect of earnings before accrual to earnings management manners in different levels of investor protection. In contrast to prior literature, this study shows when companies with strong investor (institutional investors) have low earnings before accruals have relatively high earnings management than companies with individual investors.

3. RESEARCH METHOD

3.1. Sample

The sample consists of manufacturing companies collected from Stock exchange of Iran. It covers 212 companies from the Iran. Over the period of 2006-2008, there were 636 firm year usable observations of which 432 observations are INS and 204 observations are IND. As shown in Table 1, the INS are on average larger in terms of Total Accruals, and Table 1 also shows that the return on assets is almost equal in both groups (~0.12).

Table 1: Descriptive Statistics For INS and IND

| Descriptive Statistics For INS | | | | | |
|--------------------------------|-----|---------|---------|--------|----------------|
| | N | Minimum | Maximum | Mean | Std. Deviation |
| Total Assets | 432 | 18 | 13224 | 540.41 | 1085.732 |
| Gross Revenues | 432 | 0 | 9395 | 416.30 | 786.274 |
| Current Liability | 432 | 1 | 11896 | 360.70 | 885.839 |
| Current Assets | 432 | 4 | 9848 | 343.31 | 724.422 |
| Property, Plant and Equipment | 432 | 5 | 2402 | 125.09 | 241.592 |
| Operating Income | 432 | -155 | 1262 | 60.43 | 125.619 |
| Total Accruals | 432 | -2061 | 2331 | 5.45 | 182.134 |
| Earnings Before Accruals | 432 | -.83 | 1.70 | .1155 | .18676 |
| Discretionary Accruals | 432 | -.48 | .96 | .0059 | .14631 |
| ROA | 432 | -.210 | .610 | .11786 | .117905 |

| Descriptive Statistics For IND | | | | | |
|--------------------------------|-----|---------|---------|---------|----------------|
| | N | Minimum | Maximum | Mean | Std. Deviation |
| Total Assets | 204 | 21 | 64767 | 2260.62 | 7382.296 |
| Gross Revenues | 204 | 15 | 45039 | 1745.39 | 6283.806 |
| Current Liability | 204 | 15 | 48814 | 1520.17 | 5671.632 |
| Current Assets | 204 | 25 | 34079 | 1344.10 | 4143.862 |
| Operating Income | 204 | -19 | 8314 | 404.05 | 1187.884 |
| Property, Plant and Equipment | 204 | 4 | 16487 | 394.16 | 1367.699 |
| Total Accruals | 204 | -5894 | 4628 | 1.61 | 688.837 |
| Earnings Before Accruals | 204 | -.33 | .84 | .1399 | .15434 |
| Discretionary Accruals | 204 | -.51 | .59 | -.0022 | .12842 |
| ROA | 204 | -.158 | .595 | .11268 | .107882 |

3.2. Earnings Management Measures

In order to examine the earnings management, both total accruals and discretionary accruals are used. Following Haribar and Collins (2002) total accruals are estimated as follow:

$$TA_{it} = \Delta CA_{it} - \Delta CL_{it} - \Delta CASH_{it} + \Delta STDEBT_{it} - DEP_{it} \quad (1)$$

Where TA_{it} is the total accruals in year t for firm i, ΔCA_{it} is change in current assets from year t-1 to year t for firm i, ΔCL_{it} is the change in current liabilities from year t-1 to year t for firm i, $\Delta CASH_{it}$ is the change in cash from year t-1 to year t for firm i, $\Delta STDEBT_{it}$ is the change in short term debt from year t-1 to year t for firm i, and DEP_{it} is the depreciation expense in year t for firm i.

To estimate the discretionary accruals, the modified Jones model is used (Dechow, Sloan and Sweeney 1995):

$$\frac{TA_{it}}{A_{it-1}} = \alpha_{1i} \frac{1}{A_{it-1}} + \alpha_{2i} \frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}} + \alpha_{3i} \frac{PPE_{it}}{A_{it-1}} + \varepsilon_{it} \quad (2)$$

Where TA_{it} is the total accruals in year t for firm i, A_{it-1} is total assets in year t-1 for firm i, ΔREV_{it} is revenues in year t less revenues in year t-1 to year t for firm i, ΔREC_{it} is net receivables in year t less net receivable in year t-1 for firm i, PPE_{it} is gross property, plant and equipment in year t for firm i, and ε_{it} is error term in year t for firm i (unexplained component of total accruals)

To examine the difference in earnings management practices between INS and IND, I divided observations to two levels and conduct a difference test of accruals means. For each group of companies, I construct two portfolios based on the earnings management measure, the low 50% of mean and the high 50%. For example, I calculate the earnings before accruals (earnings before accruals = (operating income^t / total assets^{t-1}) – discretionary accruals^t), and for each group of companies I rank the observations according to this measure and I calculate the mean of earnings before accruals and then I divide them into two portfolios, one for the lowest 50%, the second for the highest 50% of mean. If INS are more aggressive in managing earnings, INS will follow heavier income increasing strategies relative to the IND in the lowest 50% portfolio, so that they will have significantly more positive accruals than IND. On the other hand, in the highest 50% portfolio, the INS will follow more aggressive income decreasing strategies that will leave them with significantly more negative accruals than the IND.

RESULTS

Table 2 shows the means of the earnings before management, that is operating earnings before total accruals or discretionary accruals. In table 2, the companies are ranked based on their earnings before total accruals into two portfolios. In the panel A the statistics of companies in the lowest portfolio are listed and in the panel B the statistics for companies in the highest portfolio are listed. The mean of total accruals for firms in the lowest 50% EBA in terms of earnings before total accruals is 50.0918 for INS, while this mean is 150.4906 for IND firms. The difference between the two means, 4.035, is statistically significant at 1% level. In the third column, the mean for total accruals for the companies in the highest 25% in terms of earnings before total accruals is -39.1828 and -147.2654, for INS and IND, respectively. The difference between the two means is -0.451 and it is significantly different from zero at 1% level. The interpretation of these results is that INS use significantly higher positive accruals, compared to IND, when the earnings before total accruals is poor, while they use significantly higher negative accruals, relative to IND, when earnings are exceptionally high. The same pattern is clearly evident when dividing the sample into portfolios based on the earnings before discretionary accruals. In Panel A and B, INS in the lowest earnings portfolio have mean discretionary accruals of 0.07715 and IND have a mean of discretionary accruals of 0.05753. The difference between the two means is 0.070857, which is significantly different from zero at 1% level. In the third column, I compare between INS and IND that fall in the highest 50% of earnings before discretionary accruals. The INS have negative accruals of -0.06532 and IND have less negative accruals of -0.06185. The difference, -0.064209, is significantly different from zero at 1% level. This means that INS employ more aggressive earnings decreasing policies when they have high earnings, and try to increase earnings using more aggressive earnings increasing policies when earnings are substantially low. The overall results in Table 2 indicate that INS are more aggressive in managing earnings relative to IND and that they manipulate earnings downward when they have high earnings and upward when they have low earnings in a manner that is significantly more aggressive than IND.

Table 2: means of the earnings before management

| Panel A | | | | Panel B | |
|---------------|-----------------|----------------|------------------------|----------------|------------------------|
| Lower 50% EBA | | | | Higher 50% EBA | |
| Group | | Total Accruals | Discretionary Accruals | Total Accruals | Discretionary Accruals |
| IND | Mean | 150.4906 | .05753 | -147.2654 | -.06185 |
| | N | 102 | 102 | 102 | 102 |
| | Std. Deviation | 570.66195 | .121353 | 763.71983 | .105941 |
| INS | Mean | 50.0918 | .07715 | -39.1828 | -.06532 |
| | N | 216 | 216 | 216 | 216 |
| | Std. Deviation | 196.97938 | .142826 | 153.93305 | .110991 |
| Total | Mean | 82.2952 | .07086 | -73.8508 | -.06421 |
| | N | 318 | 318 | 318 | 318 |
| | Std. Deviation | 363.69865 | .136424 | 452.17290 | .109242 |
| t-test | Mean Difference | 82.29523 | .070857 | -73.85078 | -.064209 |
| | t-ratio | 4.035 | 9.262 | -2.912 | -10.481 |
| | Std. Deviation | 363.69865 | .136424 | 452.17290 | .109242 |
| | Sig. | .0002 | .0001 | .0004 | .0001 |

EBA= Earnings Before Accruals

Regression Analysis

In table 3, I use regression analysis to validate the results of the differences test analysis shown in Table 2. I regress a dummy variable on the accruals measure. That dummy variable equals 1 for INS and 0 for IND. Therefore, a positive and significant indicates that INS have more accruals relative to IND. In the regression model I control for earnings before the accrual measure, the operating income of the last period, and the accruals measure in the pervious period. I run the regression analysis twice using total accruals and discretionary accruals as measures for earnings management as shown in (3) and (4).

$$TA_{it} = \beta_0 + \beta_1 D + \beta_2 EBTA_{it} + \beta_3 OP_INC_{it-1} + \beta_4 TA_{it-1} + \varepsilon_{it} \tag{3}$$

$$DA_{it} = \beta_0 + \beta_1 D + \beta_2 EBDA_{it} + \beta_3 OP_INC_{it-1} + \beta_4 DA_{it-1} + \varepsilon_{it} \tag{4}$$

Where TA_{it} is total accruals calculated in (1), DA_{it} is discretionary accruals as calculated in (2), D is a dummy variable that equals 1 if the firm is INS and zero otherwise, $EBTA_{it}$ is earnings before total accruals, $EBDA_{it}$ is earnings before discretionary accruals, OP_INC_{it-1} is operating income in year t-1, TA_{it-1} is total accruals in t-1 and DA_{it-1} is discretionary accruals in year t-1. The results in Table 3 show that the coefficients on the dummy variable, β_1 , for both models are positive and significant at 5% level (coeff. 0.026 and 0.050; t-value 1.146 and 1.477, respectively). This means that INS increase total and discretionary accruals on average more than IND. These results support the results of Table 2 that INS manage earnings more aggressively relative to IND. The regression results also show the significantly negative association between the earnings before accruals and the accruals measure, β_2 , which indicates that companies manage earnings depending on the level of earnings in the current year. If a company have a high before accrual earnings, on average, it manage the earnings downward, on the other hand if it has low earnings before accruals, it manage earnings upward which is consistent with the earnings smoothing pattern.

Table 3: regression analysis

| ANOVA | | | | | | |
|--------------|-------------|-----------------------------|------------|---------------------------|---------|------|
| Model | | Sum of Squares | df | Mean Square | F | Sig. |
| 3 | Regression | 8.609E13 | 4 | 2.152E13 | 403.674 | .000 |
| | Residual | 3.364E13 | 631 | 5.332E10 | | |
| | Total | 1.197E14 | 635 | | | |
| Coefficients | | | | | | |
| Model | | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
| | | B | Std. Error | Beta | | |
| 3 | (Constant) | 16658.161 | 17163.784 | | .971 | .332 |
| | D | 23762.396 | 20201.994 | .026 | 1.176 | .024 |
| | EBTA | -.879 | .023 | -1.761 | -37.486 | .000 |
| | OP_INC(t-1) | .972 | .035 | 1.321 | 28.096 | .000 |
| | TA(t-1) | .055 | .024 | .050 | 2.296 | .022 |
| ANOVA | | | | | | |
| Model | | Sum of Squares | df | Mean Square | F | Sig. |
| 4 | Regression | 3.402 | 4 | .851 | 75.703 | .000 |
| | Residual | 7.089 | 631 | .011 | | |
| | Total | 10.492 | 635 | | | |
| Coefficients | | | | | | |
| Model | | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
| | | B | Std. Error | Beta | | |
| 4 | (Constant) | .047 | .008 | | 5.592 | .000 |
| | D | .014 | .009 | .050 | 1.477 | .014 |
| | EBDA | -.378 | .024 | -.521 | -15.808 | .000 |
| | OP_INC(t-1) | 1.648 | .000 | .076 | 2.241 | .025 |
| | DA(t-1) | .222 | .034 | .215 | 6.563 | .000 |

Conclusion

Using a sample of different groups from Iranian companies, this paper shows that earnings management patterns differ between the two groups of companies (companies with institutional investors and companies with individual investors). Using two approaches to test for earnings management, the mean difference test, and regression analysis, the results show that INS follow more aggressive earnings management strategies relative to the other groups. INS manages earnings more aggressively downward compared to the IND if they have exceptionally high earnings. On the other hand, INS manages earnings more aggressively upward relative to other groups if they have low earnings. Also, the result of this study shows firms with high individual investor have relatively low earnings management when their earnings before accruals is low than other companies that have low earnings before accruals.

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