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Mechanisms of Corporate Governance and Earnings Opacity: An Evidence in an Emerging Market

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Abstract

In today's turbulent environment, many investors emphasize the importance of earnings transparency, and the lack of information or its uncertainty has become a fundamental issue in the financial markets. Therefore, it is rare to find anyone who ignores the importance of transparency in financial reporting, because shareholders and creditors make their important investment decisions based on companies' financial information. Therefore, the purpose of this research is to investigate the mechanisms of corporate governance and the opacity of earnings in the capital market of Iran during the period of 2013 to 2022 and for 113 examples of companies listed to the Tehran Stock Exchange. This research has been used to estimate the model using the panel data method, it indicates that there is no significant relationship between the characteristics of the board of directors and earnings opacity; and there is a significant relationship between the characteristics of auditors and earnings opacity. The results of this research are used for managers and investors.

Keywords: Corporate governance, Characteristics of auditors, Characteristics of the board of directors, Earnings opacity.

1 | Introduction

In today's turbulent environment, many investors emphasize the importance of earnings transparency, and the lack of information or its uncertainty has become a fundamental issue in the financial markets. Therefore, it is rare to find anyone who ignores the importance of transparency in financial reporting, because shareholders and creditors make their important investment decisions based on companies' financial information [1]. They want more and more transparent information about the performance of companies. Full disclosure along with transparency of financial reporting can create safe conditions and improve

investors' confidence [2]. Therefore, earnings management or manipulation can be recognized as one of the factors that lead to earnings uncertainty. In the absence of complete earnings transparency, managers are provided with the opportunity to hide negative information within the company in order to maintain their jobs and professional reputation. Therefore, negative and bad information accumulates inside the company [3, 4]. When the mass of accumulated negative information reaches its climax, it will become impossible and costly to maintain it for a longer period of time. As a result, the mass of negative information entered the market at once and caused the stock price to crash [5].

Financial reporters should provide useful information for investors, potential creditors and creditors to make appropriate decisions and allocate resources (FASB and IASB, 2010). In this process, the financial reporter has the task to reduce information asymmetry and agency cost between shareholders (principal managers) and managers (agents). In the absence of useful financial reporting, managers have more opportunities to shirk their responsibilities to shareholders. For example, managers can use discretionary accruals to manage earnings to hide negative (bad) information or engage in optimistic stock price maximization activities or compensation contracts [6, 7]. Bushman and Smith [8] suggest three different ways through which earnings opacity can affect financial markets. The first two ways deal directly with the firm's cost of capital through moral hazard and adverse selection. First, high-quality accounting information should reduce adverse selection costs by helping investors distinguish between a good and a bad investment; As a result, estimates and estimates are reduced, which in turn reduces capital costs. Second, high-quality accounting information should reduce moral hazard by helping investors distinguish between good and bad managers, thereby increasing management monitoring, which lowers the cost of capital [9, 10]. The third channel deals with transaction costs and liquidity. Earnings opacity increases agency costs by weakening the relationship between actual unobservable earnings and reported accounting earnings. Investors in markets with high agency costs try to protect themselves by increasing the bid-ask spread, which increases transaction costs and, as a result, investors get higher stock returns and require less commercial activity.

In recent years, corporate governance has become a major and dynamic aspect of business, and attention to it is increasing exponentially, and progress in the application of corporate governance law is growing globally [11]. International organizations such as the Organization for Economic Development and Cooperation provide acceptable international standards in this matter. In the United States and the United Kingdom, they continue to strengthen their corporate governance systems and pay special attention to shareholders and their relationships, accountability, improving the performance of the board of directors, auditors, and accounting and internal control systems. They are concerned that companies are controlled and managed with these methods. In addition, component investors, institutional investors, accountants and auditors and other actors of the money and capital market scene are aware of the existential philosophy and the necessity of constant reform and improvement of corporate governance [12].

Corporate governance is one of the important concepts that so far many definitions have been presented in relation to it, however, corporate governance can be defined as a set of methods and processes with the help of which companies are guided and controlled. One of the benefits of a strong corporate governance is that it controls management's opportunistic behaviors and reduces such behaviors. One of these opportunistic behaviors is earnings smoothing, which managers try to secure their interests through. Earnings smoothing is one of the causes of the lack of transparency of accounting earnings, and in other words, it has an inverse relationship with the transparency of accounting earnings [13, 14].

The opacity of accounting earnings causes information risk and thereby increases the investment risk and investors' expectations and increases the cost of capital. Therefore, earnings smoothing can be considered as the recipient of two significant negative consequences [4]. The first negative consequence of earnings smoothing is that it reduces the transparency of accounting earnings, and the second negative consequence is the increase in the cost of capital due to the opacity of accounting earnings. Considering the beneficial role of a strategic system in reducing management's opportunistic behavior such as earnings smoothing,

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theoretically it can be expected that a strong management system can increase the transparency of accounting earnings and reduce the cost of capital, and in other words, a strong strategic system It can reduce the negative consequences of earnings smoothing [15, 16].

Corporate governance systems have been shown to reduce agency risks and reduce managerial actions that harm shareholder wealth. Consequently, an effective corporate governance system should lead to an improved level of financial reporting. In particular, corporate governance systems are designed to reduce agency costs and preserve shareholder wealth. The following two mechanisms for corporate governance form the basis of the analysis: 1) board structure and 2) audit quality [17, 18].

The role of the board of directors and audit quality in the lack of earnings transparency in an emerging market like Iran has not been investigated yet, and these criteria show internal and external governance mechanisms that aim to increase the quality of financial reporting information [19]. In particular, auditors obtain assurance regarding the fair presentation of all financial statements prepared by management. While the board of directors appoints the auditors and approves the audited financial statements before they are released to the public. Therefore, this research seeks to answer this question: Is there a relationship between corporate governance mechanisms (internal and external) and earnings opacity in Iran's capital market?

2 | Research hypotheses

In this research, the corporate governance mechanisms are divided into two categories, the characteristics of the board of directors and auditors. Therefore, the following hypotheses have been explained:

I.   There is a significant relationship between the characteristics of the board of directors and earnings opacity.

II.   There is a significant relationship between the independence of the board of directors and earnings opacity.

III. There is a significant relationship between the duality of the board of directors and earnings opacity.

IV.   There is a significant relationship between board members and earnings opacity.

V.   There is a significant relationship between major shareholders and earnings opacity.

VI.   There is a significant relationship between auditors' characteristics and earnings opacity.

VII. There is a significant relationship between the size of the audit firm and earnings opacity.

VIII. There is a significant relationship between the auditor's opinion and earnings opacity.

IX.   There is a significant relationship between the auditor's fee and earnings opacity.

X.   There is a significant relationship between the auditor's expertise and earnings opacity.

3 | Research Method

3.1 | Statistical Population

The statistical population of the research is the companies listed to the Tehran Stock Exchange in the period of 10 years from 2013 to 2022. Statistical samples are selected by systematic elimination, and the minimum limits for selecting samples are as follows:

1. Companies whose fiscal year ends 29/12/XX.

2. Companies that were admitted to the stock market before 2013.

3. They should not be other than financial and investment intermediary companies (investment, holding, leasing and banks).

4. The required data is available.

According to the applied restrictions, 113 companies from Tehran Stock Exchange were studied as a sample. This study used regression to analyze 1,130 firm-year observations of listed companies in Tehran Stock Exchange from 2013 to 2022.

3.2 | Research Variables and Models

In this research, in order to test the hypothesis, the following regression model taken from the research of [20] has been used:

$$\text{OPACITY}_{it} = \beta_0 + \beta_1 \text{BOARD} - \text{COMP}_{it} + \beta_2 \text{AUDIT} - \text{COMP}_{it} + \beta_3 \text{SIZE}_{it} + \beta_4 \text{LEV}_{it} +$$
$$\beta_5 \text{AR}_{it} + \beta_6 \text{BM}_{it} + \beta_7 \text{ST}/\text{PT}_{it} + \beta_8 \text{ROA}_{it} + \varepsilon_{it}$$

(1)

Dependent variable

OPACITY: earnings opacity obtained by using the following model [20]:

$\text{OPACITY}_{it} = \text{AbsV}(\text{DACC}_{it-1}) + \text{AbsV}(\text{DACC}_{it-2}) + \text{AbsV}(\text{DACC}_{it-3})$. That DACC is derived from the residual of the modified Jones model [21].

$$\frac{\text{TACC}_{it}}{\text{TA}_{it-1}} = \alpha_0 + \alpha_1 \left(\frac{1}{\text{TA}_{it-1}}\right) + \alpha_2 \left(\frac{\Delta \text{REV}_{it}}{\text{TA}_{it-1}}\right) + \alpha_3 \left(\frac{\text{PPE}}{\text{TA}_{it-1}}\right) + \alpha_4 \left(\frac{\text{NI}}{\text{TA}_{it-1}}\right) + \varepsilon_{it}$$

(2)

TACC represents the total accruals that result from the difference between operating earnings and operating cash flow. TA also represents the book value of total assets. ΔREV is obtained from the difference between the sales of the current year and the previous year. PPE also refers to machinery, property and equipment. NI also represents the net earnings of the company. It should be noted that equation (2) is estimated based on year and industry. Then the estimation of $\alpha 1$, $\alpha 2$ and $\alpha 3$ obtained from equation (2) is used to estimate DACC as follows:

$$\text{DACC}_{it} = \frac{\text{TACC}_{it}}{\text{TA}_{it-1}} - \left[\hat{\alpha}_1 \left(\frac{1}{\text{TA}_{it-1}}\right) + \hat{\alpha}_2 \left(\frac{\Delta \text{REV}_{it}}{\text{TA}_{it-1}} - \frac{\Delta \text{REC}_{it}}{\text{TA}_{it-1}}\right) + \hat{\alpha}_3 \left(\frac{\text{PPE}}{\text{TA}_{it-1}}\right)\right]$$

(3)

ΔREC represents changes in accounts receivable.

Independent variables

It includes the characteristics of the board of directors and the characteristics of auditors:

BOARD-COMP: characteristics of the board of directors obtained from the following relationship:

$$\text{BOARD} - \text{COMP} = \sum (\text{INDEPEND}_{it} + \text{DUALITY}_{it} + \text{BOARDSIZE}_{it} + \text{DAGSH}_{it})$$

In the above relationship, the variables include:

INDEPEND: The independence of the board of directors, if the ratio of non-obligatory members to the total members of the board of directors is higher than the median of the sample, the number is one and otherwise zero.

DULITY: The duality of the board of directors, if the CEO is also the chairman of the board of directors, the number is 1, otherwise the number is zero.

BOARDSIZE: If the number of board members is more than the median of the sample, the number is one and otherwise the number is zero.

DAGSH: The percentage of total shares owned by major shareholders, if it is greater than the median of the sample, the number is one and otherwise it is zero.

AUDIT-COMP: The characteristics of auditors obtained from the following relationship:

$$AUDIT-COMP_{it} = \sum (BIG_{it} + AUDITFEE_{it} + EXPERT_{it} + AO_{it}).$$

In the above relationship, the variables include:

BIG: The size of the audit firm, if the audit organization is in charge of auditing the company, the number is one and otherwise it is zero.

AO: auditor's opinion, if the auditor's opinion is conditional, number 1, otherwise zero.

AUDITFEE: The auditor's fee, if the logarithm of the auditor's fee is greater than the median, the number is one and otherwise it is zero.

EXPERT: Expertise of the auditor, if the auditor is an expert, number 1, otherwise zero.

Control variables

SIZE: company size, logarithm of total book value of assets.

LEV: Financial leverage, the ratio of debt to total assets.

AR: Accounts receivable to total assets.

BM: Ratio of book value to market value of equity.

ST/PT: loss, if the company has been loss-making for two consecutive years, the number is one, otherwise, the number is zero.

ROA: Return on assets, the ratio of net profit to total assets.

4 | Research Finding

4.1 | Descriptive Statistics

Table 1 shows the descriptive statistics of research variables.

Table 1. Descriptive statistics of research variables.

Variable	Symbol	Mean	Median	Max	Min	S.D
Earnings opacity	OPACITY	.23	.2	.91	.01	.14
Characteristics of the Board of Directors	BOARDCOMP	1.08	1	4	.0	.84
Characteristics of auditors	AUDITCOMP	1.63	2	4	.0	.92
size of the company	SIZE	14.45	14.35	20.30	10.49	1.54
Financial Leverage	LEV	.62	.6	3.97	.04	.37
Accounts Receivable	ARV	.25	.22	.81	.0	.18
Book-to-market ratio of equity	BM	.24	.2	3.67	-6.25	.57
loss	STPT	.16	.0	1	.0	.36
return on assets	ROA	.11	.1	.69	-.6	.16
Independence of the board of directors	INDEPEND	.41	.0	1	.0	.49

<div align="center">Table 1. (Continued).</div>

Variable	Symbol	Mean	Median	Max	Min	S.D
Auditor's opinion	AO	.49	.0	1	.0	.5
The size of the auditor	BIG	.2	0	1	.0	.06
Board size	BOARDSIZE	.003	.0	1	.0	.06
Audit Fee	AUDITFEE	.45	.0	1	.0	.0
Institutional shareholder	DAGSH	.49	.0	1	.0	.5
The duality of the board of directors	DULITY	.18	.0	1	.0	.38
The expertise of the board of directors	EXPERT	.48	.0	1	.0	.5

4.2 | Estimation of the Research Model

Based on *Model (1)*, *Hypotheses (1)* and *(6)* of the research were tested and the results are shown in *Table 2*.

<div align="center">Table 2. Estimation of the first and sixth hypothesis.</div>

Symbol	β	t	Sig.
C	.19	7.83	.000
BOARDCOMP	.0008	.19	.8419
AUDITCOMP	-.013	-6.49	.000
SIZE	.003	2.04	.0415
LEV	-.01	-1.12	.2610
ARV	.01	.83	.4036
BM	-.002	-.35	.7198
STPT	-.001	-.12	.8972
ROA	.04	3.16	.0016
R^2	.79	F	10.60
R^2 Adj.	.63	Durbin-Watson	1.98

Based on the results of *Table 2*, the first hypothesis means that there is no significant relationship between the characteristics of the board of directors and earnings opacity, and the sixth hypothesis means that there is a significant relationship between the characteristics of auditors and earnings opacity.

4.3 | Estimating the Hypotheses of the Characteristics of the Board of Directors and Auditors

The test results of other hypotheses that have not been tested are shown in *Table 3*. The results showed that there is a positive and significant relationship between the independence of the board of directors and earnings opacity. Also, the results showed that there is no significant relationship between the dual duties of the board of directors and earnings opacity. Also, there is a negative and significant relationship between the size of the board of directors and earnings opacity; and there is a negative and significant relationship between major shareholders and earnings opacity.

The results showed that there is no significant relationship between the size of the audit firm and the auditor's opinion and earnings opacity. There is a negative and significant relationship between the auditor's fee as auditor's independence and auditor's expertise and earnings opacity.

Table 3. Estimation of other hypothesis.

Symbol	β	t	Sig.
C	.17	8.14	.0000
INDEP	.02	3.44	.0006
DUAL	.005	1.45	.1451
BOARDSIZE	-.02	-3.62	.0003
DAGSH	-.01	-2.16	.0305
BIG	-.008	-1.11	.2664
AO	-.005	-1.14	.2542
AUDITFEE	-.02	-14.07	.0000
EXPERT	-.01	-2.05	.0400
Size	.004	3.21	.0014
Lev	-.01	-1.99	.0462
ARV	.02	1.06	.2852
BM	-.01	-0.3	.9682
STPT	-.001	-.005	.9959
ROA	.04	1.68	.0919
R^2	.64	F	12.42
R^2 Adj.	.59	Durbin-Watson	1.75

5 | Conclusion and Discussion

The present study examines the impact of corporate governance mechanisms on earnings opacity. The results showed that most governance mechanisms have a significant relationship with earnings opacity. These findings can greatly help regulators and investors, as earnings opacity is an issue that exacerbates agency costs and leads to adverse selection [22, 23]. The results of our study help regulators and policymakers in an emerging market like Iran to implement reforms to improve the quality of national governance. This can be achieved by using good governance practices, improving shareholder rights, and activating regulations and laws governing the performance of companies. Based on the above discussion, this study revealed limitations that may stimulate further research. We have focused on some variables of corporate governance mechanisms. However, we also recommend considering other board-related characteristics such as the number of women on the board (board gender diversity), CEO tenure, which are not present in this study. For example, examining the structure of leadership in relation to gender and whether this factor directly affects earnings transparency would be beneficial in order to get more answers about how more women in leadership could affect this.

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Data Availability

The data that support the findings of this study are available upon reasonable request from the author.

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