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CONTENTS

Sr. No.	TITLE & NAME OF THE AUTHOR (S)	Page No.
1.	DO EXECUTIVE DIRECTORS MANIPULATE EARNINGS? <i>SEYED HOSSEIN HOSSEINI & MOHAMADREZA ABDOLI</i>	1
2.	MANAGEMENT EDUCATION – IMPACT OF VALUE ORIENTATIONS ON CAREER & BUSINESS <i>PUSHPA SHETTY</i>	7
3.	STRATEGIC GAINS OF BY-PRODUCT MARKETING: A STUDY ON SELECTED COMPANIES OF BANGLADESH <i>GOLAM MOHAMMAD FORKAN & TAHSAN RAHMAN KHAN</i>	13
4.	THE EFFECT OF CURRENCY DEVALUATION ON THE ETHIOPIAN ECONOMY'S TRADE BALANCE: A TIME SERIOUS ANALYSIS <i>FIKREYESUS TEMESGEN & MENASBO GEBRU</i>	17
5.	MUTUAL FUNDS IN INDIA: AN ANALYSIS OF INVESTORS PERCEPTIONS <i>DR. PRASHANTA ATHMA & K. RAJ KUMAR</i>	21
6.	FINANCES OF CENTRE FOR DISTANCE EDUCATION, OSMANIA UNIVERSITY, HYDERABAD, ANDHRA PRADESH: AN ANALYTICAL STUDY <i>G. VENKATACHALAM & P. MOHAN REDDY</i>	27
7.	THE INFLUENCE OF MARKETING ON CONSUMER ATTITUDE FUNCTIONS FOR KITCHENWARE, A STUDY WITH SPECIAL REFERENCE TO KOCHI METRO <i>ANILKUMAR. N</i>	32
8.	BEHAVIOURAL FINANCE: A NEW PERSPECTIVE FOR INVESTMENT IN FINANCIAL MARKET <i>DR. SREEKANTH. M S</i>	39
9.	THE EFFECT OF MERGER AND ACQUISITIONS ON THE SHAREHOLDERS' WEALTH: EVIDENCE FROM THE FOOD INDUSTRY IN INDIA <i>DR. RAMACHANDRAN AZHAGAI AH & T. SATHISH KUMAR</i>	42
10.	WHETHER DIFFERENCES MAKE DIFFERENCES? A NEW PARADIGM ON WORKFORCE DIVERSITY <i>D. RAMADEVI & DR. S. A. SENTHIL KUMAR</i>	54
11.	CORPORATE SOCIAL ENGAGEMENT: NEW BASE LINE TO CORPORATE SOCIAL RESPONSIBILITY <i>KAVITA MEENA</i>	59
12.	GREEN MARKETING <i>BRIJESH SIVATHANU PILLAI & KANCHAN PRANAY PATIL</i>	64
13.	MARKET EFFICIENCY AND INTERNATIONAL BENCHMARKS IN THE SECURITIES MARKET OF INDIA – A STUDY <i>DR. MUNIVENKATAPPA</i>	74
14.	CHALLENGE OF LIQUIDITY RISK AND CREDIT RISK IN INSURANCE COMPANIES WITH SPECIAL REFERENCE TO INDIAN PUBLIC SECTOR GENERAL INSURANCE COMPANIES <i>AVINASH TRIPATHI</i>	82
15.	CONTEMPORARY ISSUE ON DEREGULATION OF SAVING ACCOUNT INTEREST RATE <i>DR. RAJIV GANDHI</i>	87
16.	A STUDY ON THE EFFECT OF FOOD ADVERTISEMENTS ON CHILDREN AND THEIR INFLUENCE ON PARENTS BUYING DECISION <i>GINU GEORGE</i>	92
17.	DETERMINANTS OF CORPORATE DIVIDEND POLICY IN SELECT PRIVATE SECTOR CEMENT COMPANIES IN TAMIL NADU - AN EMPIRICAL ANALYSIS <i>DR. V. MOHANRAJ & DR. N.DEEPA</i>	107
18.	THE ROLE OF 'FOLLOW THE NEIGHBOUR' STRATEGY AND FACTORS INFLUENCING INVESTMENT DECISION WITH REFERENCE TO NASIK CITY <i>BHUSHAN PARDESHI, PAVAN C. PATIL & PADMA LOCHAN BISOYI</i>	110
19.	IMPACT OF ADVERTISING ON BRAND RECALL AND BRAND PERSONALITY FORMATION: A STUDY OF ORGANISED FASHION RETAILING <i>HIMANSHU SHEKHAWAT & PREETI TAK</i>	116
20.	A CASE STUDY ON STRESS MANAGEMENT IN WORKING WOMEN IN GOVERNMENT\SEMI-GOVERNEMNT ENTERPRISES IN SHIMLA, (H.P.) <i>SHALLU SEHGAL</i>	122
21.	LEVERAGE ANALYSIS AND IT'S IMPACT ON SHARE PRICE AND EARNING OF THE SELECTED STEEL COMPANIES OF INDIA – AN EMPIRICAL STUDY <i>MUKESH C AJMERA</i>	129
22.	A STUDY ON LEVEL OF EXPECTATION OF MUTUAL FUND INVESTORS & IMPACT OF DEMOGRAPHIC PROFILE ON PERIOD OF INVESTMENT IN MUTUAL FUND <i>TARAK PAUL</i>	136
23.	IMPACT OF MERGERS & ACQUISITIONS ON FINANCIAL PERFORMANCE: WITH SPECIAL REFERENCE TO TATA GROUP <i>NEHA VERMA & DR. RAHUL SHARMA</i>	140
24.	EXPLORING SERVICE INNOVATION PROCESS AND STRATEGY IN DEVELOPING CUSTOMER RELATIONSHIP-WITH REFERENCE TO CENTURYBANK 'YES BANK' <i>SHILPA SANTOSH CHADICHAL & DEBLINA SAHA VASHISHTA</i>	144
25.	EMPLOYEE LOYALTY ABOVE CUSTOMER LOYALTY <i>AFREEN NISHAT A. NASABI</i>	152
26.	FDI IN MULTIBRAND RETAILING IN INDIA: PERCEPTION OF THE UNORGANISED RETAILERS IN BUSINESS CAPITAL OF UTTARAKHAND <i>DEEPAK JOSHI</i>	156
27.	COMPARATIVE STUDY OF SELECTED PRIVATE SECTOR BANKS IN INDIA <i>NISHIT V. DAVDA</i>	161
28.	IMPACT OF HRM PRACTICES ON PERFORMANCE OF NON-ACADEMIC EMPLOYEES OF OPEN UNIVERSITIES IN INDIA <i>B. LAXMINARAYANA</i>	167
29.	POST-MERGER FINANCIAL PERFORMANCE APPRAISAL OF ACQUIRING BANKS IN INDIA: A CASE ANALYSIS <i>AZEEM AHMAD KHAN</i>	172
30.	MANPOWER REQUIREMENT ASSESSMENT CONSIDERING THE MAKE OR BUY DECISION POLICY OF CENTRAL WORKSHOP IN AN INTEGRATED STEEL & POWER COMPANY <i>AKHILESH JHA, SOUPOARNO MUKHERJEE & RANDHIR KUMAR</i>	176
	REQUEST FOR FEEDBACK	181

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DO EXECUTIVE DIRECTORS MANIPULATE EARNINGS?

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ABSTRACT

In this study we examined the effect and role of executive directors and ownership concentration of companies on probability of earnings manipulation. Companies in our study have been accepted in Tehran stock exchange and include 168 companies that are randomly selected. The investigated period has been between 2007 to 2011 and single variable linear regression method is used and the acceptable error level is considered 5%. Earnings manipulation is calculated by adjusted Jones model and discretionary accrual accounting. Results showed that in studied companies the higher the ratio of board of directors, the more the earnings manipulation rate, and there is a significant relationship. In addition, in companies where dispersion of shareholders is more, earnings manipulation rate is also more. In other words in companies where majority of shares ownership belongs to one or more shareholders, earnings manipulation and management rate are also more. Examining studied companies revealed that dispersion of shareholders is more in private companies, and shareholders often have low number of shares and also the board of executive directors ratio is 73%, while it is 58% in state companies. In addition, the percentage of bankruptcy in private companies is 26%, while it is 41% in state companies.

KEYWORDS

Earnings manipulation, executive director.

INTRODUCTION

Renders et al. 2010 and Rahnamayroodposhti and nabavichashmi, 2011 believes that the managers may embark with a set of real financial events to manipulate the in registering the public costs and advertisement and discounts and administrative costs also the coagulation of contracts which causes the deviance of clients from financial statements.

In the face of the divergence between sacred and secular in the west. Islam has always been viewed as the blueprint and social cement of a civilization .They explore alternative perspectives on governance by comparing the Islamic model of governance with the conventional western model. Within this framework, they present the principles of Islamic economics and Justice and review the practices of taxation, budget deficits, and government finance. This methodology selects the theories that are closest to the Islamic spirit.(Iqbal and Lewis 2009 ;Teresa and Pergola, 2009)

Watts and Zimmerman, 1990 and Chodhari, 2007 and Decow et al .1996 and Roychowdhury, 2006, believes that the managers may embark with a set of real financial events to manipulate the profits. Such cases we can refer to changing the sales program, costs of research and development and tardiness in registering the public costs and advertisement and discounts and administrative costs also the coagulation of contracts which causes the deviance of clients from financial statements.

A numerous research have shown (Piot and Janin, 2007; Meca and balesta, 2009) that in companies is which the ownership distribution is more than others and there is no stockholders or on the other hand the stockholders are distributed. The possibility of controlling over the managers performance is less than others.

Some researcher in different countries has emphasized this subject that the companies whose board members are non-duty-board and more experienced and skillful in the company's subject field, can have a good control over the executive managers and managing director performance.

And reduce the agencies, costs, moreover if the managing director's duty is separated from the board in the company. Controlling over the managing director performance will be improved (Yu, 2010; Youngbyun and et al. 2011; Wan, 2009).

According to the results of other researchers (Cao 2010, Atmaja 2009) about the effect of improvement of super in tendency and control over the reduction of the managers agency costs and according to the publication of the corporate governance by Tehran Stock Exchange the present research has been done and is being tried to investigate the corporate governance according to Iran particular circumstances and also accounting standards.

REVIEW OF LITERATURE

Ibrahim and abdulesamad 2010 in their own research in have considered the relationship and existence effect of internal auditor and auditing committee and earnings management. They have assessed the effect of different dimension of auditing quality such as accountant prestige, the existence of auditing committee and their dependence over management and the profit alteration. The results of their research were that the existence of accountants from 5 auditing famous companies has not caused the earnings management reduction. The existence of auditing committee has caused the earnings management. They express that these results in corporate governance is related to French companies which is different from the U.S.A.

Mohammad Alabbas 2009 in his research in Saudi Arabia Market has recompensed to relationship of corporate governance with earnings management. The temporal period of his investigation was 2005 - 2007. For the measurement of in discretionary accrual accounting items of the constituents which have been used in this research. The board combination, their independence, the existence of auditing committee in companies and the sovereignty of board duty form managing director of the companies. He has observed no meaningful relationship between corporate governance contractual and earnings management but realized that there is a negative relationship in companies between the auditing institute sizes and discretionary accrual accounting items.

Silvia Serijaro and Seyed Harta Otama 2008 in his research in Indonesia considered the relationship of the earnings management method with the companies' ownership structure and the size of the company and corporate governance. They realized that family structure in companies has a relationship with both the importance and the earnings management. They also have not observed and found any relationship between company's size and the existence of holding companies, constitutive investment and corporate governance with earnings management.

Agaiee and Chalaki 2010 in their research have referred to the relationship of constitutive investors and board independence with profit flattening in Iranian companies. They realized that there is a negative meaningful relationship between constitutive ownership and earnings management and also board independence with earnings management. They did not find any relationship between ownership concentration with earnings management.

Hasas Yeganeh 2009 have referred in Iran the different effective factors on placement of the company ownership system. The results of their investigation are the effect of factors such as company's ownership structure and the country legal framework and financial systems of a company.

Yazdainan 2007 have referred in Tehran Stock Exchange to the relationship of board independence and the existence of internal accountant with profit alteration by managers. The result of their research was if the percentage of the constitutive is more than %45, the earnings management reduces and also there is a meaningful relationship between board independence and the existence of internal auditor.

Midary 2006 has referred the effect and the position of landowner structure and distributed and public ownership structure and family ownership structure in Iran economy and has concluded that in Iran stock market like countries China and India against the U.S.A landowner structure and distributed has had the worst performance.

Mehrazin and et al 2008 in their research for the exploration of voluntary undertake items have referred to compare the different models in Iranian companies and ultimately, concluded that Johns' modified model and the modified model with their inflation show a better behavior toward earnings management.

Chen and Elder and Hung 2010 examine the incentive and entrenchment effects of controlling shareholders on the association between the investment opportunity set and earnings management in Taiwan. They find that firms with more investment opportunities are more likely to engage in earnings management and also find incentive effects of controlling shareholders on firms financial reporting behavior in that cash flow rights are negatively associated with absolute abnormal accruals under a growth opportunity setting. Their results further indicate that high-growth firms with a high deviation between cash flow right and control right are more likely to engage in earnings management.

Judge 2010 have studied in Iran about different effective factors on placement of the company ownership system. The results of their investigation are the effect of factors such as company's ownership structure and the country legal framework and financial systems of a company.

IMPORTANCE OF THE STUDY

The importance of this study is due to examining the impact of board of directors composition in Iranian companies on earnings manipulation. This view can be explained based on agency theory. Thus agency theory in Iranian companies is somehow studied. In addition, the effect of shareholders on earnings manipulation is also studied.

STATEMENT OF THE PROBLEM

The studied problem in this research is the relationship and influence of board of directors and shareholders composition on earnings manipulation probability by executive directors elected by shareholders and board of directors. In addition, the effect of choosing the chairman by board of directors based on Iran commercial law on earnings manipulation is another case to be investigated.

OBJECTIVES

The objectives of this study include:

1. Examining the effect of board on probability of earnings manipulation by managers.
2. Examining the effect of shareholders on probability of earnings manipulation by managers.
3. Examining earnings manipulation in private, state, bankrupt and non-bankrupt companies.

HYPOTHESIS

According to the above researches' results in Iran and according to the corporate governance performance by accepted companies' in Tehran Stock Exchange, hypothesis have been compiled:

Hypothesis 1: there is meaningful and negative relationship between non executive director and discretionary accrual accounting items.

Hypothesis 2: there is meaningful and negative relationship between ownership concentration of companies and discretionary accrual accounting items.

RESEARCH METHODOLOGY

In this section research, variables have been identified and their way of measurement has been explained and then the experimental research according to theoretical principle and also Iran environmental and legal circumstances arranged.

EXECUTIVE DIRECTOR RATIO

Iranian companies according to trade Law and corporate governance rule and their article can choose their board of directors from out of the company; these directors can be the managers of other company but on the basis of related law to governmental organization they cannot be the managers of governmental corporation. The names of these boards are disclosed in annual report of corporation to public. Since these directors do work full-time in the company are informed about the detail performance of corporation but they have not independence and can supervise on directors and CEO. This ratio is obtained through dividing the numbers of executive directors by total number of the board of directors.

OWNERSHIP CONCENTRATION RATIO

In Iranian companies stockholders usually embark to choose the managers and other stockholders (having little share) don't have any role in choosing the managing directors and managers. From the point of view of theoretical it is confirmed. It is supposed that stockholder must take into view his/her benefits and must not consider other stockholders. Iran owns concentration law has not presented a special quality control mechanism. For the measurement of this variable in each company, own concentration rate is calculated the more this standard, the more the concentration of stockholders.

Own concentration is how is the distribution of allotment between different companies stockholders. The less the stockholders, the more concentrated is own. In this study, in order to calculate the own concentration ratio from Herfindal –Hirschman model has been used. The above standard is obtained through total square root of allotment percentage belong to companies' stockholders.

Side by side the standard, own concentration rate is increased and in the situation that total allotment belongs to one person. The most value will be allocated and is calculated for equivalent 10000 units whereas, ownership structure was distributed and all stockholders own equal ratios. The "HHI" has the least value and is calculated for the equivalent of $N/10000$.

$$HHI = \sum (p_i / p * 100)^2$$

(Equation 1)

MANIPULATED EARNINGS

The discretionary accrual accounting is substitute for manipulated earnings and is measured with Jones' modified model. In this model has been attempted to separate the discretionary accrual and undiscretionary. The effect of economic condition a business on contractual items for a specific period of time which is known as " event period" with selling and properties and machinery variables and equipments is estimated as follow:

$$\frac{TA_{it}}{A_{it-1}} = \alpha_1 \left(\frac{1}{A_{it-1}} \right) + \alpha_2 \left(\frac{\Delta REV_{it}}{A_{it-1}} \right) + \alpha_3 \left(\frac{PPE_{it}}{A_{it-1}} \right) + \epsilon_{it}$$

(Equation 2)

TA_{it} is the total accrual accounting items, A_{it} is total assets, REV_{it} is changes of selling income and PPE_{it} is changes of properties machinery and equipments. After estimating of parameters of the above model by the help of information of the year 2007 to 2010, each company through implementation of temporal models of in discretionary accrual accounting items as mentioned below estimates for the "estimation period" it means the year 2010.

$$NDA_{it} = \alpha_1 \left(\frac{1}{A_{it-1}} \right) + \alpha_2 \left(\frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}} \right) + \left(\frac{PPE_{it}}{A_{it-1}} \right)$$

(Equation 3)

In the last step the discretionary accrual accounting items or the standard of earnings management is calculated as below:

$$DA_{it} = \frac{TA_{it}}{A_{it-1}} - NDA_{it}$$

(Equation 4)

On the basis of theoretical, the total accrual accounting items is calculated with the below method according to annually financial statements. In this research we calculate the difference between net income and net cash flow from the operation on the basis of Iran accounting standards as total accrual items.

$$TA_{it} = E_{it} - OCF_{it}$$

(Equation 5)

In the above formula E_{it} reagents the net profit before the tax and ocf_{it} cash flow from the operation and TA_{it} reagents the total accrual accounting items in time period of 2011.

RESEARCH MODEL

According to theoretical bases and research literature and also other carried out researches in Iran, the relationship between variables will be identified as below. By dividing the variable of corporate governance to each of favorable components of research which has been pointed in hypothesis; the research model will be compiled as below:

$$DA_{it} = \alpha_0 - \alpha_1 * \% \text{exe director} - \alpha_2 * \% \text{Own Conc} + \alpha_3 * \text{Variable Control} + \epsilon$$

(Equation 6)

% **exe** as the executive directors or in - board of director ratio and %**own conc** as the ownership concentration of the companies and **variable control** involved the controls variables of research, for example the type of company's ownership (on the basis of governmental and private) and companies bankruptcy according to the Z_{altman} index.

RESULTS & DISCUSSION

For the considering of research models and also the check up the research hypothesis, the accepted companies have been evaluated in Tehran Stock Exchange. The end of their fiscal year should be the end of ESFAND (Mid - March) and should not involve the investment companies and in time period Of 2007 to 2011 their data should be available.

The number of the companies according to the above condition is 281 which 168 companies from different industries have been chosen randomly.

TABLE 1: DESCRIPTIVE STATISTIC OF THE STATISTICAL SAMPLE CORPORATION

Number of Selected Corporation	Total Number of Corporation	Type of industries
17	29	Mineral corporation
13	21	Food Corporation
26	45	Cement and Tile corporation
31	65	Metal corporation
28	45	Automobile corporation
28	41	Petrochemical corporation
25	35	Pharmacy corporation
168	281	Total

Before investigation and checking up each of the research hypothesis the results of descriptive statistic related to each of the variables will be studied. The results of the tests related to regression presumptions are offered and in the end the results of research hypotheses will be displayed. The results of variables are shown in below table:

TABLE 2: TABLE OF DESCRIPTIVE STATISTIC OF THE VARIABLES

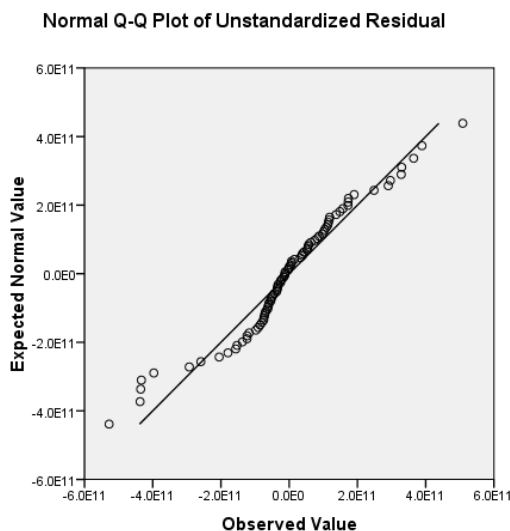
Variance	St. Deviation	Statistical Mean	Type of corporation	Variable
2.633	1.415	-4.127	dependence	Discretionary accrual accounting
3.3464	2.3621	0.5621	Independence	executive director Ratio
1.1374	2.3790	6.1673	Independence	ownership Concentration ratio

As it is shown in the above table, the deviation results from criteria and the variables variances in companies are close to each other and are not much.

Before the investigation of hypothesis we investigate the presumptions regression model:

1- The investigation of being normality of reminders. In this case the "Kolmogrouf Smirnov" test has been used; one method for investigating the results of this test is drawing the diagrammatic reminders which have been mentioned below:

GRAPH 1: NORMAL PLOT OF UN STANDARDIZED RESIDUAL



Moreover, the results of statistical hypothesis H_0 based upon data normality, since P-value is more than %5 the confirmation and the hypothesis confronting it has not been confirmed.

N	NORMAL PARAMETER	KOLOMOROV- SMIRNOVE	SIGN
168	.0000562	1.746	0.169

2- The investigation of independence observation. In this test with the help of a Durbin-Watson dependant errors is assessed, or on the other hand, the investigation of whether the observed quantities have relationship with the other qualitative observations or not? If the hypothesis of the independent errors is not confirmed, the use of regression is impossible the results of this test have been show as below:

TABLE 3: CONSEQUENCE OF DURBIN-WATSON TEST

Model	R	Change Statistics		Durbin-Watson
		R Square Change	F Change	
1	.129	.060	1.005	2.006

As it is shown in the above table, the technical Durbin -Watson at normal level in, that is, more than 2 and less than 2.5. Thus we can conclude that the errors are dependant from each other.

3- The conforming test of independent variables. For the investigation that whether independent variables have high correlation or not, the VIF has been used which its results show lack of correlation between independent variables with each other.

The investigation of the research has been complied considering Iran environmental situations as below:

RESEARCH HYPOTHESIS

In the first hypothesis has been mentioned that there is a negative and meaningful relationship between discretionary accrual accounting items with executive director. In this hypothesis, it is supposed that companies whose number of in-board director is more than out-board directors, the rate of discretionary accrual accounting items, is more too. Therefore, CEO have the motivation of manipulate financial figures. The results of the regression experiment have been mentioned as follow:

TABLE 4: RESULTS OF FIRST HYPOTHESIS

Model	R Square	Adjusted R Square	Std. Error of the Estimate		
				R ² Change	Sig. F
1	.36	0.23	2.572E11	0.19	0.02

As results are shown in the table above, sign F scale is lower than the scale of acceptable error level (%5). Therefore the hypothesis is confirmed and the meaningful relationship between in-board and the discretionary accrual accounting items scale is confirmed, as well.

The coefficient signal is positive which reveals the direct relationship between them. The correlation intensity between them is on the basis of R² coefficient, multiple %23.

Base on second hypothesis, there is a meaningful relationship and negative between ownership concentration and the discretionary accrual accounting items. On the basis of Iran corporate governance, companies shouldn't prefer the majority's to minority's interest and should not have priority. but the manager are usually chosen by the majority, thus the majority's profit protection has priority. We expect that this event changes in to reality, and the more is the portion distribution, the possibility of earnings manipulation is more, the results of the statistical experiment as follows:

TABLE 5: RESULTS OF SECOND HYPOTHESIS

Model	R Square	Adjusted R Square	Std. Error of the Estimate		
				R Square Change	Sig. F Change
1	0.52	- 0.38	3.376E11	- 0.19	0.018

As the above table show, sign F is less than alpha %5 therefore; the negative and significant relationship between ownership concentration and discretionary accrual accounting items is confirmed. It means, in companies which ownership dispersion is high, then possibility has earnings manipulation occur.

OTHER STATISTICAL RESULTS

One of the variables which are very important and significant in Iranian companies is the type of the company's ownership with respect to governmental and non-governmental. We expect that in private companies due to overhauling the competition concept and market and increasing the owner's wealth, the earnings manipulation and stakeholders' misleading often occurs or is weaker. More over the internal auditing because of its role over improvement of supervision on manager should have an active role, furthermore, this earning manipulation is more for misleading the stockholders and beneficiaries in companies due to financial problems who involved with financial stress. On the basis of Zaltman companies divided into two groups bankrupt and un bankrupt, it was obvious that in bankrupt companies the average of this standard is more and managers of these companies have more motivation for earning manipulation.

The variable size of the companies as an effective factor on motivation possibilities for earnings management in different researches in Iran, the size of the natural logarithm of total assets corporations entered as control variable in research method. The total results haven't changed for none of the hypothesis but the relationships reinforced a lot as though it increased for ownership concentration 67 percent and for non executive directors 33 percent which express the meaningful effect of the variable. These results in brief show below:

TABLE 6: RESULTS OF OTHER STATISTICAL METHOD

Average executive directors ratio	Percent Bankruptcy corporation	Owner Concentration	Mean of earnings management	Percent have internal Auditor	Description
0.73	26	5692	3.1278	67	Private Corporation
0.58	41	7629	4.3981	59	Government Corporation

FINDINGS

On the basis of theoretical framework research and also other carried out researches in Iran, it was supposed that by accomplishing the corporate governance in Iran, the supervision over managers' performance of companies has been improved decreasing or omission of discretionary accrual accounting or manipulate of the earnings by managers.

In first hypothesis, the relationship between in-board and earnings management has been confirmed and there is a positive relationship. The existence of in-board is mostly for the protection of stockholder beneficiary in Iranian companies and for managers don't have the possibility of profit manipulation. This goal has been confirmed in this hypothesis. Therefore managers manipulate earnings for achieve their goals. Their goals often are continues management on corporation and compensation and up price of shares corporation. Results revealed earnings management in governmental corporation is high as the private corporations. Further more mean of earnings management in Private Corporation is low, rank of concentration of corporations is low too. Number of corporations are bankruptcy in private corporations is low thus weak financial corporation almost manipulate earnings and mean of earnings management in power financial corporation is lower than weak corporations. In contrary in governmental corporations bankruptcy is more and mean earnings management is more and ownership concentrations is more. corporation that manipulate earnings generally do not protect of internal auditors. As results shown, in private corporations executive directors ratio is very low thus board of directors often full time and busy directors and CEO cannot manipulate earnings.

In the second hypothesis, the relationship between ownership concentration and discretionary accrual accounting item has been confirmed. Their relationship is meaningful and negative. Thus ownership dispersion in corporation causes to managers for earnings manipulation. This is more in government ownership corporations to private corporations. If ownership of corporation is concentrate, then managers for supervise by board and stockholders possibility cannot smoothing earnings. Results revealed that in corporations that concentrations ownership is high and do not internal auditors and executive directors is high, mean of earnings management is high too, thus management can easily and without supervision manage earnings. More above, results shown that corporate that has high concentration ratio are high executive ratio and high earnings management, thus managers with knowledge and cooperative with board of directors manipulate earnings.

RECOMMENDATIONS

In final base on results of research and investigate corporate governance law of Iran suggestion includes:

1. TSE ranking corporations as corporate governance same other countries.
2. In almost, board of directors corporations do not have financial or accounting or economic technical membership thus decision board of directors almost without economical.

CONCLUSION

It is expected based on agency theory that CEOs attempt to manipulate and manage earnings in order to protect their interests. In this regard, factors effecting the selection of chairman in Iranian companies are studied. According to Iran commercial law, directors are elected by shareholders and chairman is elected by board of directors. Results showed that shareholders composition has a significant negative relationship with election of board and chairman and earnings manipulation indirectly. It means that in companies where dispersion of shareholders is more, since they can not have an important effect on chairman's performance and there is not a consensus and agreement between them, the chairman can manipulate earnings easily. In addition, the effect of board in terms of full time and temporary on CEO's performance is also studied and it was revealed that the more the percentage of full time board, the more the probability of earnings manipulation and there is kind of performance coordination between chairman and them and according to Iran commercial law, managing director is one of the executive directors. Thus Iran commercial law is regulated so that provides the possibility of earnings manipulation and there is not an exact control system based on corporate governance system intended and it is necessary to be reviewed seriously.

SCOPE FOR FURTHER RESEARCH

It is suggested to investigate the effect of non-executive board in future studies.

It is suggested to investigate other models of measuring earnings manipulation in future studies.

It is suggested that other control variables such as size and leverage of company, etc enter the research model in future studies.

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