



INTERNATIONAL JOURNAL OF RESEARCH IN COMPUTER APPLICATION AND MANAGEMENT

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BOARD DEPENDENCE, INTERNAL AUDITORS AND EARNINGS MANAGEMENT: AN EMERICAL RESEARCH OF IRAN

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ABSTRACT

In this study we consider effect of performance of Iran corporate governance rule on earnings management by company. On the basis of Iran business law, the companies in Tehran stock exchange administration by board of directors and they must has internal auditing and protect minority stockholders against majority. In this study the corporate governance has been considered from board and audit committee attitudes. In order to do this research, the information of the companies in financial statements and the reports of the Tehran stock exchange have been used. For the measurements of the earnings management variables Joen's modified model has been used. The choice of the companies is randomly and the confidence interval has been considered %95. Time period was 2007 -2011 and 113 corporation randomly selected. Regression statistical method has been applied. The results of the research are the meaningful and positive relationship of executive directors with earnings management. The existence of internal auditor in companies causes the improvements quality of earnings and the relationship is meaningful and negative. In companies that concentration of ownership is high; earnings management is also high and has a meaningful relationship with them. Other results revealed nonexecutive directors ratio is high in almost of corporation in Iran.

KEYWORDS

Earnings management, Executive directors, Internal auditors.

INTRODUCTION

There are wide variety of governance mechanisms used throughout the world. In Anglo – American economies, for example, the primary governance mechanism is the equity market (Saberwal and Smith 2008). In Western European and some Asian economies, however, the primary governance mechanism is relatively concentrated ownership patterns via pyramidal ownership structure (Levy 2009). In transition economies, like China, the primary governance mechanism is the state and informal networks (Shen and Lin 2009). In India, business groups provide accountability, especially in the larger firm (Zattoni and Pederson and Kumar 2009). Notably, Islamic nations primarily rely on Sharia law to curb and guide business decisions (Safieddine 2009) (Richard and Skinner and Allen 2008, 2009) and (thaghi 2009) and (Baharmoghadam 2010) and (Shiper 1984) and (Chodhari 2007) believe 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.

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A numerous research have shown (Joong and others 2009, Viasani and others 2006) 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 nonexecutive director 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 agency 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 (Hasasyeganeh 2009-2008 and Abdoli 2010, Aghaie and Chalaki 2007).

According to the results of other researchers 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 (TSE) present research has been done and is being tried to investigate the corporate governance according to Iran particular circumstances and also accounting standards.

In almost of research in Iran about earnings management indicate that 75 percent of corporations manipulate earnings and profits in various levels-gross profit, operational income and net income. (Abdoli 2010, Baharmoghadam 2009, Sagafi 2009, Hasasyeganeh 2008 and et al)

The present study contributes to extant published literature on corporate governance practices and earnings management. Although a large and growing literature documents that governance affects earnings management, never studies have concentrated on how corporate governance systems and law corporate governance of Iran affect on accrual accounting items. This study provides implications for this question in Iranian context.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

EARNINGS MANAGEMENT

(Nabar and Thai 2007) examines the impact of investor protection and national culture on earnings management for a sample of 30 countries. The results indicate that earnings management is negatively associated with outside investor rights, consistent with Leuz et al. (2003). They also find that earnings management is relatively high in countries with high uncertainty avoidance scores and relatively low in countries where the primary language is English.

(Jiantao and Richard Harrison 2008) have tried to investigate the relationship between corporate government and the culture of country they operate in. This research is done on 399 multinational and manufacturing companies all around the world. In their research they analyzed the subject of culture according to Mr. Hofstede's mode. They have taken centralization of ownership, band controlling and governmental ownership in to consideration on corporate government. The result was the confirmation of the effect that culture and legal rights have on corporate government. Nen (2008) has concentrated on the relationship between earnings management and Hedging management or danger covering which is about money. His investigations are done according to (employer- agent) theory.

(Saghafi and Rezazade2009) have analyzed the cultural basis of accountant's professional behavior. During the research they tried to study Hofstede model and its analysis about the effect of accountant's behavior on different aspects such as conservativeness, and concealing and disclosing of information. The result was the confirmation of social value's effect on the professional behavior of accountants in measuring and disclosing of information but this affect's direction is not completely in conformity with their expectations and the statistical interesting of results was not meaningful.

(Baharmoghadam and Saghafi 2010) through a research analyze the important motives which will affect the earnings management in stock marketing companies. During the research they could find some evidences about the presence of a relationship the structure of ownership, the main presentation of shares amount of awards which is paid to manager's job quality of accounting agencies the quantity of company's improvement, financial structure and amount of earnings managements.

(Visvantan 2008) in his research in India corporations has primarily focused on real earnings management. This study examines the role of corporate governance in the context of "real" earnings management where firms attempt to achieve desired earnings numbers by departing from normal operating activities. Using a sample of 6,759 firm years, the study examines several overall board characteristics and audit committee characteristics in the context of real earnings management. The study finds limited support for some of the factors that have been found to be significant in constraining accruals type earnings management. Having a higher proportion of independent directors appears to be helpful in limiting this type of earnings management, however. These results should be of interest to investors and regulators who rely on governance mechanisms to oversee the integrity of corporate financial reporting.

(Abdoli .M ,and Royaiee .R, 2010) studies relation and affects cultures and earnings management in TSE .Results confirm relation individualism and power distance with earnings management but relation masculinity with earnings management don't confirm .Coefficient relation in privative versus government corporation was high.

(Hasani and Baharmogadam 2010) in their study investigate relation real earnings management in TSE. They focus on cash flow of operations, discretionary expense and change in inventory in corporations Results indicate meaningful relation operational cash flow and change in inventory and earnings management.

BOARD OF DIRECTORS

(Young Byun and Seok Hwang and Jong lee 2011) study value information of corporate decisions and corporate governance practices in Korea .they investigate a direct link between corporate governance practices and strategic corporate decisions such an investment, financing dividend policies and cash holdings .Their findings show that the value implications of financing, investment, dividend, and cash – holding decisions are strong for firms with sound corporate governance practices.

(Mohammad Al Abbas 2007) in his research in Saudi Arabia Market has recompensed to relationship of corporate governance with earnings management. The time period of his investigation was 2005 to 2007. For the measurement of discretionary accrual accounting items uses Jones model. 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.

(Aghai and Chalaki 2009) in their research have refund to the relationship of constitutive investors and board independence with earnings management 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.

(Yazdainan 2007) have refund in Tehran Stock Exchange to the relationship of board independence and the existence of internal auditor with earnings manipulation 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.

(Mehrazin and Noravesh and Nikomaram 2008) in their research for the exploration of earnings management items have refund 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.

Hypothesis 1: There is meaningful and positive relationship between executive directors and accrual accounting items.

INTERNAL AUDITORS

(Meca and Ballesta 2009) studies and meta – analyze of 35 studies the effect on earnings management of firms board of directors and ownership structure .Their findings show that the results of previous studies on CEO duality and audit committee independence are caused by sampling error . In addition, the measure of discretionary accruals moderate the association between earnings management and some corporate governance.

(Charles Pynt and Remi Janin 2007) in their own research in French 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 auditor reputation, the existence of auditing committee and their dependence over management and the earnings management. The results of their research were that the existence of auditors from five 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.

(Renders and Gaeremynck and Sercu 2010) try to establish whether a positive relationship exist through modeling the relationship more carefully. After controlling for selection bias and endogeneity simultaneously. Find a significant positive relationship between corporate governance ratings and performance.

(Abdoli 2010) in his research has refund to the relationship of companies' ownership structure and the existence of major shareholder and the existence of internal auditor with earnings management. The result of his research is the confirmation of the existence of internal auditor with the reduction of earnings management and private corporations almost have internal auditors but some of government corporations have internal auditor .Any of corporation don't have auditing committee in Iran.

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 complied:

Hypothesis2: There is negative and meaningful relationship between internal auditor in company and accrual accounting items.

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.

DATA AND SAMPLE

EXECUTIVE DIRECTORS

On the basis of Iran Trade Law, the companies are managed in the format of board and on the basis of articles; some of the board members can work in the company full-time and strive as a full-time manager. These managers are more informed than others about the happened events and more interested than others, therefore, there can be a kind of interest conflict between them and other stakeholders. They have little independence. On the basis of Iran corporate governance law, the board should registry the qualifications and executive directors of the board members in his yearly report and announce to all stakeholders and other people to company's web site. It is necessary to divide the number of them to all members of the board in order to measure members of the executive director's ratio.

INTERNAL AUDITOR

On the basis of Iran corporate governance law, companies have to have an internal auditor which strives under the control of manager's director or board. The internal auditor can audit and provide report in all of the financial and operational fields and made a report. In Iran, there is no auditing committee and this role plays more restricted by internal auditor. For the inquiry of research hypothesis the statistical community divided into two groups. Internal auditor and lack of internal auditor and the mean of the two communities compare and tested.

Discretionary accrual accounting

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

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

Thus, TA_{it} is the total accrual items, A is total assets, REV is changes of selling revenue and PPE is changes of properties, plant and equipments. After estimating of parameters of the above model by the help of information of the year 2005 to 2009, each company through implementation of models in discretionary accrual accounting items as mentioned below estimates for the "estimation period" it means the year 2010.

$$NDA_{it} = \alpha_1 \left(\frac{1}{A_{it-1}} \right) + \alpha_2 \left(\frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}} \right) + \left(\frac{PPE_{it}}{A_{it-1}} \right) \quad (\text{Equation 2})$$

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

$$DA_{it} = \frac{TA_{it}}{A_{it-1}} - NDA_{it} \quad (\text{Equation 3})$$

On the basis of theoretical view, the total accrual 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.

$$TA_{it} = E_{it} - OCF_{it} \quad (\text{Equation 4})$$

In the above formula, E reagents the net income before tax and ocf , net cash flow from operations and TA reagents the total accrual items in time period of 2010.

SAMPLE

For the considering of research models and also tests research hypothesis, accepted companies have been in TSE. The end of their fiscal year should be the end month of Esfand (December) and should not involve the investment companies and time period 2007 to 2011 their data should be available.

The number of the companies according to the above condition was 345 which 113 companies from different industries have been chosen randomly.

DESCRIPTIVE STATISTICS

Before investigation and checking up each of the research hypothesis, the results of descriptive statistic related to each of the variables studied.

TABLE 1: TABLE DESCRIPTIVE STATISTIC OF THE VARIABLES

St. Deviation	Variance	Statistical Mean	Type of corporation	Variable
4.217	3.933	-5.507	dependence	Earnings management
1.4528	2.8594	0.353	Independence	Executive directors ratio
3.8141	2.9541	0.6315	Independence	Internal Auditor

As it is shown in the above table, the st.deviation results for earnings management is high. This shows in average in all corporations earnings management is done .63 percent of corporation has internal auditors.

RESEARCH RESULTS

According to theoretical principles and research literature and also other carried out researches in Iran, the relationship between variables will be identified as below:

$$DA_{it} = \alpha_0 + \alpha_1 * CG_{it} + \alpha_2 \text{ Variable Control} + \varepsilon \quad (\text{Equation 5})$$

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:

$$DA_{it} = \alpha_0 - \alpha_1 * \% \text{exe director} + \alpha_2 * \text{inter audit} + \alpha_3 * \text{Variable control} + \varepsilon \quad (\text{Equation 6})$$

DA_{it} as the discretionary accrual accounting items (dependent variable) – independent variable include: **% exe director** as the busy director and full time on company and - **inter auditors** as the internal auditor of company that employee of corporation and report to board of directors - **variable control** involved the controls variables of research include ownership corporation as the basis of "herfindal-hireshman" model and size corporation as the basis of logarithm total assets.

1-In the first hypothesis has been mentioned, there is a positive and meaningful relationship between discretionary accrual accounting items with executive director. In this hypothesis, it is supposed that companies whose number of employed executive director is high, the rate of discretionary accrual accounting items is, more too. And the reason is, they are going to show a improved performance. Therefore, they have the motivation of manipulating the financial figures.

Thus, the continuation of their pressure in the board of the companies increased and this issue is interpretable along the pictorial of manipulate earnings in theoretical framework. The results of the regression experiment have been mentioned as follow:

TABLE 2: RESULTS OF FIRST HYPOTHESIS

Model	R Square	Adjusted R Square	Std. Error of the Estimate	Sig. F
1	0.37	0.42	2.802E11	0.021

As results are shown in the table above, sig f scale is less than the scale of acceptable error level (It means %5). Therefore the hypothesis is confirmed and the meaningful relationship between executive director and the discretionary accrual accounting items scale is confirmed, as well.

The coefficient signal is positive and high which reveals the positive and direct relationship between them.

In the second hypothesis, considering the situation of Iran environmental economic we expect that, in spite of the lack of prediction and the presence of auditing committee in Iran, but the presence and the role of the internal auditor in the company, causes the financial behavior of executive managers to be in the direction of stockholders.

We expect that there is a meaningful relationship between the average discretionary accrual accounting items in the companies which has internal auditor to the average of this in companies which don't have internal auditor. The results of the experiment have been shown in the follow table:

TABLE 3: RESULTS OF SECOND HYPOTHESIS

Model	95% Confidence Interval		correlation	t	Sig. 2tailed
	Lower	Upper			
Internal auditor – non internal auditor	- 2.3489	1.8365	.58	2.08	0.017

As the above table shows, sign T scale is less than alpha %5, thus, the hypothesis research based on meaningful relationship between internal auditors in the companies with the discretionary accrual accounting item has been confirmed. The relation between them is positive. The intensity of relationship between them is high which expresses the high correlation between them (58%) .

OTHER STATISTICAL RESULTS

For investigate effect of dependence variables as a whole (ownership concentration and and size corporation) on discretionary accrual accounting item uses multivariate regression. Results of these regression is shown bellow in ANOVA analysis:

TABLE 4: RESULTS OF ANOVA

Model	Sum of Squares	Mean Square	F	Sig.
Regression	.513	.171	2.117	.0407
Residual	17.911	.218		
Total	18.424			

On the results of table revealed that Sign is lower of 5%, and then relation of dependence variables on discretionary accrual accounting items is confirmed.

The variable size of the companies as an effective factor on motivation possibilities for earnings management in different researches, the size of the natural logarithm of sale entered as control variable in research model. The results haven't changed for none of the hypothesis but the relationships reinforced a lot as though it increased for own concentration 83 percent and for executive director 24 percent which express the meaningful effect of the variable.

For indicate effect of dependence variables on discretionary accrual accounting items uses FORWARD methods. Results of these are shown on following table:

TABLE 5: RESULTS OF FORWARD ANALYSIS

Model	Beta Ln	t	Sig.	Partial Correlation	Co linearity Statistics
					Tolerance
Executive Board	.395	2.787	.0271	.390	.645
Internal Auditors	.293	1.712	.0347	.329	.989
Size Corporation	.269	1.282	.0581	.263	.998
Ownership concentration	.187	1.069	.04792	.202	.969

On the table above, executive directors has most effect on discretionary accrual accounting items. Beta multiple indicate this results. The results above indicate all of variables affect on earnings management.

More above results indicate that Iranian corporation's board of directors almost has specialize in engineering and only 34 corporations has executive director in accounting or finance and economics .In many of corporations, number of non executive director more than executive directors and this directors selected out of corporation – by major stockholders or holding companies - and they don't have information about performance of managers corporation and they have multiple profession .

DISCUSSION AND CONCLUSION

On the basis of theoretical principals of the research and also the other carried out researches in Iran, it was supposed that by accomplishing the corporate governance in Iran, the supervision over managers' performance of trade companies has been improved audits crystallization is in decreasing or omission of discretionary accrual accounting in order to manipulate of the earning by managers. This subject in the hypothesis research has been examined by decreasing the statistical profit by manager's agency's costs for stakeholders and other interested groups decreased and financial reporting improves and also fair-minded of financial statistics of reporting which is important in the view of auditors of standards auditing is provided.

In the first hypothesis the effect of executive director over decreasing of earnings management scale has been confirmed and it was our imagine by presence of employed managers in company and their membership executive director that dependence to financial position of corporations directing the profit along their beneficiary should be tampered and occurring such subject has been confirmed .

Companies which have internal auditor the possibility of earnings management has been decreased and internal audits could play their role precisely in spite of the lack of the presence of auditing committee. By investigating the researched companies it was distinguished that most of the executive director in Iranian companies have no financial and economic expertise. Therefore to make sure toward the performance of financial domain we necessarily have to support the internal audit and sort them in our sub-directory in order to report them directly.

In final, base on results of research suggestions include:

1. Independence of board and number of nonexecutive directors was concentrated
2. In corporate governance law of Iran do not predict auditing committee and other committees
3. TSE corporation do ranking as corporate governance same other countries

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