

“Impact of Corporate Governance on Earnings in Markets”

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ABSTRACT

The purpose of this paper is to explore whether firms with good corporate governance practices in Peru present higher quality of accounting information. In 2008, the Lima Stock Exchange launched an index including the stocks of firms with good corporate governance practices. Firms that want to be included in the index must submit a self-assessment based on 26 principles of governance practices described in the Principles of Good Governance for Peruvian Corporations. This self-evaluation must be verified by an external firm. I find that firms included in the index present more value relevant, more persistent, and more conservative accounting reports.

I. INTRODUCTION

After the accounting scandals in early 2000 and the financial crisis in 2006, regulators around the world put a lot of attention on corporate governance practices that might restore the investors' confidence in accounting information. For example, in 2002, U.S Congress passed the Sarbanes-Oxley Act of 2002 (SOX) to protect investors from the possibility of fraudulent accounting activities by corporations. The SOX Act mandated strict reforms to improve financial disclosures from corporations and prevent accounting fraud. Several governments in Latin America also introduced regulation to promote good corporate practices. In Peru, in September 2002, the National Supervisory Commission for Firms and Securities (CONASEV) published the Principles of Good Governance for Peruvian Corporations (GGPC), which adapted the corporate governance principles established by the Organization for Economic Co-operation and Development (OECD) in 1999 (Lopez & Rios, 2005). Since the end of 2004, firms have voluntarily submitted a self-assessment survey on the 26 principles of good corporate governance practices to CONASEV as an appendix to their annual reports. Authorized auditing firms must verify the validity of the declarations. Based on these self-assessments, on July 1, 2008, the Lima Stock Exchange (LSE)

developed and launched a Good Corporate Governance Index (GCGI) that contained securities of the firms with the best corporate practices in Peru and that met the minimum liquidity level of the LSE. While adopting good corporate governance practices is voluntary in Peru, firms with publicly listed securities have to disclose their financial information and also report on the degree of their compliance with the PBCG. Because these principles extraordinary observations.

II. REVIEW OF LITERATURE

There are various confirmations on the relationship between corporate administration practices and manipulation of company financials. Following are some noticeable investigations with regard to this: Xie et al. (2003) studied the job of the directorate, the audit committee and the executive committee in anticipating and mitigating manipulation of earnings. Post inspecting the relations employing a collection of 282 firm-year impressions of S&P 500 index companies, they inferred that profit management is less likely to happen or happens less regularly in organizations whose management includes greater external autonomous directors as well as directors with experience of working in corporates. Research further recommended that the level of manipulation in financials is related to the structure of the audit committee independence (and to a smaller degree the official board of trustees) and therefore might empower a council to depict improved working in its oversight limit. Shen and Chih (2007) examined the impact of governance measures on smoothing of financials in Asia's emerging markets. The results suggest that corporates with strong administrative policies are inclined to reflect smaller degree of profit management. It also displayed that there exists a size-effect for earnings manipulation, this means that bigger companies are more likely to engage in profit smoothing, but strong governance in such corporates might normally reduce the impact. Further results of the paper show that companies with greater growth (lesser

profit yield) are likely to incorporate profit management, but strong administrative measures can reduce the impact. Further, corporates in robust anti-director rights economies are more likely to portray earnings management to a more significant extent. It also states that there exists a drastic point of variation for effect of leverage, i.e. in the case where the governance index is substantial, effect of leverage exists, whereas otherwise reverse effect is seen for leverage. It reflects that a greatly levered company with poor governance is more likely to be inspected closely and thus will find it more difficult to trick the public by manipulating financials. Liu and Lu (2007) examined the connection among Corporate Governance and Earnings Management in publicly trading corporates in China by incorporating a tunnelling outlook. The factual research strongly recommended that disputes of majority Stockholders with minority investors represent a substantial part of profit smoothing in China's public companies. Many studies have established that high standards of administrative policies have a remarkable influence on reducing profit smoothing. Cadbury (1992) showed the importance of independence of the board as a measure of effective corporate governance, which was restated by Fama and Jensen (1983) and Shleifer and Vishny (1997) through agency theory and by Beasley (1996) and Dechow et al. (1996) through violation of regulations. On the other hand, the Blue Ribbon Committee used independence of audit committee as a measure. Many other researchers have used audit committee independence to study the relation. Another measure of corporate governance is how many directors does the board of a company have (Toronto Stock Exchange (TSE) Committee on Corporate Governance in Canada, 1994). The two perspectives on the effect of board size are: 1) A bigger board has a lower probability of functioning successfully and is convenient for the CEO to manage (Jensen, 1993). A bigger board facilitates improved environmental connect as well as greater skill diversification (Dalton et al., 1999). Hence, due to lack of consensus, it is important to check the direction of the relation among profit smoothing and governance measures in corporates. Klein (2002) conducted empirical research on 692 listed US firm years to examine if board features and audit committee independence are related to any manipulation in financials. Through the examination, he built up an inverse connection of board or review advisory group autonomy with profit smoothing. Park and

Shin (2004) based their study on 539 firm years in Canada to study the effect of board composition on the level of profit smoothing for a period from 1991 to 1997. However, they did not find any significant base to the relationship. These results contradicted the common beliefs and research results conducted in the UK and the USA. Agrawal and Chadha (2005) empirically investigated the existence of a relationship between the likelihood of a company managing earnings and its corporate governance mechanisms. They established that audit committee independence and board composition do not have any relationship with the probability of restatement. They also found that the likelihood of this is substantially less in corporates that have an autonomous financial professional as a part of the board or audit committees.

Asian Economic and Financial Review, 2019, 9(12): 1335-1345 1338 © 2019 AESS Publications. All Rights Reserved. Chair and CEO duality composes a significant feature of the directors and therefore governance measures. Academic papers (including (Fama and Jensen, 1983; Jensen, 1993)) reports, and publications by various regulatory councils and organizations have showed that the role of CEO and Chairman should not be designated to one individual to minimize earnings manipulation practices. The chair has the responsibility of defining the objectives for meetings of directors and reviewing these meetings as well as nominating executives and monitoring them. For corporates where CEO-Chair Duality exists, the likelihood of facing accounting implementation decisions by the authorities is higher for GAAP violations (Dechow et al., 1996). Research pertaining to CEO– chair duality recommends a direct relationship of CEO–chair duality with manipulation of financials. The research pertaining to managerial ownership portrays conflicting results. These investigations may be segregated into 2 parts following 2 varied perspectives to managerial ownership. One method is „entrenchment effect“ of stockholdings by managers (seen in scenarios when the executives and stockholder opinions are not completely similar or aligned), while the alternative method is the 'incentive alignment effect“ of ownership of managers (seen in scenarios where the opinions of given parties are completely in alignment

III. RESEARCH DESIGN

In order to test the impact of good governance practices in earnings quality, I use two

properties of earnings: earning persistence, and accounting conservatism, and one measure based on the response of investors: the earnings response coefficient (ERC). My first proxy for earning quality is the ERC, which is usually perceived as a measure of value relevance of accounting information. The ERC is a market-based proxy of earnings quality that measures how the change in earnings from one period to another affects firms' stock returns. This metric specifically evaluates how investors react to changes in earnings numbers reported by firms. I use the long window ERC by regressing the annual stock returns on the annual change in earnings (Hanlon, Maydew, & Shevlin, 2008).

Model 1

$$Ret_{i,t} = \alpha_0 + \alpha_1 Ch_Earni,t + \alpha_2 GOV_{i,t} + \alpha_3 Ch_Earni,t * GOV_{i,t} + Industry\ Dummies + Year\ Dummies + \varepsilon_{i,t}$$

where $Ret_{i,t}$ is firm i 's stock return, including dividends in year t ; Ch_Earni,t is the annual change, between year $t-1$ and t , in firm i 's earnings before interest and taxes scaled by the beginning of the period total assets; and $GOV_{i,t}$ is a dummy variable that takes the value of 1 if firm i is included in the GCGI in year t and 0 for firms not included in the index in year t . I include the interaction of $GOV_{i,t}$ and Ch_Earni,t to measure the effect of changes in earnings on market returns for firms included in the GCGI in the Lima Stock Exchange. I expect the coefficient α_3 to be positive and statistically significant if the firms with good governance practice present more relevant accounting numbers. The first earnings property that I use as a proxy of earnings quality is earnings persistence. Persistent earnings indicate earnings information that is more sustainable and predictable, which may improve valuation models (Dechow et al., 2010). I estimate earnings persistence by regressing current earnings per share on last year's earnings per share (Francis, LaFond, Olsson, & Schipper, 2004).

Model 2

$$EPS_{i,t} = \beta_0 + \beta_1 EPS_{i,t-1} + \beta_2 GOV_{i,t} + \beta_3 EPS_{i,t-1} * GOV_{i,t} + Industry\ Dummies + Year\ Dummies + \varepsilon_{i,t}$$

where $EPS_{i,t}$ is firm i 's earnings per

share in year t and $EPS_{i,t-1}$ is firm i 's earnings per share in year $t-1$. $GOV_{i,t}$ is a dummy variable that takes the value of 1 if firm i is included in the GCGI t and 0 for firms not included in the GGI in year t . I include the interaction of GOV and the $EPS_{i,t-1}$ to measure the effect of good corporate governance practices on the persistence of earnings. I expect the coefficient β_3 to be positive and statistically significant if good corporate governance practices increase the persistence of earnings. The second earnings property I use as a proxy of earnings quality is earnings conservatism. I use the Basu model (1997), which measures the asymmetrical timeliness of earnings to bad news compared to good news.

Model 3

$$EBIT_{i,t} = \gamma_0 + \gamma_1 D + \gamma_2 Ret_{i,t} + \gamma_3 D * Ret_{i,t} + \gamma_4 GOV_{i,t} + \gamma_5 D * GOV_{i,t} + \gamma_6 Ret_{i,t} * GOV_{i,t} + \gamma_7 D * Ret_{i,t} * GOV_{i,t} + Industry\ Dummies + Year\ Dummies + \varepsilon_{i,t}$$

where $EBIT_{i,t}$ is firm i 's earnings before interest and taxes for firms in year t . $D_{i,t}$ is a dummy variable which takes the value of 1 when firm i 's annual return in year t is negative. $Ret_{i,t}$ is firm i 's annual return in year t . $GOV_{i,t}$ is a dummy variable that takes the value of 1 if firm i is included in the GCGI t and 0 for firms not included in the index in year t . The $D_{i,t}$ coefficient measures the sensitivity of earnings to bad news. I expect the coefficient γ_7 to be positive and statistically significant if good corporate governance practices increase the level of conservatism in earnings.

Sample and Descriptive Statistics

I obtain annual financial data for all firms listed in the LSE from Economatica. Each year I selected the firms listed in the GCGI and other firms in the LSE with all available information to compute the variables under analysis. I did not include financial firms because they are heavily regulated and it might have an impact in the properties of accounting information. The final sample consists of 420 observations from 2009 to 2015. Table 1 presents the distribution of firms per industry and year. More than half of the observations correspond to two specific industries: 1) manufacturing and mining; and 2) oil and gas.

Appendix 1. List of firms included in the GCI in 2015

Firm	Auditor
Alicorp	PCR-Pacific Credit Rating
BBVA Banco Continental	PCR-Pacific Credit Rating
Grana y Montero	Grant Thornton
Ferreycorp	PCR-Pacific Credit Rating
Buenaventura	MC&F
Cementos Pascamayo	PWC
Milpo	Deloitte
Refineria La Pampilla	MC&F
Credicorp	Deloitte

Year	Sector							
	Accommodation	Agro	Construction	Information	Management	Manufacturing	Mining, Oil and Gas	Real Estate
2009	2	7	1	2	4	30	7	0
2010	2	6	1	0	3	29	14	2
2011	1	6	1	1	4	28	13	1
2012	1	6	1	1	4	26	13	1
2013	2	5	1	1	4	22	11	1
2014	2	7	1	1	4	22	13	1
2015	2	7	1	1	4	24	15	0
Total	12	44	7	7	27	181	86	6

Table 1. Distribution of the observations per year and industry

Table 2 presents the descriptive statistics of the main variables under analysis. The average annual return for the sample is 9.9%. Almost 12.6% of the observations in my sample are included in the GCGI in the LSE.

Table 2. Descriptive statistics

Table 2 presents the descriptive statistics of the main variables under analysis.

GOV_{it} is a dummy variable that takes the value of 1 if firm i is included in the GCGI in year t and 0 for firms not included in the index in year t . Ret_{it} is firm i 's stock return, including dividends in year t . Ch_Earn_{it} is the annual change, between year $t-1$ and t , in firm i 's earnings before interest and taxes scaled by the beginning of the period total assets. EPS_{it} is firm i 's earnings per share in year t . EPS_{it-1} is firm i 's earnings per share in year $t-1$.

Variable	Std.				
	Obs	Mean	Dev.	Min	Max
GOV_{it}	420	0.126	0.332	0	1
Ret_{it}	420	0.099	0.436	-0.754	1.499
EPS_{it}	420	0.187	0.474	-1.773	3.508
EPS_{it-1}	420	0.206	0.504	-0.387	5.656
Ch_Earn_{it}	420	0.001	0.085	-0.752	0.387

Table 3 presents the Pearson correlation coefficients. As expected, the firms' annual returns are positive correlated with change in earnings. The firms' current period EPS is positive correlated with last period EPS.

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Table 3. Correlation matrix

Table 3 presents the Pearson correlation coefficients. The definition of the variables is presented in Table 2.

		1	2	3	4	5
1	GOV	1				
2	Ret	0.0177	1			
3	EPS t	0.0554	0.1285	1		
4	EPS t-1	0.0636	-0.0343	0.6265	1	
5	Ch_Earn	0.0599	0.2933	0.1469	-0.1723	1

IV. RESULTS AND DISCUSSION

The results of Model 1 are presented in Table 4. The coefficient of the variable measuring the change in earnings between consecutive periods is positive and statistically significant (0.947 p-value < 0.01). The change in earnings has a positive impact on the annual firms' returns. In addition, the coefficient of the interaction between good corporate governance and the change in earnings is positive and significant (1.469 p-value < 0.01). This result supports my hypothesis that corporate governance practices have a positive impact on the ERC. The value relevance of earnings is higher for firms with good levels of corporate governance in Peru.

[Insert Table 4 around here]

The results of Model 2 are presented in Table 5. The coefficient of firms' EPS last period is positive and statistically significant (0.323, p-value < 0.10). The persistence of earnings is positive and significant for the listed Peruvian.

V. CONCLUSION

Given research concentrates on studying the influence of corporate governance measures on the management of earnings in India across a duration of 8 years starting 2004 to 2018. The multi variable regression based study under the random effect approach has been utilized for calculation. The output provides confirmation of a profound positive relation among CEO-chair duality and discretionary accruals showing that to control manipulation, the CEO and chairman of the company, preferably should not be the same individual. The designations should be occupied by 2 different people. Also, ownership of managers in a company again depicts a direct relation with discretionary accruals. On the other hand, output shows insignificant association of board size and audit committee independence with discretionary accruals signifying that greater percentage of autonomous directors on the audit committee may or may not lead to a rise in the

discretionary accruals, thus portraying that independent directors on the committee might not play a significant role in reducing management of earnings. Funding: This study received no specific financial support. Competing Interests: The authors declare that they have no competing interests.

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