A Review on The Influence of Corporate Governance Mechanism on Earnings Quality of Banks

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Abstract - Corporate governance mechanisms play significant roles in protecting the rights of stakeholders especially in assuring that the stakeholders get the reliable and relevant financial information regarding the performance of the banks. Effective corporate governance mechanism is important in ensuring high quality of financial reporting. This paper focuses on the earnings quality as a measure of financial reporting quality in the context of banking industry and its relation with the corporate governance mechanisms. This paper highlights the relationship between board of directors (board size and board independence), audit committee (audit committee size and audit committee independence) and external auditor and earnings quality. The findings of previous literature, however, still inconclusive, and this paper serves as preliminary study for future study.

Keywords: Corporate Governance; Financial Reporting; Earnings Quality; Banks;

1 Introduction

The financial report plays an essential role in providing information on a firm's financial position and performance. It serves as a communication tool that not only mitigates the agency problem between the shareholders and management, but also enhances the investors' confidence in the firm. The investors, as well as the creditors, rely on the usefulness of the information in the financial report to make relevant and reliable economic decisions. Thus, the financial statement must provide high quality financial reporting for the purpose of reducing the information asymmetry and cost of capital as well as enhancing the efficiency of capital resource allocation and corporate governance (Tang, Chen, & Ling, 2016).

According to the agency theory, accounting information is exposed to the opportunistic behavior of managers in the agent-principal relationship. The agency problems arising from the principals on the ownership side, and managers on the agents' side, cause information asymmetries and might jeoperdize the financial reporting quality. The stakeholder, on the other side, rely on the information in the financial reports to assess the performance of the bank and make informed decisions since some of them have no rights in the management of the fund and corporate governance practices.

The past financial scandals involving large companies have trigger concerns on the quality of financial reporting and the effectiveness of corporate governance practice. Corporate governance mechanisms plays significant role in limiting the behaviour of the management that may deviate from the objectives of the firm. Sound and effective corporate governance mechanisms curb the management opportunistic behaviour and cause the management to report high quality of financial report. Corporate governance mechanisms including board and audit committee's independence constrain management's behavior and can raise the quality of financial reporting information and reduce information asymmetry between the management and stakeholders. Essentially, the agency theory posits a positive relationship between corporate governance and earnings quality. However, most of the empirical findings derived from the listed and non financial firms. This paper reviews the relevant literatures on the earnings quality in the context of banking. This paper highlights the relationship between corporate governance mechanisms and its influence on banks' earnings quality by specifically focusing on the characteristics of the board of director (BOD), audit committee and external auditor.

This paper is organized as follows. Section 2 describes the past literature on the financial reporting quality and earnings quality in the banking context and the findings of past studies on the relationship between corporate governance mechanisms and earnings quality. Section 4 concludes the paper by stating the findings from the previous literature and limitations of this study.

2 Literature Review

2.1 Financial Reporting Quality

The definition of financial reporting quality remains ambigious (Gras-Gil, Marin-Hernandez, & de Lema, 2012). However, the notion of financial reporting quality is usually associated with the quality of the financial information presented in the financial statement of a firm. The financial report is prepared by adhering to the local country and international accounting and financial reporting standards that have been adopted, such as the IFRS. A higher level of compliance with IFRS not only reflects ahigher quality of financial reports but also signals that good corporate governance and transparent practices are in place in order to attract investors in the capital market (Hla & Md Isa, 2015).

High quality of financial reporting is reflected in various measurements, and one of those is earnings quality. Earnings quality is a signal of a firm's performance. According to Schipper and Vincent (2003), users of financial reports are interested in earnings quality because such information influences their decision-making in contracting and investments. Earnings information is usually used to value the firm's performance as it captures the accrual accounting element that is not present in the cash flow (Dechow,1994). This accrual is estimated based on the management's discretion. Thus, it might trigger opportunistic behavior from managers that subsequently would affect the quality of earnings (Al-Attar & Maali, 2017).

The manipulation of accruals is perceived as earnings management behavior. Earnings management behavior compromises the quality of earnings in an inverse relationship. In general, high financial reporting quality is associated with earnings quality. According to Abernathy, Herrmann, Kang, & Krishnan (2013) , high financial reporting quality is reflected in the earnings forecasts that are more accurate, less dispersed and less volatile. High earnings quality signifies low earnings management practice and vice versa (Al-Rassas & Kamardin, 2015).

2.2 Earnings Quality in the Banking Context

Various measurements or proxies, or metrics or attributes have been used by the past researchers to measure the quality of earnings reported in the financial report. Researchers have used those measurements or proxies because earnings quality cannot be observed directly (Pagalung & Sudibdyo, 2017). According to Dechow, Ge, and Schrand (2010), there is no specific measurement that could fix all decision models. Earnings quality is measured either as determinant factors or as consequences. The determinant factors are the factors that influence the earnings quality of the firm. It could be the inherent factors that might come from within the firm, such as size and performance of the firm; or that might influence the discretion of the firm, such as accounting policy choice; or

from the external environment in which the firm operates, such as industry classification (Parte-Esteban & García, 2014; Pagalung & Sudibdyo, 2017).

Dechow et al. (2010) categorized these determinants into six: firm characteristics, comprising firm performance, debt, growth and investment, and size; financial reporting practices, comprising accounting methods and other financial reporting and principles-based versus rules-based methods; governance and controls, comprising BOD, internal control procedures, managerial share ownership, managerial compensation, and managerial change; auditors and equity market incentives, comprising incentives when firms raise capital and incentives provided by earnings-based targets; and external factors, comprising capital requirements, political processes, and tax and non-tax regulations. In this case, earnings quality is tested as a dependent variable, while for the consequences of the proxy, it is tested as an independent variable.

Past literature on earnings quality has used various measurements to measure earnings quality, including the most widely used, i.e., discretionary accruals, loan loss provision (LLP), small positive income target, and income smoothing. Despite the existence of extensive literature on earnings management practices in the banking industry, only a few have been solely devoted to the Islamic banking industry. There are a number of studies on Islamic banking in multiple countries: the Middle East and North Africa (MENA) region (Mohamed & Zarai, 2014; Abdelsalam, Dimitropoulos, Elnahass, & Leventis, 2016); Economic Research Forum (ERF) countries (Quttainah, Song, & Wu, 2013); and Middle East region (Othman & Mersni, 2014). Abdelsalam et al. (2016), for instance, used three different metrics of discretionary accruals, LLP, and small positive income target to measure earnings management (Hamdi & Zarai, 2014) applied net distributable profit divided by the total assets to measure earnings, earnings loss avoidance and abnormal LLP (Quttainah et al., 2013). To date, both informational and opportunistic earnings measurements have been used to test conventional banking as well as Islamic banking.

In the banking and financial institutions context, earnings quality is measured differently because banks operate in a highly regulated environment that intrinsically distinguishes them from non-financial firms. Thus, banks have different incentives to manage earnings. In addition, their financial reports differ from industrial firms. Several past studies have proven that LLP is widely used as an accounting manipulation tool by bank managers (Alali & Jaggi, 2011; Ali, Kabir, & Abul, 2015). Ali et al. (2015) evinced that managers of OIC banks, whether Islamic or conventional, use LLP as an income smoothing tool. Their study sample was 291 Islamic and conventional banks from 35 countries from the OIC for six years from 2003 to 2008. Their findings indicate that the banks that have adopted IFRS as their accounting standards show less manipulation of earnings due to the argument that the IFRS is a more principle-based system, requiring higher accounting information disclosure compared to local Generally Accepted Accounting Principles (GAAP).

In a similar vein, prior to that, Alali and Jaggi (2011) documented that managers of large banks and banks with high-risk asset portfolios use LLP to manage reported earnings more than small banks and the banks with low-risk asset portfolios. By using a sample of 106,567 US commercial banks throughout the period from 1991 to 2008, they found that earnings management practice was apparent during the financial crisis. Furthermore, they argued that regulatory standards for different sizes of banks might not be effective in controlling managerial behavior of earnings and capital ratio management.

Other studies have addressed the use of income smoothing by Islamic banks. Taktak and Mbarki (2014) reported that Islamic banks do not smooth their net income through LLP. However, it appears that profit equalization reserves (PER) and investment risk reserves (IRR) probably have been used as income smoothing devices to the shareholders to maintain stable results, rather than to benefit the depositors. Their findings are based on a sample of 66 Islamic banks over the period of 2001 to 2006. Abdelsalam et al. (2016) asserted that religious norms embedded in the governance framework of Islamic banks can suppress opportunistic managerial behavior. By comparing Islamic banks and its conventional counterparts in the MENA region during the 2008 to 2013 period, they found that Islamic banks report less frequent small positive income, fewer discretional accruals as well as lower discretionary LLPs, relative to discretionary security gains and losses.

2.3 Corporate Governance Mechanisms and Earnings Quality

This section reviews past literature on the banking sector's corporate governance mechanisms, especially those focused on Islamic banking. The main components of corporate governance, i.e., BOD characteristics, audit committee characteristics, and audit quality are highlighted. Essentially, the agency theory posits a negative relationship between corporate governance and earnings management. Empirical studies have also concluded that various relationships exist between corporate governance and earnings management (Iraya, Mwangi, & Muchoki, 2015). Ugbede, Lizam, and Kaseri (2013) showed that high earnings quality of Malaysian banks compared to Nigerian banks is attributable to its good corporate governance principles, structure and practices. Besides, prior studies have shown that internal governance mechanisms are more effective in suppressing managers' discretionary behavior in the banking sector due to complex agency problems and information asymmetry. Stringent regulations of the banking industry outweigh the functions of external governance mechanisms (Mersni & Othman, 2016).

Leventis, Dimitropoulos, and Anandarajan (2012) argued that in the case where the earnings reported in the financial report are not really informative, investors should evaluate the bank's corporate governance efficiency to make better investment decisions. The industry players value the obligatory disclosure of a firm's corporate governance structure to evaluate the informativeness of the firm's earnings. A firm with well-governed corporate governance receives more attention from the industry players.

Leventis and Dimitropoulos (2012) investigated the efficiency of corporate governance mechanisms using the corporate governance quality (CGQ) index. The index was developed from 67 different governance provisions mandated by the Sarbanes-Oxley (SOX) Act and the SEC certification requirements concerning structure and mechanisms of the BOD, internal auditing, anti-takeover and ownership. They examined whether earnings quality as proxied using three different measures (small positive net income, the difference between discretionary realized security gains and losses, and discretionary accruals estimated from the Jones's (1991) model is affected by the CGQ. Their empirical results based on 315 US listed commercial banks from 2003 to 2008, indicate that banks with high quality corporate governance could enhance the quality of earnings.

Notwithstanding the relative inferences that have been widely tested in financial institutions, there has been only minimal research with respect to IFIs, specifically in the context of Islamic banking.

According to Abdelsalam et al. (2016), religious and moral values inherent in the Islamic banking principles constrain managers of Islamic banks from being involved in opportunistic behavior. Hence, this adherence does not only act as a monitoring mechanism, but also increases managers' moral accountability in their decision-making and encourages them to produce higher quality financial reporting reflected through earnings quality. Using three different metrics to measure earnings quality, based on 24 Islamic banks and 76 conventional banks in the MENA region, their results show that Islamic banks are more conservative in manipulating their earnings compared to their conventional counterparts. Islamic banks reported more LLP relative to non-performing loans and loan charge-offs, less frequent small positive income and lower discretionary accruals. In addition, they noted that Islamic banks' preference for hiring auditors from the Big Four audit firms compared to their conventional counterparts is incredibly affecting their earnings of higher quality.

Apart from the BOD, empirical studies have also emphasized on the role of the audit committee. The audit committee is a statutory committee established by the BOD. Audit committee bears the major responsibility of monitoring the financial reporting process and all aspects of the financial report in order to ensure a firm's credibility, integrity and operations (Bahreini & Mat Zain 2013; Osemene & Fakile 2018).

2.3.1 Board Size and Earnings Quality

According to the agency theory, board size depends on the size of the firm (Fama 1980). Larger banks tend to have larger boards (Cornett, McNutt, & Tehranian, 2009). There is a long-standing assumption that a large board size leads to better monitoring of earnings quality (Xie, Davidson, & DaDalt, 2003). It is expected that the board can effectively influence the managerial decisions as its role consists of assessing decisions and controlling the executives (Allegrini & Greco, 2013). Since

the BOD holds managers answerable to shareholders for their actions and decisions, therefore, the board has a great influence on financial reporting integrity. However, previous studies have not found consistent evidence on the relationship between earnings quality and board size. The proponents of a large board assert that such boards can comprise different and diverse expertise to control managers' behavior.

According to Quttainah et al. (2013), larger boards are more effective in lessening income-increasing earnings management and are essential for limiting earnings management. Mersni and Othman (2016) also corroborated these results based on their study on the impact of corporate and *Shari'ah* governance mechanisms on the reporting of LLP in 21 Islamic banks and 18 conventional banks from seven countries in the Middle East region for the period of 2000 to 2008. Their results, estimated using random-effects specifications, show that a larger board has a negative relationship with discretionary loan loss provisions (DLLP).

Fodio, Ibikunle, and Oba (2013) found similar results based on their study of a sample of 25 Nigerian insurance firms from the period 2007 to 2010. A larger board can pool the expertise and experience of its members to control managers' behavior. Iraya et al. (2015) documented that a larger board decreases earnings management behavior of companies listed on the Nairobi Securities Exchange (NSE) in Kenya. It is argued that a larger board leads to an increase in the board's monitoring capacity. These results confirm the previous results of Xie et al. (2003) on DLLP and Chtourou, Bedard, and Courteau (2001). On the other hand, according to the agency theory, a smaller board is more efficient and effective in monitoring and controlling (Hillman and Dalziel 2003; Jensen 1993). It is more suitable for disciplining the managers (Fodio et al., 2013), minimizing agency costs and ensuring proper coordination and communication amongst board members (Quttainah et al., 2013).

2.3.2 Board Independence and Earnings Quality

Board independence is an essential factor for ensuring the effectiveness of the board (Quttainah et al., 2013). Boards comprising independent directors are found to be more likely to reduce discretionary behavior (Taktak & Mbarki, 2014; Idris et al. 2017). Iraya et al. (2015) asserted that independent directors enhance governance practices and found a negative relationship between independent board members and discretionary accruals. Idris, Abu Siam, & Nassar (2017) corroborated these findings in the context of Jordanian financial and non-financial firms. Their earnings quality is high in the presence of independent directors. However, the monitoring power of board independence is not effective in family-controlled firms.

Siagian and Tresnaningsih (2011) provided evidence that discretional accruals of public listed firms on the Jakarta Stock Exchange (JSX) reduced in the first and second years after the requirement by

the JSX to have at least 30% independent directors on the board. Busirin, Azmi, and Zakaria (2015) confirmed these findings in the Malaysian context and argued that independent directors are associated with earnings manipulation.

In the banking context, Cornett et al. (2009) studied 47 largest bank holding companies headquartered in the US for the 1994 to 2002 period. Their findings suggest that earnings management and governance mechanisms are endogenous variables. The two-stage least squares estimator (2SLS) regression was used to address the endogeneity issue. Their measurement of board independence is different from other studies because the CEO, who is a non-member of the nominating committee, was regarded as an independent director. Their results show that board independence has a negative and significant association with the measurement of earnings (DLLP), indicating that independent directors limit the practice of earnings management to boost earnings.

2.3.3 Audit Committee Size and Earnings Quality

Audit committee size is defined by the number of directors on the audit committee. The size of the audit committee depends on the size of the BOD and size of the firm. The audit committee is responsible for monitoring the reliability of the financial statement and it is asserted that the audit committee's monitoring role is deemed to have failed in the case of errors in the financial restatement (Rahim, Johari, & Takril, 2015). According to Safari (2017), the size of the audit committee and composition, as suggested by regulators, play a vital role in reducing incentives for managers to engage in earnings management activities. The structure of the audit committee has a significant association with earnings management, whereby a large audit committee is more effective in reducing the magnitude of discretionary accruals. A larger audit committee provides better monitoring of the financial reporting process as it has the advantage of more experts in the committee; hence, the probability of restating the financial statement is reduced, and therefore, earnings quality would also be improved (Lin, Li, and Yang 2006; Mishra and Malhotra 2016).

Besides, the audit committee is in a better position to monitor management on ambiguous accounting practices and alleviate the magnitude of fraudulence in the financial statement (Lin et al. 2006; Mishra and Malhotra 2016). Inaam and Khamoussi (2016) conducted a meta-analysis study on audit committee size and earnings management based on mixed results from 19 past studies. They found that there is a significant association between audit committee size and earnings management, whereby a large audit committee is more preferable. A positive relationship between audit committee size and quality of financial reports was also found by Hamdan et al. (2013) and Felo et al. (2003).

However, the results of past studies on audit committee size and earnings quality are mixed. Ayemere and Elijah (2015) investigated the relationship between audit committee size and

discretionary accruals of 50 Nigerian companies from the period 2006 to 2013. Their finding showed that audit committee size has a significant negative relationship with discretionary accruals, supporting the notion of the agency theory. According to Al-Farah (2001), the increase in the size of the audit committee can be unmanageable, thereby leading to a decrease in the efficacy of activity of the audit committee due to the waste in costs and disorganized work. On the other hand, past literature also reported that there is no relationship exists between audit committee size and earnings management (Bédard, Chtourou, and Courteau 2004; Hamdan et al., 2013; Majiyebo et al., 2018; Xie et al., 2003). According to Alkdai and Hanefah (2012), audit committee size is not an essential factor in limiting earnings manipulation even though a larger audit committee is assumed to be more advantageous in terms of responsibilities, technical ability, expertise and power in their supervising roles.

2.3.3 Audit Committee Expertise and Earnings Quality

Numerous studies have evinced that financial and accounting expertise would lead to high quality of earnings. Audit committee members with experience and knowledge in accounting and auditing are essential for the audit committee to execute its oversight duties effectively. Members with expertise can help other audit committee members to be familiar with financial and operational reports in the process of reviewing the financial report (Ayemere and Elijah 2015). The relationship between audit committee expertise and discretionary provisions was proven by Zgarni et al. (2018) in the context of Tunisian commercial banks, as negative and significant. This corroborates the prior findings of Ayemere and Elijah (2015) and Xie et al. (2003) in the context of listed firms.

According to Ittonen et al. (2017), audit committee members and the chairman who are former auditors, can enhance the financial reporting quality of financial institutions. These audit committee members use their professional auditing experience to prevent the use of DLLP. Based on their study of 78 large US publicly traded banks from the 2004 to 2012 period, the authors further reported that their results are attributed to the audit committee members and chairman who are former auditors, not engaging with the bank's current external auditors. Sellami and Fendri (2017) further proved that accounting and financial experts are more favourable than industry experts without accounting and financial expertise in influencing the compliance level of the financial report to the IFRS.

Badolato et al. (2014) examined the importance of having audit committee financial expertise in mitigating earnings management. The authors investigated 29,073 firm-year observations from 2001 to 2008 and found that financial expertise in the audit committee has a negative and significant association with abnormal accruals. Ojeka et al. (2015), in their research concerning only accounting financial expertise, analyzed 18 Nigerian listed banks on the NSE between the period of 2003 to 2011. This study used Least Squares Dummy Variable (LSDV) to examine the relationship between financial expertise of the audit committee and financial reporting quality of

Nigerian deposit money banks by using the measurements of total accrual quality and audit report lag. Their finding indicates that the presence of financial experts in the audit committee has a positive and significant impact on financial reporting quality.

According to Abernathy et al. (2013), financial and accounting expertise in the audit committee is attributable to the audit committee's effectiveness and high quality of financial reporting. It is considered as the most influential and crucial factor that determines the integrity and reliability of financial reports (Ojeka et al. 2015). The analysts perceive financial report of firms with accounting financial experts in the audit committee as more credible and reliable. The authors opined that financial accounting experts carry more tangible economic benefits to the users of financial reports. Financial accounting experts are associated with more exceptional analysts' forecast accuracy and lower forecast dispersion. Thus, consistent with the prior literature, financial accounting expertise in the audit committee increases the ability to anticipate future earnings, indicating the high quality of earnings and high financial reporting quality.

2.3.4 External Audit Quality and Earnings Quality

The external auditor is a mechanism that can mitigate the agency problem in a firm (Inaam and Khamoussi 2016). The external auditor is an independent party who is responsible for inspecting financial matters and ensuring financial transactions are accurate and reliable (Md Nasir 2013). An independent external auditor is expected to reduce the manipulation of earnings. The external auditor is selected by the audit committee, and there is a tendency by the audit committee to select Big Four audit firms. Big 4 audit firms are selected based on national reputation, training and experience of senior audit personnel and quality of audit services (Alkdai and Hanefah 2012). Big Four audit firms are more independent, and the financial information of the firm that hires Big Four audit firms is more reliable (Ugbede et al. 2013).

According to Alkdai and Hanefah (2012), large audit firms are more likely to influence the disclosure of additional information by the firm as they play an essential role in limiting opportunistic behavior of management, hence reducing the shareholders' agency costs. The goal to achieve high-quality financial reporting depends on the part that the external auditor plays in supporting the quality of financial reporting of the firm. A high-quality auditing standard cultivates adherence of the firm to the set accounting standards, hence leading to a reliable, transparent, and relevant financial report (Farouk and Hassan 2014).

Taktak and Mbarki (2014) examined the impact of external audit quality on the discretionary provisions of major banks in Tunisia for the period from 2003 to 2007. This study draws attention to the factors that impact the quality of the external audit, i.e., reputation, the ability of reservations disclosure and the presence of a co-auditor. Their results reveal that it is not preferable to appoint a

co-auditor if both auditors belong to a Big Four firm as it provides incentives to manage earnings. Both auditors with Big Four affiliation can increase accounting manipulation. The co-audit works properly only in the presence of a single member belongs to the Big Four audit firm. They further asserted that it might be attributed to the weak legal and disciplinary system of auditors in Tunisia where civil and criminal liability involving the auditors is uncommon.

Similarly, Ozili (2017) stated that weak bank supervision and legal enforcement institutions in the African region make the role of Big Four firms to be ineffective. Based on a sample of 302 African banks throughout 2004 to 2013, Ozili (2017) investigated whether the choice of Big Four auditor would influence the income-smoothing practice of African banks. The author concluded that the Big Four audit firm is less effective in moderating the extent of income-smoothing of African banks. Big Four audit firms would rather not lose their clients in Africa, their new base, compared to providing high-quality audits that discourage LLP manipulation. African banks are more willing to pay lower audit fee to the auditors affiliated to a Big Four audit firm that is more advantageous to them.

Yasar (2013) studied a sample of listed firms in Turkey, and found that the role of the external auditor to deter earnings management behavior is limited. According to Yasar (2013), auditors are less likely to provide high-quality audits in the case where the institutional environment has no effective audit and oversight mechanisms for auditors. Ugbede et al. (2013) compared the relationship between auditor status and earnings management of banks in Malaysia and Nigeria and found similar results. Using a sample of all the listed Nigerian banks and Malaysian commercial banks for the years 2007 to 2011 and the discretionary accruals-based Jones Model, their finding shows that there is no significant difference between the Big Four auditors for both Malaysian and Nigerian banks on the quality of earnings. However, the authors concluded that the earnings quality of Malaysian banks is considered reasonable compared to Nigerian banks. Nigerian banks are more likely to manage their earnings compared to Malaysian banks. This occurs because of differences in the corporate governance principles, structure and practices between Malaysia and Nigeria.

3.0 Conclusion

Over time, growing concerns with the influence of corporate governance mechanisms on banks' earnings quality, have led to continuous discussions among academicians and industry players. Furthermore, few prominent cases of mismanagement scandals have gained attention to the relevance of corporate governance in protecting and balancing the rights and interests of shareholders as well as of other stakeholders (Grais and Pellegrini 2006). In fact, the central focus of effective corporate governance dwells on protecting the interests and rights of stakeholders.

This paper provides discussion on earnings quality as a proxy of financial reporting quality and the influence of corporate governance mechanisms on earnings quality by emphasizing on the characteristics of BOD (board size and board independence), audit committee (audit committee size and expertise) and external auditor quality. Even though the extant previous study has focused predominantly on the developed and developing countries, the findings were still inconclusive. Thus, there are gaps on the remaining knowledge on the impact of BOD, audit committee and external auditor characteristics on the earnings quality specifically in the developing countries. Future study may consider other characteristics of BOD, audit committee and external auditor such as remuneration and fee that are also substantial in influencing the earnings quality. Therefore, this study offers motivation for future study on corporate governance mechanisms and earnings quality as well as benefit the academician, regulators and industry players to better understand the influence of corporate governance mechanisms on the financial reporting quality in general.

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