Corporate Governance and its Effect on Earnings Quality in Retail Industry of the United Kingdom

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ABSTRACT----The main aim of this work is to find the possible relationship between the corporate governance & the earnings quality in UK retail sector, as well as to examine the effect using board characteristics (i.e. board independence, CEO duality and board size) on earnings management. The five years data, for 2010 to 2014, from 38 retail and wholesale companies listed on London stock exchange has been analysed. The basic approach was to perform regression analysis between the corporate governance (independent variables) and proxy for earnings quality, to determine the earnings management using accrual component (dependent variable). No relationship statistically significant was found between the corporate governance variables and earnings quality. The only statistically significant result found from the regression analysis is for 2014, and shows that the SIZE is a predictor variable for earnings quality with positive relation. The main limitation found has been the size of data sample, but the study does show insignificant results in line with some of the pervious studies. It also leads to the conclusion that, as the environment within the firms keep on changing, the new variables of corporate governance can be used to investigate their impact on the earnings quality.

Keywords---Corporate Governance, Retail industry, Earning management, Board characteristics, CEO (Chief Executive Officer)

1. INTRODUCTION

To study the possible effect of corporate governance on earnings quality within retail industry in the United Kingdom (UK) is important as it makes a part of the country economy. The available literature predicting relation between the corporate governance and the earnings quality provide contradictory results. According to a study [1] the effect of governance on earnings is found to be significant, whereas another study [2] oppose it. Hence it seems advantageous to study and elaborate this effect further.

In the modern world the need for good corporate governance is becoming essential as it regulates the organisation and help it perform the internal and external operations better. Strong relations have been found between good corporate governance and performance within an organization [3]

Earnings quality is regarded as a very important factor for the decision makers such as investors, shareholders and regulators. They use the earnings information to value the firm as the higher the earnings quality is, the better it will define the financial performance of the firm [4]. Earnings management is basically the way how the management manoeuvre/manipulate the accounting figures in order to achieve the desirable position, and benefit themselves by reducing or increasing the cash flows or accruals. In current atmosphere of competition and meeting targets, this often leads to high manipulation of accruals in order to record the high profits, resulting in lowering earnings quality by earnings management.

A study has thus been made, applying the Regression Model, to access the significance of relation between the corporate governance variables (chair role, size of the board and independency of the board) and earnings quality. The basic methodology applied to obtain the earnings quality is the earnings management with the proxy abnormal working capital accruals [5]

2. THE LITERATURE REVIEW

2.1 Corporate Governance

Corporate governance is a way to structure the practices, by which matters of the company are directed and controlled, in to rise in share prices [7], order to boost the shareholders’ confidence and the value by improving performance of the firm [6]. There is no specific definition for corporate governance, but it is the system to direct and control the organisations [7]. Corporate governance provides set of rules for better environment practices in areas such as board’s characteristics addressing agency conflicts [8]. Corporate governance is concerned with ensuring that firm runs in the best interests of shareholders and other stakeholders [9]. The implementation of good corporate governance makes the overall performance of the firm better and ultimately leads to rise in share prices [17].
2.1.1 Governance Mechanisms

There are many channels of corporate governance and they can be useful in determining as to how well the structure of governance is in the organisation. The main mechanisms and characteristics for good corporate governance are discussed in depth below:

(a) Board Size

Board size is a very important matter. The recent studies have been inclined more towards the smaller boards as the larger boards appear to be less effective, hard to coordinate, and the costs are higher too [6]. A study of UK firms identifies that no significant relation is found between the board size and the firm performance, and it is due mainly to the communication gap and ineffectiveness of the board [10]. This raises the issue with larger boards in that it is hard to identify free-rider directors who do nothing towards making the business environment better. However, the evidence contradicts [11] and it suggests that a larger board bring more skills and resources into the firm, resulting in a better firm performances. It ideally, therefore, should be made sure that when boards get larger, the drawback of having an extra board member does not outweigh the advantages.

(b) Board Independency

Board independency is another matter where there are enormous arguments surrounding. It is important for the board to operate in line with the shareholders mandate through non-executives. The independency is vital, and having a majority of outside directors is usually referred to as a sign of good corporate governance because it helps in the detection and reduction of fraudulent activities occurring within the organisation [12]. According to UK combined codes the board should consist of at least one third of non-executive directors to improve the efficiency. Also, non-executive directors bring more skills and ideas to the company. According to a study of UK firms, the non-executives are known to work in favour of shareholder’s interests and that the best practice is to maintain a balance between the executives and the non-executives [13]. On the other hand, a higher number of non-executive directors can fade the board effectiveness, lower the performance, and avoid the executives from joining, though executives also play a very crucial role in management [14, 11]. One of the studies argue that for certain board committees, such as finance and strategy, performance with more non-executive directors is better [6]. It is over emphasized that the governance structures actually result in excessive time spent on independent directors being provided with the detailed information about the firm [15].

(c) Duality of the Role of CEO/ Chairperson

The studies in respect of the Board leadership have shown that there are mixed results about whether the role of chairperson and chief executive officer should be held by two different persons or not. As the aim of the board is to run in the interests of shareholders, if the Chief Executive Officer (CEO) is the chairperson it will result in monitoring their own decisions, thus making the board less effective. On the other hand in some other studies it has been argued that the combined position will allow making the timely decisions and the board effective, because the executive directors have more knowledge, familiarity and expertise about the company for setting the board agenda [2]. A study, however, contradicts and gives evidence that the duality of CEO/Chairperson actually has negative impact on the firm value [11]. These arguments suggest that there is no ultimate solution to this issue and the structure should rather be dependent on organisation’s characteristics. It, therefore, is important to study the perspective of separation of roles to be valuable for the company.

2.2 Earnings Quality

Earnings quality in context of accounting is basically a firm’s capability to give a fair view of company’s future through their reported earnings figure or in other words their income [4]. A high quality of information is referred to as accurate, timely, comparable and most importantly neutral. It is something very important for many users of the financial reports such as investors, regulators, auditors etc. The reported earning has usefulness to reflect and predict the changes in the wealth of a company.

Earnings quality is often explained through the accrual component of the earnings rather than the cash flow [16]. It is important for the shareholders and debtors to have timely and true information. But, managers are more inclined to influence earnings possibly by using different estimates and accounting methods following the earnings management or earnings conservatism [17]. It is very important to keep the earnings of better quality because a study indicates that UK bankrupt firms had lower earnings quality leading to their failure [2].

2.1.1 Earnings Management

Earnings management is fundamentally the management behaviour, and its judgement of manipulating the financial information to mislead about performance of the company. According to a formal definition the earnings management occurs when managers use judgment in financial reporting and in structuring the transactions to alter the financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting number.
Earnings management can be done through real earnings management (REM) or accrual earnings management (AEM) methods [18]; accrual is the natural increase or advantage in finances. Real earnings management requires methods such as selling assets & the price discounts etc., which possibly can reduce the firm cash flows and value, whereas accrual earnings management is much more easier to incur[19,20]. Accrual earnings management is also used more by managers as it is not so simple for the decision makers as to interpret the financial accounting number. The earnings management can thus be used as a measure for earnings quality as it is the main function while manipulating accruals.

2.3 Relation between Corporate Governance and Earnings Quality

It has been found in the previous studies that there is a substantial impact of corporate governance on earnings management, and firms with growing opportunities are more driven towards earnings management [21]. Companies with lower earnings quality, higher earnings management tend to have a more strong relation with corporate governance. The relation is also found to be reciprocal [22]. This means that earnings management is used as an effect of corporate governance and/or then corporate governance policies are applied to cover the earnings management.

In one of the earlier studies it has been found that increase in the ownership concentration, the board size and the board independence will lead to a decrease in the earnings management, and an increase in the board activity, and that the CEO duality in the board will further increase the earnings management [23]. In another study separation of the role of CEO and chairperson is found demanding the strict accounting environment to compensate any weaknesses in reporting the earnings [24]. Moreover it has been predicted that the smaller (larger) board size is more (less) effective towards quality of the earnings [25].

A different, though scarce, evidence has been found regarding the relation between governance and the earning quality in the retail industry in UK. However some of the studies signal a high demand for enhanced earnings as per requirements of the governance rules [26]. Thus the initial presumption in the present project may be that the solid governance will lead to a better monitoring of management and better earnings quality. The questions that may arise in this context, and may be answered, are the following:

- Does the mechanism of corporate governance affect the earnings quality in U.K retail industry?
- How significant is the relation between corporate governance practices and the earnings quality

3. RESEARCH APPROACH AND DESIGN

3.1 The Research Design

Analysis was carried out of retail industry in UK, as it holds about 5.7% of the UK economy [27], based on five years data from 2010 to 2014. The culture of industry changes with time. The study, therefore, to explore the effect of corporate governance on earnings quality in the industry, will benefit the organisations to identify and adopt the culture that promotes good corporate structure with better class of earnings, and may ultimately benefit in particular the whole economy.

3.2 Methodology

Earnings quality is determined making use of the earnings management because both have a significant relation between them; the quality of earnings is poor when mainly the earnings are managed, and vice versa. The accrual earning management (AEM) needs to be applied as accruals, the natural increase in finances, are considered to be a component of the earning quality [4], and more likely to be used by managers to manage earnings rather than structuring the actual transactions [18]. The methodology for identifying the earnings quality has been structured [28] based on the idea of earnings management with the proxy abnormal working capital accruals [5]. Abnormal working capital accruals (AWAC) are calculated by taking the proxy abnormal working capital [5]. Abnormal working capital accruals (AWAC) are calculated by taking the difference between the actual and expected non-cash working capital. The dependent variable in data analysis is the logged abnormal accruals representing the earnings quality and is calculated using the following relation [28].

\[ AWAC_t = WC_t - (WC_{t-1}/St_{t-1}) \cdot St_t \]

\[ WC = \text{Non-cash Working Capital Accruals} \]

\[ = (\text{current assets - cash and short term investments}) - (\text{current liabilities - short term debt}) \]

\[ WC_{t} = \text{Working Capital Accrual for the current year} \]

\[ WC_{t-1} = \text{Working Capital Accruals for the previous year} \]

\[ St = \text{Revenues for the current year} \]

\[ St_{t-1} = \text{Revenue for the previous year} \]

It leads to multiple linear regression model equation as follows:
AWCA = βCHAIRROLE + βSIZE + βNONEXECUTIVES,
where β determines the significance of the model,
CHAIRROLE = Separation of Chairperson and CEO,
SIZE = Size of Board of Directors, and
NONEXECUTIVES = Number of Non-Executive Board Members

3.3 Sample Data Collection

The data base used in this work for attaining the sample was from Orbis [44], which has been investing globally for over 25 years, with the main objective to empower their clients by enhancing their savings and wealth. Orbis data base holds information about the large listed & the unlisted forms and is a reliable source. The search to attain the sample of companies for this project was based on 38 companies selected from the wholesale and the retail trade sector in UK.

4. RESULTS

Multiple linear regression model (MLR) was applied to the data set of UK retail companies for each of the years from 2010 to 2014 as it remains a mainstay analysis in organizational research [45]. Use was made of the software package SPSS, the widely used programme for statistical analysis [46,47], to see if chair role, size and non-executive influence the proxy for quality of earnings.

In Table.1 the multiple linear regression value “R square” represents the percentage of data that explains dependent variable by independent variables, CHAIRROLE, SIZE and NONEXECUTIVES. The correlation came out to be exceptionally low for all the years ranging between 1% and 26%, with the highest being in the year 2014. The adjusted R square appeared to be negative for 2013, 2012 and 2010, which further suggests that explanatory variables provide negligible explanation for earnings quality.

Table 1: Multiple Linear Regression Values

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2013</th>
<th>2012</th>
<th>2011</th>
<th>2010</th>
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<tbody>
<tr>
<td>R Square</td>
<td>26%</td>
<td>1%</td>
<td>4%</td>
<td>12%</td>
<td>4%</td>
</tr>
<tr>
<td>Adjusted R Square</td>
<td>20%</td>
<td>-8%</td>
<td>-4%</td>
<td>4%</td>
<td>-4%</td>
</tr>
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</table>

The results in Table.2 were obtained by applying ANOVA test [48]. It is a categorical variables Centered Predictor for numerical outcomes; linear regression. It is a particular form of statistical hypothesis testing used in the analysis of experimental data. ANOVAs are useful for comparing (testing) three or more groups or variables for statistical significance, and to develop & confirm an explanation to the observed experimental data. The test result, calculated from the null hypothesis and the sample, is called statistically significant if it is deemed unlikely to have occurred by chance, assuming the truth of the null hypothesis, but only if the prior probability of the null hypothesis is not high.

In the typical application of ANOVA, the null hypothesis means that all groups are simply random samples of the same population. For example, when studying the effect of different treatments on the same population of patients, the null hypothesis would be that all treatments have the same effect (perhaps none). Rejecting the null hypothesis would imply that different treatments result in altered effects. A statistically significant result, when a probability (p-value) is less than a threshold (significance level), justifies the rejection of the null hypothesis, but only if the null hypothesis is not high.

Table 2: Multiple Linear Regression Model- Year wise Significance (Sig) in terms of the β-coefficient

<table>
<thead>
<tr>
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<tr>
<td>Beta coefficient</td>
<td>Sig</td>
<td>Beta coefficient</td>
<td>Sig</td>
<td>Beta coefficient</td>
<td>Sig</td>
</tr>
<tr>
<td>Model Sig</td>
<td>-4637.2</td>
<td>0.329</td>
<td>-2811.48</td>
<td>0.908</td>
<td>40.42</td>
</tr>
<tr>
<td>SIZE</td>
<td>2333.09</td>
<td>0.008</td>
<td>1609.23</td>
<td>0.703</td>
<td>-69.22</td>
</tr>
<tr>
<td>NONEXECUTIVES</td>
<td>-1243.34</td>
<td>0.214</td>
<td>-2856.79</td>
<td>0.623</td>
<td>662.75</td>
</tr>
<tr>
<td>Constant</td>
<td>-5956.12</td>
<td>0.209</td>
<td>301.26</td>
<td>0.99</td>
<td>-1615.55</td>
</tr>
</tbody>
</table>
The results given in Table 2, based on Multiple Linear Regression Model, interestingly show that it is the only statistically significant model for 2014 because with 95% confidence level the significance is less than 0.05, thus making beta (β) significant. The SIZE of the board variable was the only significant predictor of earnings quality. Therefore, positive beta coefficient for the variable indicated that as the number of directors in the board increases, the value of abnormal accruals also increase, and hence the earnings quality decreases.

The probability (p-value) for 2013, 2012, 2011 and 2010 are all above 0.05 and it is making them statistically non-significant. It thus implies that the characteristics of corporate governance do not have any effect on the earnings quality. The overall results in the context of hypotheses are:

Hypothesis 1: There is significant relation between corporate governance and earnings quality.
Conclusion: Rejected, no significant relation found.

Hypothesis 2: The separation of chair role is negatively linked to earnings management.
Conclusion: Null hypothesis, no significant relation found.

Hypothesis 3: The size of the board positively linked to earnings management.
Conclusion: Accepted, significant positive relation found in only in year 2014 results. Null hypothesis, no significant relation found as per all other results.

Hypothesis 4: Independent directors on board are negatively linked to earnings management.
Conclusion: Null hypothesis, no significant relation found.

### 5. DISCUSSION

#### 5.1 Literature Linked to Results

As the results came out to be opposite to the predicted hypothesis, and the corporate governance variables did not statistically influenced the earnings quality, it can be advantageous to explore the literature supporting the results and perceive if the results are close to certainty.

The results for multiple linear regressions for each of the five years have shown that the board SIZE appear to be the only statistically significant predictor of earnings quality for only the year 2014. From the UK study covering a long period it has been concluded that corporate governance does not have an impact on performance of the company, and hence does not affect the earnings quality [15, 29]. However, the board SIZE of the firm does cause an increase in manipulation of the earnings, and this is supported by a study based on the listed companies of China [30]. Other studies [25, 31] also suggest the board SIZE to be positively linked to the earnings management. It, therefore, supports that keeping the board SIZE smaller is to be more effective for the earnings quality; the larger boards can in fact make the earnings quality lower.

Nevertheless, an Australian study reveals that the board characteristics do not have the impact on the abnormal accruals, thus have no link to the earnings management [32]. The two latest studies [33, 34] show no relation between the board size, the board independency, the duality and the earnings management, hence showing no influence of the board characteristics on the earnings quality. In the context of two other studies [2, 35], the separation of chair role is not linked to the quality of earnings.

Among the Canadian firms, the relation between earnings management and non-executives is found to be non-significant [36]. The explanation to this finding [31, 37] is that non-executives could possibly be under the influence of the executives on the board and hence, less effective in controlling the management from influencing the earnings. Another reason could also be that independent directors are deficient of knowledge in company matters. The evidence from the UK firms implies that when the earnings management is high, the non-executives are ineffective to influence the income decreasing accruals [17].

As most of the firm in the sample were of a larger SIZE, it suggest that larger companies do not tend to be involved in the earnings management [38]. In larger companies it is difficult to manage earnings because there is a high supervision by the
investors and other market analysts. The small organisations are rather better to be engaged in the earnings manipulation. Also, the smaller firms are more suitable to be involved in managing earnings in order to avoid losses [39]. This is because the smaller companies are motivated towards influencing the profits upwards to make the firm more attractive.

5.2 Weaknesses of the Model

A research study is mostly somehow restrained by the limitations and impacts on the findings’ precision. This study also carries overall a few weaknesses of the overall research. Primarily it is believed that these varied and contradictory results are due to the complexity of both corporate governance’s and earnings quality’s proxies. This actually is because there is no exact measure generated to determine or quantify the exact value for governance and earnings quality. The variables chosen for quantifying corporate governance’s effect are not sufficient enough to serve the purpose, as there is a range of different mechanisms in governance. Also every industry/firm has its own operating environment and it, therefore, is certain that there is no suitable framework to judge the quality of corporate governance. Similarly, abnormal working capital accruals can also not fully represent the earnings quality and earnings management. There are various types of measures for earnings quality. It may, therefore, not be appropriate to measure abnormal accruals within the retail industry.

The sample size, though gives the impression of being well-designed, was not large enough. Using a sample of 38 companies, and examining the 5 years data, can perhaps not reflect on the actual impact of governance on the earnings management. The significance of the results could have been better with the larger sample because R square values in the findings have come out to be significantly low. Also, the quality of sample cannot be unquestionable and there is always a proportion of doubt present.

The result does not necessarily imply that corporate governance has a little impact on organizational behaviour to manipulate earnings. The result may also indicate that the possibility to measure and capture the construct of corporate governance is very limited due mainly to using the existing structural measures. There could be other factors within the governance that actually are derivers of the earnings quality.

5.3 Other Factors Affecting the Earnings Quality

The implication of the insignificant results is that to predict earnings quality of retail companies in the United Kingdom, based on the corporate governance, may be very difficult. Looking solely at the structure of Boards of Directors, and whether there is a separation between the Chairperson and the CEO, is not enough to predict the earnings quality. Additional study needs, therefore, to be carried out to determine the other factors, possibly the significant predictors of the earnings quality, in order to make the earnings quality better by reducing the earnings management within the retail industry in the United Kingdom.

Investigating the effect of board characteristics to gauge the impact of corporate governance is also not enough. There are many other important factors of the governance, such as institutional ownership, directors’ pay, financial expertise and many more affecting the quality of corporate governance. It actually is the structure and characteristics of the sub committees in the governance system which affects the organisation’s choice of performance management. It also is claimed that earnings management is affected negatively by the board meetings and the activity of three vital committees namely, the audit committee, the nomination committee and the remuneration committee [38, 40].

Board with more directors holding the financial background have a tendency to reduce the inappropriate managing of the earnings. It is also argued [40] that board members with the financial expertise are lean to lower the abnormal accruals and lead to increasing the earnings quality. The presumption that financial skills are to be beneficial to the earnings quality [31], and that members of the audit committee with the financial expertise make an increase in the conservative accounting causing reduction in managing the earnings [36, 41], are also supported.

The board diversity also is an emerging area within the board characteristics [7, 42]. It has been found [43] that a board consisting of more female directors can have a negative impact on the earnings management. Another view is that diversity in the context of ethnicity does not have any effect on the earnings management [31].

As a whole, the corporate governance is a vast area with various aspects. To quantify, therefore, the precise effect of corporate governance on the earnings quality is quite difficult and work encumbered. More research is thus required to draw the definite conclusions about this area, providing the companies with a framework to follow in order to improve the quality of earnings.

6. CONCLUSIONS

This study is based on a model [28] for measuring earnings management, the proxy for earnings quality. The corporate governance variables considered in this study are the board independence, CEO duality and the board size. These are the mostly used and important board characteristics.

The regression model for each of the years came out to be statistically non-significant except for the year 2014. The results are mainly in line with the previous findings [32, 33, and 34]. The regression model for the year 2014 showed that only size
of the board is positively related to earnings management, meaning by that the larger board can in fact decrease the earnings quality as was concluded earlier [25,31]. This causes hypothesis 3 to be accepted making rest of the hypotheses null, neither accepted nor rejected, thus implying that other factors have no effect on the earnings quality. The implication of having no relation between the basic board characteristics and the earnings quality in the industry could be that the firms may be encouraged to put more focus over the other governance factors, rather than consuming time and the money on non-executives, making sure that changes in the structure of board do not affect other influential matters.

Another factor to be highlighted is that the sample used holds mostly the larger companies, and the larger companies are expected less to be involved in the earnings management than the smaller [38, 39]. This implies that the accruals in the data may be mostly related to the normal accrual accounting practices.

The credence of the results of this study could be improved by mainly increasing the sample size to emphasize that the board SIZE, CHAIROLE and NONEXECUTIVES do not have influence over the earnings quality. Also the variables used in this study cannot show the overall quality of corporate governance as they are not the only important elements to represent the corporate governance fully. So another improvement can be to add more precise corporate governance variables found in literature for example, board committees, financial expertise, and board diversity to answer if corporate governance has any effect on the earnings quality [31, 38, 40, 43].

To conclude, therefore, it is essential to carry out further studies by applying the more convincing methodology as the corporate governance, the earnings quality measures and proxies cannot be 100% certain.

The previous studies present too contradicting opinions about identifying the effect of corporate governance on the earnings quality. Therefore to identify specific relation between the corporate governance and the earnings quality in retail industry in UK will help in identifying the trend. Importance of gauging the earnings quality is crucial for the decision makers because it will help them identify the future status of the organisation.

This study provides a platform to start planning more in depth studies in order to be certain about the effect of corporate governance on the earnings. Conclusively, this study finds no relation of the corporate governance with the earnings quality, except from the size of the board that is negatively linked to the earnings quality, though with little evidence.

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