

The Effect of Market Competition, CEO Influence, and Corporate Governance on Smoothing Earnings, Accruals, and Firm Devaluation

Saeedeh Rezaee

Master of Accountancy (MAcc), Islamic Azad University of Chalous, Chalous, Iran.

Abstract

One of the primary goals of earning smoothing is maintaining the company's reputation because it makes the company more efficient and dynamic. Gaining a suitable position among competitors and the capital market makes investors and creditors more favorable towards the company, and the company does not need to spend more to compete with other similar companies and to get less credit and loans. The purpose of the paper was to examine the effect of market competition, CEO influence, and corporate governance on smoothing earnings, accruals, and firm devaluation among the firms listed on the Tehran Stock Exchange. The population was 161 stock exchange companies during the period 2012-2017. The results showed that market competition, CEO influence, and corporate governance (CG) have no significant effects on earnings smoothing. Moreover, market competition and corporate governance did not significantly affect accruals. However, CEO influence has a positive and significant effect on accruals. Finally, market competition, CEO influence, and CG do not have a significant effect on company value.

Keywords: Market Competition, CEO Influence, Corporate Governance, Smoothing Earnings, Accruals, Firm Devaluation

Classification: JEL: G34 +E31 +G32 +G3

INTRODUCTION

Competitiveness is a process, through which every institution tries to perform better than others and to outperform other institutions. At the international level, the countries must compete for the wealth and benefit of their societies given the lack of the necessary financial, technical and specialized sources. Hence, gaining competitiveness capabilities in the world today has turned into one of the major challenges of various countries at the international level. There are some elements to be considered for becoming competitive. On the other hand, all major decisions of some companies are made by their CEOs, whereas the decisions are made more transparently and using consensus among senior managers in some other companies. If the individuals have various ideas, the distribution of decision-making power in the companies can affect the decisions made. The previous studies have developed a hypothesis on how CEO dominance among senior managers affects corporate capital structure options using these ideas. They have particularly tried to explain the structure of corporate capital based on the CEO's decision-making power ^[1, 2].

CEOs have a critical role in strategic decisions affecting the long-term value of a company ^[3]. The studies regarding CG shows the positive effect of various mechanisms like board supervision and the market mechanism on controlling the

company through the relocation of managers to reduce agency conflicts between managers and shareholders. Nonetheless, some companies still do not deprive shareholders of their welfare in the absence of these types of governance mechanisms, in spite of understanding the significance of these mechanisms in matching managers' interests with shareholders ^[4]. Clearly, the motivation for the managers of these companies is forces other than the traditional mechanisms of CG. Such a force, as cited in Chaurkaria et al. (2012), is competition in the market. However, decision making in some companies is the result of a consensus among senior executives. However, in some

Address for correspondence: Saeedeh Rezaee, Master of Accountancy (MAcc), Islamic Azad University of Chalous, Chalous, Iran.
Email: mahyas6831@gmail.com

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companies, the CEO makes all major decisions^[1]. Moreover, they believe that various managers have various ideas and therefore the distribution of decision-making power in companies can be affected by the type of decision made. Furthermore, managerial influence not only derives from the source of ownership power but also rooted in other formal and informal sources such as structural power and prestige power^[5].

The empirical evidence resulting from the theoretical discussions shows the range of effectiveness of CG mechanisms. Many studies have shown that the quality of CG positively affects stakeholder interests, although some evidence has reported the opposite case. However, others have not yet shown any relationship between the two^[6]. In examining the basic features, we assumed that one of the significant elements may be the importance of the diversity of stakeholder groups in relation to their share in the firm. This means that the major stakeholders - those to whom the organization has commitments - have priority over the sub-stakeholders. Primary stakeholders control significant resources for survival and significantly affect the company^[7]. Thus, a firm with proper CG must value the interests of its primary stakeholders to ensure that its commitments are fulfilled and that competitive resources are maintained. Compared to secondary stakeholders, they are not involved in dealing with companies and are not essential for the survival of the company. Their demands are placed lower than those of other primary stakeholders when the managers evaluate the relative costs, returns of strategy various, and scarce resource allocation of the company. However, the studies available on the relationship between CG quality and stakeholder interests have generally been considered as the interests of all stakeholders regardless of their unequal share^[8, 9].

The most relevant literature to the present paper is the texts that deal with why managers prefer to report smooth earnings, empirical examination of the earnings smoothing, and the factors ending differences in firms' earnings smoothing. Smoothing can reduce the risk and earnings fluctuations of the firm and thus reduces the rate of return needed. It can increase the smoothing of stock prices and this is probably because of the simultaneous decrease in probable losses that uninformed shareholders suffer for liquidity reasons. The companies may attempt downward earnings ratios prior to share repurchase to reach earnings growth after the excessive expected repurchase. A paper is based on this view of Fadenberg and Tyrol (1995)^[10]. They present a theoretical explanation for earnings smoothing. The base of their explanation is the idea that reporting bad profits can be very costly for managers and cause them to report profits in a way that "shifts" earnings from bad to good. They assume that all managers are realistic - their exemplary managers are not biased - but they hate risk. Moreover, they assume that all managers benefit from the benefits of maintaining their jobs and are fired if they show poor performance (bad earnings reported). These writers showed that the manager tries to

smooth earnings: he raises the reported earnings in bad conditions and avoids his dismissal, and on the other hand, and reports the earnings in good conditions less than the reality to "maintain" and add reported earnings to future bad earnings. Evidence that supports this theory is provided by Diffand and Park (1997)^[11, 12]. Thus, examining issues such as CG, CEO influence, and market competition on earnings smoothing is so significant.

On the other hand, firms' activities in the current complex environment and the need to identify the risks ahead are among the most significant factors in reaching success and here considering the strategic risk category (potential forces that can offset the strategy system and thus have significant negative effects on the value of the company), as well as the uncertain investment environment^[13]. Earnings management is a deliberate action to reduce changes in reported or expected earnings fluctuations, using accounting techniques within the framework of generally accepted accounting principles. The theory of procedural instability states that high volatility of corporate earnings increases the risk of investing in these companies, which affects the market price of their stocks. Indeed, earnings management in stock companies increases the satisfaction of shareholders because of the stability of the earnings received by shareholders. The issue, which has reduced the risk of investing in these companies, may affect the stock price of the companies. On the other hand, the companies showing their earnings smoother have to use various accounting ways in each period and thus have to disclose this^[14]. Given the above, the study analyzes the effect of market competition, CEO influence, and CG on smoothing earnings, accruals, and devaluation of the company. Overall, the innovation of the study can be summarized as exploring the effect of market competition, CEO influence, and CG on smoothing earnings, accruals, and company devaluation as the simultaneous effect of these components have not been examined previously.

LITERATURE REVIEW

Sheikh (2018) examined the effect of market competition on the relationship between CEO influence and firm innovation, finding that powerful CEOs produce more innovation and invention compared to other executive managers^[15]. Moreover, competition in the commodity market has a significant role in reducing the problems of the organizations, and CEOs use their power in the best interests of shareholders. Lee et al. (2017) examined the relationship between CEOs' decision-making power and the capital structure of Chinese firms. The results show a strong non-linear relationship between CEO influence and financial leverage. Additionally, the results show that CEO's power over financial leverage is stronger in public companies. Sariyoll et al. (2017) examined the effect of CEO power on heuristic and organizational innovation. Using the data from 150 US firms, the results showed a significant positive relationship between CEO power and heuristic innovation. Contrary to predictions, firms that are run by powerful CEOs and appointed by outside CEOs are more likely to engage in

exploratory innovation. Generally, the findings provide a more detailed explanation of the link between CEO power and innovation in the organization. Laxmana et al. (2015) examined the relationship between product market competition and corporate investment decisions^[16]. The results show that more competitive industries firms (with lower HHIs) are associated with R&D capital as well as higher standard deviations of return on equity, indicating that more competitive firms are more risk-averse than less competitive industries. Moreover, our results show that for firms with positive FCF and are among the more competitive industries (industries with lower HHIs) are associated with fewer overinvestments of cash flow, which shows that the competition in the product market is a governance mechanism that weakens the relationship between positive FCF and overinvestments.

METHODOLOGY

The present was applied: based on the analysis of empirical evidence (corporate financial statements). Firstly, the statistical relationships between the variables were examined and the statistical assumption test was examined in case of a significant relationship between the variables. Moreover, the study was applied in terms of purpose. Given the theoretical foundations of the study, we will test the following hypotheses within the framework of probit models:

Hypothesis 1: Market competition, CEO influence, and CG have a significant effect on earnings smoothing.

Hypothesis 2: Market competition, CEO influence, and CG have significant effects on accruals.

Hypothesis 3: Market competition, CEO influence, and CG have a significant effect on a company devaluation.

Furthermore, the population of the study was selected from among the stock exchange companies during the period 1982-2017 with a sample of 161 manufacturing companies listed in the stock exchange with the homogeneous conditions regarding the following four conditions to examine the models:

1. Should be present in the stock exchange from the fiscal years 2012 to March 2017

2. The companies should not be a part of banks, investment companies, intermediaries, insurance and monetary and financial institutions as these companies operational nature vary from the others
3. The end of their fiscal year should be 20 March of each year and they should not have changes in their fiscal year during this period
4. The needed information and data should be available at the end of the fiscal year at all examined years

In this study, a multivariate linear regression model was used to test the first and second hypotheses, and logit and probit methods were used to test the third hypothesis.

Research model

$$\begin{aligned} \text{Earning Smoothing}_{it} &= \alpha_0 + \beta_1 \text{CEO power}_{it} \\ &+ \beta_2 \text{market competition}_{it} \\ &+ \beta_3 \text{Corporate Government}_{it} \\ &+ \beta_4 \text{control variables}_{it} + \varepsilon_{it} \end{aligned}$$

$$\begin{aligned} \text{Accrual}_{it} &= \alpha_0 + \beta_1 \text{CEO power}_{it} \\ &+ \beta_2 \text{market competition}_{it} \\ &+ \beta_3 \text{Corporate Government}_{it} \\ &+ \beta_4 \text{control variables}_{it} + \varepsilon_{it} \end{aligned}$$

$$\begin{aligned} \text{Reduce . Firm Value}_{it} &= \alpha_0 + \beta_1 \text{CEO power}_{it} \\ &+ \beta_2 \text{market competition}_{it} \\ &+ \beta_3 \text{Corporate Government}_{it} \\ &+ \beta_4 \text{control variables}_{it} + \varepsilon_{it} \end{aligned}$$

Moreover, the definitions and calculation of the dependent and independent variables in the above models are described in Table 1:

Table 1: Variables definitions

Variable	Definition
Dependent variables	
Earnings smoothing	It is measured using Sen et al. model (2011) as follows: First, discretionary accruals are estimated using the modified Jones model. This study uses the following model residuals as optional commitments.
Accruals	Inventory + Betterment Cost - Operating Cash Flow
Devaluation of the company	The dummy variable equals one if the value of the company this year is lower than last year, otherwise, it is zero.
Independent variables	

Market competition:

It is measured using the Frindle Index

The dummy variable equals to one if the number of seven variables of CEO influence is greater than the median, otherwise, it is zero

The seven variables of CEO influence are:

Cps: CEO rewards relative to other board members' rewards

Duality: Managing member: The imaginary variable equals one if the CEO is a member, otherwise it is zero.

Reality: CEO Duality: The dummy variable is one if the CEO is the chairman of the board, otherwise it is zero.

Outside Directors: The percentage of non-executive directors on the board is higher than the total number of board members.

CFO ownership: CEO ownership is equal to the percentage of CEO ownership.

Founding Family: The founding family is the dummy variable and one if the CEO is a member of the founding family of the company and zero otherwise.

Tenure: The tenure of a CEO: By calculating the number of years being a CEO

CEO influence

CG

Combined CG includes the sum of CG items as follows: Managers' independence, CEO duality, change of CEO, number of board members

Control variables

Firm size

Through the logarithm of the total assets of the company

Firm age

Through the logarithm of the firm's life span from being listed on the stock exchange until the study

Profitability

By dividing net profit over total assets

Firm growth

Increase in company sales this year compared to last year

Book to market value ratio

By dividing the book value into the market value of the company

RESULTS

Table 2 shows the descriptive statistics indices of the research data

Table 2: Descriptive indices

	Earning smoothing	Accruals	Devaluation	Market competition	CEO influence	CG
Median	-0.000296	222977.5	0.300207	1.994955	0.708075	5.094203
Mean	0.023643	76745.50	0.000000	0.562681	1.000000	5.000000
Maximum	0.928761	37287946	1.000000	242.1846	1.000000	8.000000
Minimum	-1.923356	-14188030	0.000000	-8.606178	0.000000	2.000000
SD	0.227368	2770329.	0.458585	14.22822	0.454884	0.434792
Number of observations	966	966	966	966	966	966

	Firm size	Firm life	Firm growth	Book to market value	Profitability
Median	14.35997	17.74658	786481.1	0.461803	0.130904
Mean	14.12962	16.00000	93207.00	0.433264	0.108498
Maximum	19.37431	50.00000	2.36E+08	5.971602	1.996393
Minimum	9.993237	0.880000	-1.36E+08	-3.002704	-1.063252
SD	1.590001	9.984412	12928625	0.444208	0.169404
Number of observations	966	966	966	966	966

As Table (2) shows, mean and standard deviation are determined. Among the research data, firm growth has a higher mean than other variables. Moreover, the standard deviation of profitability is the least deviation among the

variables. However, the highest standard deviation was related to firm growth.

The first model of the study stated the effect of market competition, CEO influence, and CG on earnings smoothing with the results of Model 1 reported in Table 3.

Table 3: The results of the estimation of the first hypothesis (dependent variable: earnings smoothing)

Dependent Variable: EARNING_SMOOTH				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
MARKET_COM	-0.000124	0.000599	-0.207533	0.8356
CFO_POWER	0.016568	0.011988	1.382016	0.1674
CG	-0.013958	0.021542	-0.647933	0.5172
SIZE	-0.017609	0.009033	-1.949453	0.0516
AGE	-6.94E-05	0.002706	-0.025656	0.9795
GROWTH	-2.30E-10	4.70E-10	-0.489804	0.6244
MB	-0.021085	0.010773	-1.957130	0.0507
PROFIT	0.075947	0.033179	2.288983	0.0223
C	0.313398	0.168045	1.864962	0.0626
R-squared	0.289316	Mean dependent var		0.035967
Adjusted R-squared	0.139510	S.D. dependent var		0.243978
S.E. of regression	0.221033	Sum squared resid		38.93794
F-statistic	1.931278	Durbin-Watson stat		2.348450
Prob(F-statistic)	0.000000			

As Table (3) shows, the probability of F statistic of the whole regression, showing the significance of the whole regression, was 0.000000 that showed the model significance at a 99% confidence level. Moreover, the Durbin-Watson test has a high correlation between 1.5 and 2.5, which is appropriate and shows that the assumption of non-correlation is acceptable. The estimation results of Model (1) with the

dependent variable earnings smoothing show that market competition, CEO influence, and CG have no effect on earnings smoothing.

The second model of the study stated the effect of market competition, CEO influence, and CG on accruals, whose results are reported in Table 4:

Table 4: Estimation results of the second hypothesis (dependent variable: accruals)

Dependent Variable: ACC				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
MARKET_COM	836.6069	874.6555	0.956499	0.3391
CFO_POWER	63956.57	15225.86	4.200521	0.0000
CG	-52847.81	44871.72	-1.177753	0.2392
SIZE	32748.57	12621.56	2.594653	0.0096
AGE	513.9907	3300.471	0.155733	0.8763
GROWTH	-0.001316	0.005135	-0.256304	0.7978
MB	-80320.53	36025.08	-2.229573	0.0261
PROFIT	-160703.8	61723.78	-2.603597	0.0094
C	25014.10	283717.5	0.088166	0.9298
R-squared	0.725704	Mean dependent var		1161967.
Adjusted R-squared	0.667885	S.D. dependent var		3205138.
S.E. of regression	1815369.	Sum squared resid		2.63E+15
F-statistic	12.55132	Durbin-Watson stat		1.839375

Prob(F-statistic) 0.000000

As Table (4) shows, the probability of F statistic of the whole regression, showing the significance of the whole regression, is 0.000000, indicating that the model is significant at 99% confidence level. Moreover, the Durbin-Watson test has a high correlation between 1.5 and 2.5, which is appropriate and shows that the assumption of non-correlation is acceptable. The estimation results of Model (2) with the

dependent variable accruals show that CEO influence has positive and significant effects on accruals but market competition and CG have no effects on accruals.

The second model of the study stated the effect of market competition, CEO influence, and CG on firm devaluation, the results of which are reported in Table 5:

Table 5: The results of the third hypothesis (dependent variable: firm devaluation)

Dependent Variable: D_MA				
Variable	Coefficient	Std. Error	z-Statistic	Prob.
MARKET_COM	0.002383	0.002964	0.803777	0.4215
CFO_POWER	-0.031441	0.094724	-0.331928	0.7399
CG	0.069452	0.098287	0.706627	0.4798
SIZE	-0.041337	0.028286	-1.461354	0.1439
AGE	-0.006985	0.004513	-1.547844	0.1217
GROWTH	-8.02E-09	4.58E-09	-1.751216	0.0799
MB	-0.232455	0.147767	-1.573118	0.1157
PROFIT	-0.032196	0.327194	-0.098400	0.9216
C	-0.033513	0.616433	-0.054367	0.9566
McFadden R-squared	0.011322	Mean dependent var		0.300207
S.D. dependent var	0.458585	S.E. of regression		0.457715
Akaike info criterion	1.226877	Sum squared resid		200.4948
Schwarz criterion	1.272279	Log-likelihood		-583.5815
Hannan-Quinn criter.	1.244162	Deviance		1167.163
Restr. deviance	1180.529	Restr. log-likelihood		-590.2643
LR statistic	13.36560	Avg. log-likelihood		-0.604122
Prob(LR statistic)	0.099874			

The results of the estimation of the third model in Table 5 with the dependent variable of firm devaluation show that the coefficients of market competition, CEO influence, and CG are more than 0.05. Thus, one can state that market competition, CEO influence, and CG do not have a significant effect on the reduction of accruals.

DISCUSSION AND CONCLUSION

Competition in the product market is another powerful mechanism that guarantees management non-waste of resources. If managers lose a large portion of the company's resources in a competitive market environment, their company will not be able to compete and pay its debts. Because of job anxieties that managers of more competitive industries have, they are less likely to waste company resources and make less optimal and optimal investment

decisions. Moreover, competition in the product market enhances more efficient managerial behavior as when there is competition, shareholders can monitor the performance of other companies and use this information as a criterion for evaluating their managers. On the other hand, firm management tries to smooth earnings to maintain a stable company, and hide profits changes during financial periods by prioritizing and delaying registration of items. Scholars have census that allowing various approaches in accounting standards allows managers to use each approach to their own interests, although researchers argue that in the efficient markets, managers cannot mislead the capital market by earnings smoothing. After all, with more information disclosed, management role in earnings smoothing reduces, making users of financial information more consciously making decisions and not having to pay more for information disclosure. The results of the study show that market

competition, CEO influence, and CG have no significant effects on earnings smoothing. Moreover, market competition and CG did not significantly affect accruals. However, CEO influence has a positive and significant effect on accruals. Finally, market competition, CEO influence, and CG do not have significant effects on the value of the company. According to the results, it is suggested that investors and shareholders consider the reports of the activities of the board of directors. Moreover, they should pay attention to the decisions of the general assembly. Furthermore, the stock exchange can use the results of this study to oblige the companies to disclose seasonal CG reports, and the authority of the CEO to reduce agency problems and enhance the quality of financial reporting disclosures. Scholars and analysts are advised to study industry research hypotheses.

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