

QUALITY OF CORPORATE GOVERNANCE SYSTEM AND QUALITY OF REPORTED EARNINGS: EVIDENCE FROM CEE EQUITY MARKET

Abstract

Checking the quality of the reported earnings gradually becomes an important part of the fundamental analysis as it helps to avoid the negative surprises in the following earnings announcements and, therefore, share price declines. Investors need to be sure of the figures the companies publish, while often the auditors cannot be relied upon as it was clearly seen with several Chinese companies involved in the corporate scandals (e.g. Sino-Forest, Orient Paper) as well as beginning of 21st century accounting scandals. The detection of the accounting misstatements clearly improves stock portfolio performance in the emerging markets and developed markets (Dechow, Dichev, 2001; Mahedy, 2005; Sloan, 1996; Grigorjeva, Lace, 2008 etc.).

Now the question is whether there exists any relationship between the corporate governance (CG), which is another very topical question in the developing markets. As many experts admit, there is an ongoing improvement in the corporate governance standards and the growth of the number of firms being in compliance with these standards. The local CEE stock exchanges played major role to make this process happen smoothly and swiftly. Also the companies themselves realize the benefits of having transparent corporate governance system and an increased investor interest as a result. However, one can now speculate if the earnings quality improved together with the overall management system improvement.

As the research on CEE companies shows (Bistrova, Lace, 2011) there is statistical significant evidence that corporate governance positively influences the performance of the companies. While another research proves that well-established corporate governance system is unable to ensure better corporate financial performance (Bistrova, Lace, 2012), and vice versa – poorly managed companies provide superior financial performance. International research (Jiang, Lee, Anandarajan, 2008; Li, 2009) proves that there is a positive association between the good quality of the corporate governance and the quality of earnings.

Based on the results of the previous research as well as on the assessment of current situation in CEE countries, the authors propose the following hypothesis that the good quality of corporate governance is able to ensure also the high reliability of the reported earnings. The main objective of the research is to make an assessment of CEE listed companies corporate governance system and to relate it to the quality of the reported earnings in order to discover any causal relationship if there is any, which would be valuable for the investors in CEE companies.

The study on the relationship between the quality of corporate governance and the plausibility of earnings covered the companies, which are included in the main lists of the CEE (Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Romania, Poland, Slovakia, Slovenia) stock exchanges. Overall the corpus of the research consisted of 118 companies. The study analyzes 4 year period (from 2007 to 2010), during which the influence of corporate governance on the plausibility of the financial results and its dynamics is evaluated. The data for the research purposes have been extracted mainly from the corporate annual reports. Earnings quality was assessed based on the widely-accepted measures to detect creative accounting practices: level of accruals and net income comparison to operating cash flow.

Corporate governance assessment was made based on the annual reports of FY 2009 as well as on the corporate governance reports and website information. The evaluation scores of the CEE companies corporate governance were based on the CG assessment model developed by Bistrova and Lace (2011), which is based on the compliance standards imposed by the local stock exchanges and global “Best Practice” standard. The final rank consists of 21 criteria, which are grouped according to the assessment area: management team, board of directors, information transparency and investor relations.

Research results indicate that there is a certain influence of good corporate governance quality on the improvement in earnings plausibility. It is interesting that the companies, which boast of good corporate governance quality, demonstrate rather weak financial analysis ratios such as return on equity, asset turnover, profit margin etc. The opposite result is found with poorly managed companies, which are “shining” with their financial indicators, which is an indicator of positive influence of high quality corporate governance.

Keywords: Corporate Governance, CEE countries, earnings plausibility, accrual accounting

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