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The Effects of Earnings Quality Criteria on the Agency Costs: (Evidence from Tehran Stock Exchange Market)

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Abstract

This research explores the effects of various criteria of the earnings quality on the agency costs of the companies. It attempts to respond to the following queries: "what are the effects of the earnings quality on the agency costs? The results of regression analysis suggest that there is no significant difference between the TSE market and other developed markets in the sense that a reverse significant relationship exists between different criteria of the earnings quality information and agency costs criteria. The results of MANOVA also indicate that when earnings quality information is high, the firms' agency costs are lower.

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Keywords: Agency costs; Earnings quality criteria; Agency theory; Information quality; Tehran Stock Exchange.

1. Introduction

In the last few decades, with flourishing trade and increasing investments in shares, the issues of separation of management from ownership, agency theory and the role of the financial information, have caught the attention of managers, investors and researchers (Jensen & Meckling, 1976). Consequently, special attention has focused on the costs of the agency. Generally, the costs of the agency are raised because of the existence of a potential conflict of interest which might exist between the managers (agents) and investors (principals). Given the conflict of interests

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and incompatible objectives that might be prevalent between managements and investors, managements may take some actions which may jeopardize the interest of the investors. To eliminate or alleviate this obstacle, managers and investors should jointly agree to establish various costly contractual agreements and to establish appropriate control mechanisms to monitor agents' actions, self-interest behaviour and their performances (Namazi, 2013). Since the actions and effort of the agents are exerted under the condition of uncertainty and these variables are not directly observable by the principals, some costly accounting mechanisms are also required to report and monitor the performance of agents. The control of this behaviour could also be costly. In addition, managers possess access to private information about firms' true financial operations and performance, but stockholders do not maintain such access to firms' information. The agency theory and financial literature (Namazi, 2013) unequivocally reveal that information disclosure can help mitigate principal-agent conflicts and costs. For instance, Ross (1979), via the signalling theory, reveals that a high quality firm can be signalling without any charges. In effect, signalling theory predicts that healthy firms are likely to disclose more information than distressed firms. In this process, information disclosure is one of the monitoring devices which can be adopted to reduce agency costs. Bushman & Smith (2001) explicitly point out that one of the fundamental objectives of the governance research is presenting evidence on the extent to which information provided by firms mitigate agency problems due to the separation of managers and outside investors.

The preceding literatures holistically reveal that accounting information play a significant role in the agency cost relationship, but do not unequivocally demonstrate the precise role of the quality of earnings in this sphere. In addition, the significance of various quality criteria of the earnings information in providing quality information and their effects on the agency costs are unexplored. Furthermore, since the preceding studies have been mainly conducted in the developed countries and stock markets, it is not perceptible whether or not one can generalize the findings to developing nations and stock markets.

2. Theoretical Basis and Literature Review

The theoretical foundation of this research is based upon the concept of the agency theory (Namazi, 2013). Based on the paradigm of this theory, in the managers-owners relation, the demand for financial reporting arises from information asymmetry and agency conflicts which may be prevalent between the managers and outside investors. Hence, the disclosure of quality information by the management would reduce management-stockholder conflicts.

In this study, it was hypothesized that quality earning information would decrease management-stockholders conflicts and agency costs. There is, however, no exact and comprehensive definition in regard to earnings quality. The relationship between earnings quality and information asymmetry within the context of the agency theory, has also been explored in the literature and some interesting results have been reported. For example, Bushman and Smith (2001) found that higher-earnings quality information would lead to decreased information asymmetry and it could be expended as a control mechanism to monitor agents' actions accurately. Similarly, Bushman and Smith (2001) found that providing high-quality earnings information would likely reduce informational asymmetry problems between the firm and its investors, and hence would decrease the agency costs. An (2009) argued that factual and objective earnings information would lead to higher financial information transparency which ultimately would cause a reduction of the agency costs. Evidence of research by Chuang, Xiuhong, & Zhang (2010) showed that earnings quality affects the firm's controlling agency costs significantly. Wei & Chunyan (2010) also showed that the lower the probability of the managers' voluntary disclosure of the information on specific operating cash payments, the lesser is the degree of the voluntary disclosure. Evidence of research by Edelen, Evans, & Kadlec (2011) also suggests the effective role of the transparency in providing earnings information on the agency costs. Finally, Brown, Chen, & Kim (2015) found out that those firms close to the investment –speculative boarder line, would choose the most aggressive income-increasing activities.

The preceding studies unambiguously demonstrate that disclosure and transparency of the earnings information are central factors in the agency relations; and information, particularly accounting information, would reduce the agency costs. Nevertheless, little is known about the precise role of the various criteria of the quality of earnings information in addressing agency costs (Edelen, Evans, & Kadlec, 2011). In this regard, studies concerning the examination of the role of different criteria of the quality earnings disclosure and providing information in reducing agency costs from different perspectives should be conducted. The major aim of this study is to investigate the latter