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The Impact of Corporate Governance Mechanisms on Financial Reporting Quality: Evidence from Listed Companies on the Tehran Stock Exchange

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Abstract

Purpose: *This study investigates the impact of internal and external corporate governance mechanisms—specifically audit committee independence, board financial expertise, and institutional ownership—on the financial reporting quality of firms listed on the Tehran Stock Exchange (TSE).*

Design/Methodology/Approach: *A quantitative research design is employed using a balanced panel dataset of 140 non-financial firms listed on the TSE over the six-year period from 2019 to 2024. Financial reporting quality is operationalized using the Modified Jones Model to estimate discretionary accruals, where lower accruals indicate higher reporting quality. The study utilizes Ordinary Least Squares (OLS) regression to test the hypotheses, controlling for firm size, financial leverage, and firm age.*

Findings: *The empirical results reveal that audit committee independence and board financial expertise have a significant positive impact on financial reporting quality (i.e., they significantly reduce discretionary accruals). Furthermore, institutional ownership is found to have a significant positive relationship with the quality of financial reports, suggesting that institutional investors play an effective monitoring role in the Iranian capital market.*

Practical Implications: *These findings provide valuable insights for the Securities and Exchange Organization (SEO) of Iran in refining corporate governance codes. The results suggest that mandating financial expertise and independence within corporate structures is essential for protecting investor interests and enhancing market transparency.*

Keywords: *Financial Reporting Quality, Discretionary Accruals, Audit Committee Independence, Board Financial Expertise, Institutional Ownership, Tehran Stock Exchange.*

I. Introduction

Background of the Study

Financial reporting quality is the bedrock of efficient capital markets. High-quality financial reports provide stakeholders—investors, creditors, and regulators—with a faithful representation of a firm's underlying economic reality. In the absence of such quality, information asymmetry increases, leading to adverse selection and moral hazard problems that can stifle investment and destabilize the financial system.

From an agency theory perspective, managers often have incentives to manipulate financial information to meet earnings targets, secure bonuses, or hide poor performance (Jensen & Meckling, 1976). This manipulation, often referred to as earnings management, degrades the quality of financial reporting. Corporate governance serves as the primary defense against such opportunistic behavior. It encompasses the mechanisms, processes, and relations by which corporations are controlled and directed.

Within the corporate governance framework, the board of directors and its sub-committees, particularly the audit committee, are critical. An independent audit committee is theorized to provide objective oversight of the financial reporting process, reducing the likelihood of managerial interference. Similarly, board members with financial expertise are better equipped to scrutinize complex accounting treatments and detect irregularities. Beyond the internal structure, external monitors such as institutional investors play a significant role. Due to their large stakes, institutional owners have both the incentive and the power to monitor management more closely than individual shareholders, thereby demanding higher reporting standards.

Statement of the Problem

The Tehran Stock Exchange (TSE) presents a unique environment for examining the efficacy of governance mechanisms. As an emerging market, the TSE is characterized by evolving regulatory standards, concentrated ownership structures, and a historical reliance on bank financing. While the Securities and Exchange Organization (SEO) has introduced various corporate governance codes over the last decade, the actual impact of these mechanisms on the quality of financial information remains a subject of intense debate among Iranian scholars and practitioners.

The central problem addressed by this study is whether the specific governance attributes—audit committee independence, financial expertise, and institutional ownership—effectively constrain earnings management and enhance reporting quality in the Iranian

context. Many firms in Iran face unique economic pressures, including high inflation and international sanctions, which may heighten the incentives for managers to manage earnings. It is unclear if Western-centric governance theories hold the same weight in this specific institutional setting. A lack of recent, systematic empirical evidence on these relationships creates a gap in knowledge for regulators seeking to improve market transparency and for investors attempting to assess the reliability of published financial statements.

Research Questions

To address the research problem, this study seeks to answer the following questions:

1. Does audit committee independence significantly improve the financial reporting quality of firms listed on the TSE?
2. Does the financial expertise of the board significantly enhance the financial reporting quality of firms listed on the TSE?
3. Does institutional ownership significantly impact the financial reporting quality of firms listed on the TSE?

Research Objectives

The primary objectives of this study are:

1. To empirically examine the relationship between audit committee independence and financial reporting quality (measured by discretionary accruals).
2. To investigate the effect of board financial expertise on the quality of financial reporting.
3. To analyze the role of institutional ownership as a monitoring mechanism for reporting quality.
4. To provide evidence-based recommendations for Iranian regulators and corporate boards to enhance the integrity of financial disclosures.

Significance of the Study

This research is significant for several reasons:

For Regulators: It provides empirical data on the effectiveness of current governance mandates, helping the SEO determine if further reforms are needed regarding committee compositions.

For Investors: It identifies the governance "red flags" or "green flags" that investors should look for when evaluating the credibility of a company’s financial reports.

For Auditors: The study highlights the internal environments (e.g., expert boards) that are more likely to produce high-quality financial data, aiding in risk assessment during audits.

For Academia: It contributes to the international literature on corporate governance in emerging markets, specifically providing a detailed look at the Iranian capital market during a period of economic transition.

Structure of the Article

The remainder of this article is organized as follows: The next section provides a comprehensive review of the theoretical framework and existing empirical literature, leading to the development of the hypotheses. The third section describes the research methodology, including the measurement of discretionary accruals and the OLS model. The fourth section presents the empirical results and data analysis. The final section concludes the study with a discussion of the findings, implications, and suggestions for future research.

II. Review and Hypothesis Development

Theoretical Framework

The relationship between corporate governance and financial reporting quality is underpinned by several complementary theories that explain the motivations and constraints of managerial behavior.

- Agency Theory: This is the primary framework for understanding the demand for high-quality financial reporting. As articulated by Jensen and Meckling (1976), the separation of ownership and control creates an environment where managers (agents) have information advantages over shareholders (principals). Managers may engage in "Earnings Management"—the opportunistic manipulation of accounting choices—to meet personal goals, such as maximizing bonuses or maintaining stock prices. Corporate governance acts as a monitoring mechanism to reduce these agency costs by aligning the interests of managers with those of shareholders.
- Resource Dependency Theory: This theory suggests that the board of directors and its committees are not just monitors but also providers of critical resources, such as expertise and legitimacy (Pfeffer & Salancik, 1978). In the context of financial reporting, a board with financial expertise provides the technical "resource" necessary to decode complex accounting standards (like IFRS), thereby reducing the likelihood of unintentional errors or intentional misstatements.
- Stakeholder Theory: Beyond shareholders, high-quality financial reporting is essential for creditors, employees, and the government. Freeman (1984) argues that a firm’s governance should ensure transparent communication with all stakeholders. Reliable

financial reports reduce the "information risk" for these groups, leading to lower borrowing costs and better organizational reputation.

Empirical Literature Review

Audit Committee Independence and Reporting Quality

The audit committee serves as the primary bridge between the board of directors, the internal auditor, and the external auditor. Its effectiveness is fundamentally tied to its independence. An independent committee is composed of non-executive directors who lack material ties to management, allowing them to oversee the financial reporting process without fear of retaliation or bias.

Empirical research has consistently shown that independent audit committees are more likely to support auditors in disputes with management regarding aggressive accounting treatments (Abbott et al., 2004). For instance, Carcello and Neal (2003) found that independent committees reduce the probability of financial restatements. In the Iranian context, where the Securities and Exchange Organization (SEO) has mandated audit committees for listed firms, the independence of these committees is seen as a vital check against the influence of dominant shareholders or overbearing executives. When independence is compromised, the committee may become "symbolic" rather than substantive, leading to higher discretionary accruals and lower reporting quality.

Board Financial Expertise and Reporting Quality

While independence provides the will to monitor, financial expertise provides the ability. The technical complexity of modern accounting requires directors who can understand the nuances of accrual accounting, fair value measurements, and complex tax structures.

Research by Agrawal and Chadha (2005) indicates that firms with at least one financial expert on the board or audit committee are significantly less likely to experience financial restatements. Financial experts act as a "technical watchdog," capable of identifying subtle manipulations in earnings that a generalist might overlook. In emerging markets like the Tehran Stock Exchange, where accounting standards are frequently updated and economic conditions are volatile, the role of expertise is amplified. A lack of expertise can lead to "information asymmetry" even within the board itself, as non-expert directors may defer to the CFO’s judgments without sufficient scrutiny.

Institutional Ownership and Reporting Quality

Institutional investors, such as pension funds, banks, and investment firms, are categorized as "sophisticated" shareholders. Unlike individual retail investors, they possess

the professional resources and the long-term economic incentives to monitor management actively.

The Efficient Monitoring Hypothesis suggests that institutional owners improve reporting quality by demanding transparency and penalizing firms that engage in opportunistic earnings management. Due to their large stakes, they can exercise significant voting power to demand governance reforms. However, a counter-perspective, the Strategic Alignment Hypothesis, suggests that institutional owners might collude with management for short-term gains. Empirical evidence in emerging markets generally supports the monitoring view, showing that higher levels of institutional ownership are correlated with lower discretionary accruals and more conservative accounting (Jiambalvo et al., 2002). In Iran, the presence of large institutional blocks (often state or semi-state linked) plays a defining role in corporate oversight and the demand for financial integrity.

Hypothesis Development

Following the theoretical and empirical review, we propose the following hypotheses tailored to the context of the Tehran Stock Exchange:

Audit Committee Independence: Independent directors are less susceptible to management pressure and are more focused on protecting shareholder rights. Their oversight should logically constrain opportunistic earnings management.

- H_1: There is a significant positive relationship between audit committee independence and financial reporting quality.
- H_{01}: There is no significant relationship between audit committee independence and financial reporting quality.

Board Financial Expertise: Technical competence is a prerequisite for effective oversight. We expect that boards with financial experts will be more successful in curbing the manipulation of discretionary accruals.

- H_2: There is a significant positive relationship between board financial expertise and financial reporting quality.
- H_{02}: There is no significant relationship between board financial expertise and financial reporting quality.

Institutional Ownership: As professional monitors, institutional investors increase the external pressure on firms to maintain high reporting standards to protect their substantial investments.

- H_3: There is a significant positive relationship between institutional ownership and financial reporting quality.
- H_{03}: There is no significant relationship between institutional ownership and financial reporting quality.

III. Research Methodology

Research Design

This study employs a quantitative research design utilizing a descriptive-correlational approach. To examine the research hypotheses, we utilize a balanced panel data structure. Panel data is superior in this context as it accounts for both cross-sectional variations among firms and time-series dynamics over the study period, effectively controlling for unobserved firm-specific heterogeneity that could otherwise bias the results. The study is categorized as applied research, aiming to provide actionable insights for regulators and investors in the Tehran Stock Exchange (TSE).

Population and Sample Selection

The statistical population consists of all companies listed on the Tehran Stock Exchange. To ensure a robust and homogeneous sample for the period from 2019 to 2024, a systematic elimination (filtering) method was applied based on the following criteria:

1. Firms must have been listed on the TSE prior to the start of the 2019 fiscal year and remained active until the end of 2024.
2. To maintain comparability in financial reporting, financial institutions, banks, insurance companies, and investment firms are excluded due to their unique accounting standards and regulatory requirements.
3. Firms must have a fiscal year-end of March 20 (coinciding with the end of the Iranian calendar year).
4. Firms must not have changed their fiscal year during the 2019–2024 period.
5. All necessary governance and financial data must be fully available in the CODAL database.

After applying these filters, a final sample of 140 firms was selected. With a study period of six years, the total number of observations is 840 firm-years (140 \times 6).

Definition and Measurement of Variables

Dependent Variable: Financial Reporting Quality (FRQ)

In line with established accounting literature, financial reporting quality is measured inversely through earnings management, specifically the absolute value of discretionary

accruals (|DA|). We utilize the Modified Jones Model (Dechow et al., 1995) to estimate these accruals through the following four-step process:

- Step 1: Calculate Total Accruals (TA):

$$TA_{it} = NI_{it} - CFO_{it}$$

Where NI is Net Income and CFO is Cash Flow from Operations.

- Step 2: Estimate coefficients ($\alpha_1, \alpha_2, \alpha_3$)
- using the following regression for each industry-year:

$$\frac{TA_{it}}{A_{it-1}} = \alpha_1 \left(\frac{1}{A_{it-1}}\right) + \alpha_2 \left(\frac{\Delta REV_{it}}{A_{it-1}}\right) + \alpha_3 \left(\frac{PPE_{it}}{A_{it-1}}\right) + \epsilon_{it}$$

Where A_{it-1} is total assets at the end of the previous year, ΔREV is change in revenue, and PPE is gross property, plant, and equipment.

- Step 3: Calculate Non-Discretionary Accruals (NDA):

$$NDA_{it} = \widehat{\alpha_1} \left(\frac{1}{A_{it-1}}\right) + \widehat{\alpha_2} \left(\frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}}\right) + \widehat{\alpha_3} \left(\frac{PPE_{it}}{A_{it-1}}\right)$$

Where ΔREC is the change in accounts receivable.

- Step 4: Calculate Discretionary Accruals (DA):

$$DA_{it} = \left(\frac{TA_{it}}{A_{it-1}}\right) - NDA_{it}$$

The final variable is the absolute value $|DA_{it}|$. A higher value represents lower financial reporting quality.

Independent Variables

- Audit Committee Independence (ACIND): Measured as the ratio of independent (non-executive) members to the total number of members in the audit committee.
- Board Financial Expertise (BFE): A dummy variable that takes the value of 1 if at least one member of the board has a professional qualification or an advanced degree in accounting or finance, and 0 otherwise.
- Institutional Ownership (INST): The percentage of shares held by institutional investors (e.g., pension funds, banks, and investment companies).

Control Variables

- Firm Size (SIZE): Measured as the natural logarithm of total assets.
- Financial Leverage (LEV): Measured as the ratio of total liabilities to total assets.
- Firm Age (AGE): Measured as the natural logarithm of the years since the firm's incorporation.

Variable Summary Table

Table 1: Operational Definition and Measurement of Variables

Variable Type	Variable Name	Acronym	Measurement Method
Dependent	Financial Reporting Quality	Abs(DA)	(Modified Jones Model)
Independent	Audit Committee Independence	ACIND	Independent members / Total audit committee members
Independent	Board Financial Expertise	BFE	Dummy: 1 if financial expert present, 0 otherwise
Independent	Institutional Ownership	INST	Percentage of shares held by institutional investors
Control	Firm Size	SIZE	Natural Logarithm of Total Assets
Control	Financial Leverage	LEV	Total Liabilities / Total Assets
Control	Firm Age	AGE	Natural Logarithm of years since establishment

Research Model

To test the hypotheses, the following Ordinary Least Squares (OLS) regression model for panel data is estimated:

$$|DA|_{it} = \beta_0 + \beta_1 ACIND_{it} + \beta_2 BFE_{it} + \beta_3 INST_{it} + \beta_4 SIZE_{it} + \beta_5 LEV_{it} + \beta_6 AGE_{it} + \epsilon_{it}$$

Data Analysis Procedure

The data, collected from the CODAL system and Rahavard Novin software, are analyzed using Stata 17. The analysis follows these steps:

1. Descriptive Statistics: To provide an overview of the sample characteristics.
2. Diagnostic Tests: Including the F-Limer (Chow) test to choose between pooled and panel models, and the Hausman test to choose between fixed and random effects.
3. Classical Assumption Tests: To check for multicollinearity (VIF), heteroscedasticity, and autocorrelation.
4. Hypothesis Testing: Using the regression coefficients and p-values to determine the significance of the relationships.

IV. Results and Data Analysis

Results and

Descriptive Statistics

Table 2 provides an overview of the statistical characteristics of the variables used in the study. The total number of observations is 840 firm-years.

Table 2: Descriptive Statistics of Research Variables (N=840)

Variable	Mean	Median	Std. Dev.	Min	Max
DA	0.068	0.052	0.045	0.001	0.280
ACIND	0.654	0.667	0.125	0.333	1.000
BFE	0.720	1.000	0.449	0.000	1.000
INST	0.685	0.710	0.180	0.120	0.980
SIZE	15.42	15.35	1.550	11.80	20.10
LEV	0.585	0.590	0.175	0.150	0.950
AGE	3.150	3.220	0.620	1.380	4.250

The mean value of Discretionary Accruals (|DA|) is 0.068, suggesting a relatively moderate level of earnings management among the sampled firms. The average Audit Committee Independence (ACIND) is 65.4%, indicating that most firms comply with governance codes requiring a majority of independent members. Approximately 72% of the observations feature at least one Financial Expert (BFE) on the board.

Correlation Analysis

The Pearson correlation matrix is presented in Table 3 to examine the preliminary relationships between variables and to identify potential multicollinearity.

Table 3: Pearson Correlation Matrix

Variables	DA	ACIND	BFE	INST	SIZE	LEV	AGE
DA	1.000						
ACIND	-0.245***	1.000					
BFE	-0.198***	0.155**	1.000				
INST	-0.212***	0.110**	0.085*	1.000			
SIZE	-0.055	0.140**	0.120**	0.285***	1.000		
LEV	0.315***	-0.095*	-0.050	-0.115**	0.340***	1.000	
AGE	-0.105**	0.065	0.040	0.090*	0.210***	-0.085*	1.000

The negative correlation between |DA| and the governance mechanisms (ACIND, BFE, INST) provides early evidence that stronger governance is associated with higher reporting quality (lower discretionary accruals).

Diagnostic Tests

Before estimating the final model, several diagnostic tests were conducted:

1. F-Limer (Chow) Test: The result (F = 4.12, p = 0.000) suggests that the panel data method is preferred over the pooled OLS method.
2. Hausman Test: The result (chi^2 = 22.45, p = 0.002) indicates that the Fixed Effects (FE) model is more appropriate than the Random Effects model.
3. Multicollinearity: The Variance Inflation Factor (VIF) for all variables was below 2.5, confirming that multicollinearity is not a concern for this model.

Regression Results and Hypothesis Testing

The final regression results using the Fixed Effects model are presented in Table 4. Note that since |DA| is an inverse proxy for quality, a negative coefficient indicates a positive impact on financial reporting quality.

Table 4: Regression Results (Dependent Variable: DA)

Variable	Coefficient	Std. Error	t-Statistic	P-value
ACIND	-0.0850	0.0215	-3.95	0.000
BFE	-0.0125	0.0048	-2.60	0.010
INST	-0.0440	0.0122	-3.61	0.000
SIZE	-0.0035	0.0018	-1.94	0.052
LEV	0.0780	0.0145	5.38	0.000
AGE	-0.0090	0.0032	-2.81	0.005
Constant	0.1550	0.0350	4.43	0.000
Model Summary				
Observations	840			
F-statistic	28.65			
Prob > F	0.0000			
R-squared	0.315			

Interpretation of Hypotheses:

- Hypothesis 1 (H_1): The coefficient for ACIND is negative and highly significant (ß=-0.0850, $p<0.01$). This confirms that higher audit committee independence significantly reduces discretionary accruals, thereby enhancing financial reporting quality. H_1 is supported.
- Hypothesis 2 (H_2): The coefficient for BFE is negative and significant (ß = -0.0125, p = 0.010). This indicates that the presence of financial experts on the board helps constrain earnings management. H_2 is supported.
- Hypothesis 3 (H_3): The coefficient for INST is negative and significant (ß = -0.0440, $p < 0.01$). This suggests that institutional investors play an effective monitoring role in improving the quality of financial disclosures. H_3 is supported.

Among control variables, Financial Leverage (LEV) shows a significant positive relationship with |DA|, indicating that highly indebted firms are more likely to manage earnings to avoid covenant violations.

V. Discussion and Conclusion

Discussion of Findings

The empirical analysis of 140 firms over the 2019–2024 period confirms that corporate governance mechanisms are instrumental in enhancing financial reporting quality in Iran. By reducing the absolute value of discretionary accruals (|DA|), these mechanisms mitigate opportunistic earnings management and provide a more faithful representation of corporate performance.

The support for Hypothesis 1 (H_1) demonstrates that Audit Committee Independence (ACIND) is a potent deterrent to financial manipulation. In the Iranian market, independent directors on the audit committee provide the objective oversight necessary to challenge aggressive accounting estimates proposed by management. This finding aligns with Agency Theory, suggesting that independence reduces the "information risk" for external shareholders.

The confirmation of Hypothesis 2 (H_2) highlights the value of Board Financial Expertise (BFE). While independence provides the motivation to monitor, expertise provides the technical capability. Directors with accounting and financial backgrounds are better equipped to navigate the complexities of Iranian accounting standards and IFRS, ensuring that the "watchdog" function of the board is substantive.

Finally, the support for Hypothesis 3 (H_3) underscores the role of Institutional Ownership (INST) as an external monitoring force. Institutional investors in Iran—often large

investment companies or pension funds—have the resources to scrutinize financial reports more deeply than retail investors. Their presence creates a "monitoring effect" that discourages managers from engaging in accounting practices that could lead to long-term reputational damage.

Practical and Policy Implications

The results of this study, authored by Farshad Sameni Keivani from the Islamic Azad University, offer several key implications:

- For the Securities and Exchange Organization (SEO): The findings support the continued mandate for independent audit committees and suggest that even stricter requirements for financial expertise on boards could further enhance market integrity.
- For Investors: Governance structures should be viewed as a "proxy for reliability." Firms with high independence and expert oversight are less likely to present misleading financial figures.
- For Corporate Boards: Investing in professional development for board members and maintaining high independence levels is not just a compliance task but a strategic move to lower the cost of capital by signaling transparency.

Limitations and Future Research

Despite the robust findings, this study has limitations. First, earnings management was measured using discretionary accruals; future research could use "real earnings management" (e.g., cutting R&D or sales manipulation) to provide a broader view. Second, the study focused on non-financial firms. Future inquiries could investigate whether these governance mechanisms operate differently in the banking or insurance sectors within the TSE.

Conclusion

This research provides compelling evidence that audit committee independence, board financial expertise, and institutional ownership significantly improve financial reporting quality in firms listed on the Tehran Stock Exchange. In an environment characterized by economic volatility and evolving regulations, strong corporate governance serves as a critical anchor for financial transparency. By strengthening these internal and external monitors, Iranian firms can foster greater investor trust and contribute to the overall efficiency of the national capital market.

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