

# THE RELATIONSHIP BETWEEN MINORITY DIRECTORS AND EARNINGS MANAGEMENT: AN EMPIRICAL ANALYSIS IN THE ITALIAN INSTITUTIONAL SETTING

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## Abstract

The quality of corporate governance is widely believed to play an important role in mitigating agency problems and, in particular, in determining the quality of firms' overall disclosure. Specifically, most of prior literature suggests that a set of board of directors' characteristics constrains earning management activities and contributes towards the integrity of financial statements, as predicted by agency theory. Among the various corporate governance features, the two measures of board monitoring that have been broadly related to higher earnings quality and less earning management are the proportion of outside (independent) directors and the existence of an audit committee (Klein, 2002; Xie et al., 2003; Peansell et al., 2005). However, some recent studies show that the relation between independent directors and the financial disclosure quality is not univocal and that not all independent directors have the same effectiveness in fostering corporate transparency (Marchetti et al., 2018). The appointment of "minority directors" might therefore prevent

the corporate controller from adopting opportunistic behaviors and protect minority shareholders from the discretionary activity of the block-holder, positively affecting the firm value. Indeed, allowing minority shareholders to have representatives on the board can represent an important mechanism to promote greater directors' accountability and ease tensions between corporate controllers and outside investors (Enriques et al., 2009; Belcredi & Enriques, 2014).

Empirical evidence mostly confirms the positive impact of minority directors on firms' corporate governance and financial performance and highlights the importance of minority directors as a mechanism to protect minority shareholders' interests and to increase firm value. As to the relationship between minority directors and corporate governance performance, Bianchi et al. (2011) find that the actual level of compliance to the Corporate Governance Code for the Italian listed companies is systematically higher for firms in which minority shareholders have appointed at least one director. Minority directors also play a fundamental role in structuring remuneration schemes able to provide incentives for executives to work for the best interest of shareholders and to mitigate agency costs. In this regard, by examining all Chinese A-share non-state-owned enterprises from 2008 to 2013, Zhou et al. (2017) find that the board representation of non-controlling shareholders has a positive impact on executive pay-for-performance sensitivity. At the same time, Melis et al. (2012) document a positive influence on stock option plans (SOPs) when minority directors are part of the board. Still concerning the fairness of remuneration policies, Belcredi et al. (2014) recognize a higher probability of shareholders dissent on executives' remuneration policies where minority directors are on the board and/or on the remuneration committee. In addition, consistent with Belcredi et al. (2014), Marchetti et al. (2017) show that minority directors are more likely to dissent and that market prices react slightly negatively when a minority-appointed director votes against the majority, suggesting a certain degree of "trust" in minority-appointed directors. Turning from corporate governance performance to financial performance, some papers have already stressed a positive relationship between firms' value and minority directors. Lefort and Urzua (2008), analyzing a setting characterized by high ownership concentration (the Chilean market), find that an increase in the proportion of outside directors (elected with minority shareholders' votes) positively affects firm value (as proxied by Tobin's Q) and performance (as proxied by ROA). Ten years later, Moscarello et al. (2018), by examining a sample of 104 non-financial Italian firms from 2007 to 2012, find supporting evidence about a positive relationship between the proportion of minority directors and firm value (as proxied by Tobin's Q). Focusing on the bank industry, Barry (2018) highlights a positive relationship between board structures that include directors related to minority shareholders and market valuation. These results seem to support the key role played by minority directors in alleviating agency costs associated with the risk of self-

dealing transactions by the corporate controller and, in turn, in increasing firm value. Finally, according to Cornett et al. (2008) and Marchetti et al. (2018), minority-appointed directors are associated with a better and richer disclosing environment. In fact, minority directors seem to have a positive impact on both disclosure quality and financial reporting quality, shedding lights on the role played by minority directors in fostering corporate transparency.

Relying on an inverse relationship between earnings management and the financial reporting quality, this study analyzes the relationship between the proportion of independent minority directors within the Board and the quality of financial reporting. In particular, this paper examines the effectiveness of minority directors in preventing earnings management activities, and we predict an inverse relationship between them.

This article examines the relationship between minority directors and the magnitude of abnormal accruals within the Italian listed companies over the period 2012-2017. Peek et al. (2013) show that accruals models exhibit significant cross-country variations in their predictive accuracy and in their ability to detect abnormal accruals. Therefore, in order to avoid potential inference problems in across-sample comparisons, this study focuses on one country. Specifically, this paper analyzes the Italian context since it offers a unique setting as it is the only country that, roughly a decade ago, introduced the slate voting system that aids the appointment of directors proposed by minority shareholders or, more generally, by non-controlling shareholders.

The sample consists of 125 firms listed on the Italian Stock Exchange during the reference period. During the sampling process, we exclude all firms that refer to the GICS 40 (financials) and to the GICS 60 (real estate), because of their peculiar financial reporting rules. Then, we drop from the sample all firms with a lack of historical accounting and corporate governance data and firms involved in business combinations. Therefore, the final sample is composed of 750 firm-year observations. The relatively small sample size is due to the limited size of the Italian stock market and to our sampling criteria. Nevertheless, the sample covers 76% of the Italian stock market capitalization in the reference period.

Data were collected from different sources: accounting and financial data were collected from Thomson Reuters Eikon and Datastream, while corporate governance data were hand-picked from the C.O.N.So.B. (the Italian supervisory authority for financial markets) online databases and from companies' annual reports on corporate governance and ownership structure.

In order to test our hypothesis based on the inverse relationship between minority directors and the magnitude abnormal accruals (as a proxy for earnings management), we set up the following model performed as a panel data regression with cluster robust standard errors:

$$\begin{aligned}
 AWCA_{it} = & \beta_0 + \beta_1 \text{Minority}_{it} + \beta_2 \text{BoD\_Size}_{it} + \beta_3 \text{BoD\_Indep}_{it} + \beta_4 \text{CEO\_Duality}_{it} \\
 & + \beta_5 \text{Own\_Conc}_{it} + \beta_6 \text{Size}_{it} + \beta_7 \text{ROA}_{it} + \beta_8 \text{Leverage}_{it} + \beta_9 \text{Sales\_Vol}_{it} \\
 & + \beta_{10} \text{OCF\_Vol}_{it} + \beta_{11} \text{Earnings\_Vol}_{it} + \beta_{12} \text{Neg\_Earnings}_{it} + \beta_{13} \text{WCA}_{it} \\
 & + \sum(\text{Year\_Effects})_{it} + \sum(\text{Industry\_Effects})_{it} + \varepsilon_{it}
 \end{aligned}$$

where  $i$  and  $t$  represent, respectively, the firm and the year.

The response variable ( $AWCA$ ) represents our proxy for abnormal accruals. Prior literature suggests several methods to determine abnormal discretionary accruals (Jones, 1991; Dechow et al., 1995; Peasnell et al., 2000; DeFond & Park, 2001; Kothari et al., 2005). However, given the limited number of observations in our sample, we employ the DeFond and Park's (2001) model in order to estimate the abnormal working capital accruals, as a proxy for an opportunistic managerial discretion over accounting numbers (Wysocki, 2004; Bar-Yosef & Prencipe, 2013):

$$AWCA_t = WCA_t - \left[ \left( \frac{WCA_{t-1}}{S_{t-1}} \right) * S_t \right]$$

where  $t$  identifies the reference year,  $WCA$  indicates the non-cash working capital accruals, and  $S$  stands for the annual sales. We then scale  $AWCA$  by end-of-the-year total assets and we use the absolute value of  $AWCA$  because our purpose is to estimate the magnitude of discretionary abnormal accruals, irrespective of its intent to increase or decrease income.

*Minority* represents the main regressor and is defined as the percentage of minority directors within the board of directors. In addition, we include several control variables, which might affect abnormal accruals, identifying three groups of variables that can be clustered as corporate governance attributes, financial attributes, and innate determinants of earnings quality. As corporate governance attributes, we include the board size (*BoD\_Size*), the percentage of independent directors (*BoD\_Indep*), the presence of a CEO that is also the chairman of the board of directors (*CEO\_Duality*), and the ownership concentration (*Own\_Conc*). As regards the group of financial attributes, we include total annual sales (*Size*) considered as a proxy for firm size, return on assets (*ROA*) which is defined as the ratio between operating income and total assets, and financial leverage (*Leverage*) computed as net debt over total asset. Finally, relative to the innate determinants of earnings quality (which are deemed to exercise an impact on our dependent variable) we rely on Francis et al. (2005) and we include the volatility of sales, cash flows and earnings (*Sales\_Vol*, *OCF\_Vol*, *Earnings\_Vol*) the frequency of negative earnings realizations (*Neg\_Earnings*) and the magnitude of accruals (*WCA*), in order to control for abnormal accruals due to changing within the innate components of earning quality.

After controlling for a set of variables that affects earnings quality, we find a negative and significant relationship between minority directors and the magnitude of discretionary abnormal working capital accruals. Therefore, this paper suggests that independent minority directors can be effective in constraining earnings management activities and enhancing the quality of financial reporting.

This study contributes to the accounting literature, as it is the first to investigate on the relationship between minority directors and earnings management, extending knowledge and collecting new evidence on the relation between financial reporting quality and internal corporate governance mechanisms. Moreover, our findings highlight the effectiveness of this corporate governance feature that can lead to benefits for non-controlling shareholders and financial markets.

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