

The relationship between corporate governance and management earnings forecasts being informative in a continuous disclosure environment

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Abstract

Australian listed companies are obligated to keep the share market informed by continuously disclosing price sensitive information. Management earnings forecasts are an important example of such disclosure. The purpose of this study is to determine whether corporate governance attributes such as the independence, reputation and financial expertise of directors, as well as board and audit committee activity metrics are related to more accurate and less biased management earnings forecasts.

Introduction

The research question being examined is whether director attributes such as independence, reputation and financial expertise as well as/interacting with activity metrics such as the number of board and audit committee meetings are related to the issuance of more informative (more accurate and less biased) management earnings forecasts. We differentiate this project from Chan et al. (2007) by investigating the more important issues of accuracy and bias (rather than the frequency and form) of these forecasts as well by incorporating the activity metrics, such as the number of board and audit committee meetings, into the analysis.

The separation of ownership and control in Australian publicly listed companies causes agency problems (Jensen and Meckling, 1976). Accordingly, regulatory and/or corporate governance mechanisms are employed to assist in monitoring management actions and to protect shareholders' interests. One set of regulatory requirements in Australia imposed by a unique combination of Australian Stock Exchange (ASX) listing

rules and the Corporations Act require companies to continuously disclose to the ASX information that is likely to security price sensitive. Allied to this has been an on-going debate about the identification and implementation of corporate governance principles and structures designed to ensure corporate resources are managed to meet the best interests of all stakeholders (ASX, 2007). This project provides an empirical assessment of the effect of corporate governance mechanisms on an important aspect of firms' disclosure policy, the accuracy and bias of management earnings forecasts.

Managers know more about the firm and its prospects than do shareholders. However, managers have incentives (for example, insider trading opportunities) not to meet their continuous disclosure obligations. Governance features such as director independence are likely to affect the extent to which companies disclose more informative (more accurate, less biased) earnings news to shareholders. For example, the ASX Corporate Governance Council recommends that a majority of the board and audit committee, be independent directors. Independent directors are considered more effective in monitoring senior management and thus help mitigate agency problems associated with managing such companies (Fama and Jensen, 1983).

From an academic viewpoint, research in this area is quite sparse. In the US, Ajinkya, et al. (2005) investigate the effects of institutional holdings and outside directors on the properties of management forecasts whilst Karamanou and Vafeas (2005) examine how corporate boards and audit committees are associated with management earnings forecasts. The only Australia study in this area tests and finds a significant positive relationship between the likelihood and frequency of firms issuing management earnings forecasts and measures of audit committee independence and independent director reputation but not director independence (Chan, et al., 2007). It should be noted that Chan et al. (2007), do not examine the relationship between corporate governance and the accuracy or bias associated with management earnings forecasts.

Research method

We aim to use a series of regressions to investigate the effect of corporate governance and control variables on relevant properties (accuracy and bias) of management earnings forecasts. The regression models used in Ajinkya et al. (2005) and Chan et al. (2007) will be modified and used to test the impact of corporate governance variables such as the proportion of independent directors on the board and audit committee as well as the proxies for reputation, financial expertise and the number of board and audit committee meetings.

Significance of project

We argue that director independence may be an important governance attribute, but an independent director's effectiveness may vary depending on their reputation, their financial expertise and on the extent of board/committee activity. Our proposed research will contribute to the literature in several ways. First, we argue that the reputation of independent directors is likely to be an important factor in their effectiveness as monitors. We follow Fama (1980) and Ferris et al. (2003), and argue that the need to maintain their reputation in the managerial labour market is a major incentive for independent directors to be effective monitors. Accordingly, we use the number of directorships held in ASX100 companies as a proxy for director reputation (Chan et al., 2007) and examine whether the reputation of independent directors in the managerial labour market is associated with the accuracy and bias of management earnings forecasts.

Second and related to the above, we argue that financial expertise is a key determinant of whether or not independent directors are able to identify and prevent/reduce inaccurate or biased management earnings forecasts. We intend using a direct measure such as membership of a professional accounting body complemented by sensitivity analysis using broader measures (for example, to include other finance professionals such as investment bankers). Finally, we intend testing board and audit committee activity measures as independent variables as well as their interaction with director independence.

From a professional viewpoint, the issue of corporate governance as well as continuous disclosure is very topical. The need for better corporate governance and more transparent disclosure is recognized in the recently revised ASX Corporate Governance Principles and Recommendations (August 2007). This project will make a significant contribution by allowing opportunities to evaluate, within the framework of the continuous disclosure requirements, the effect of corporate governance on the extent to which companies provide informative (more accurate, less biased) earnings guidance to their shareholders. This project is significant as improved disclosure has implications for the efficiency of capital markets.

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