The effect of remuneration of directors on the quality of reporting

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ABSTRACT

This study aims to investigate the effect of remuneration of directors on the quality of reporting. Financial managers, due to their unique expertise and technical knowledge, affect the company's financial reports more than board managers. In addition to examining this effect, this study also examines the role of two variables, corporate governance and internal control. In order to test the hypotheses of the present study, 167 researcher-made questionnaires were distributed among the financial managers of companies listed on the Tehran Stock Exchange. Confirmation analysis test and structural equations were used to test the research hypotheses. Research findings confirm the effect of remuneration of directors on the quality of reporting. The internal control variable also has a mediating role that strengthens the effect of the main variables of the research. However, the role of corporate governance in this study was not confirmed as a mediating variable. Finally, the results of this study showed that the quality of financial reporting is directly related to the remuneration of directors, which in turn, resolves the concerns of decision makers and policy makers of the company about monitoring and fulfilling loyal commitments to provide quality financial reporting.

Keywords:

remuneration of directors, Reporting Quality, Corporate Governance, Internal Control, Structural Equations.

1. Introduction

This study aims to examine the relationship between remuneration of directors and its impact on the quality of reporting. Labor unions are powerful stakeholders that influence corporate decision-making. Extensive research on the impact of labor unions on managers' reporting motivations for information asymmetry (Hilary 2006), profit management (Liberty and Zimmerman 1986; De Angelo 1991; Mautz & Richardson 1992; Cullinan and Knoblett 1994; Mora and Sabater, 2008), tax aggression (Chyz, Leung, Li, and Rui, 2013), accounting conservatism (Leung, Li, and Rui ,2009; Farber, Hsieh, Jung, and Yi, 2010) and corporate investment and financing decisions (Fallick and Hassett ,1999; Hirsch, 2004; Cheng, 2017). Other studies show that managers limit asset maintenance and increase leverage to prevent labor union activities (Klasa, Maxwell, & Ortiz - Molina 2009; Matsa 2010). Labor unions also limit operational flexibility and increased equity costs (Kacperczyk & Ortiz - Molina, 2004). But they reduce debt costs and bankruptcy risk because their motivations and preferences are similar to those of profiteers (Chen, Kasperczyk, and Ortiz-Molina,2012). Existing research also shows that labor union power is associated with profit smoothing (Hamm, Jung, & Lee, 2013) and a greater tendency to lose profit forecast analysis (Bova, 2013). Most empirical findings suggest that unions are likely to make more conservative decisions to report lower incomes or reduce their aggressive financial reporting in an effort to prevent labor unions from influencing management in negotiations. In this study, we want to examine the relationship between the accounting payment of the business unit and the quality of financial statements and the variables that adjust the corporate governance structure and internal control in promoting this relationship.

2. Research background

Paletta and Alimehmeti (2016) examined the organizational impact of internal control systems for 1,593 companies with 15,606 managers during the years 2002 to 2010. Internal control systems explain a significant amount of executive, and in particular CFO compensation, after control of corporate governance, personal executive characteristics, enterprise determinants, and macroeconomic determinants. In addition, the negative relationship between payment control systems and internal control shows that managers working in companies with inefficient internal control systems receive higher payment. The results of the longitudinal analysis show that firms with ineffective internal control systems have more representation problems and, consequently, tolerate higher levels of executive compensation. The relationship between the remuneration of directors and internal control systems does not show a significant relationship.

Sebastian Firk et al. (2018) presented the importance of financial managers in value-Based management, outcomes of performance and the challenge of financial managers' success. Supporting senior management is often cited to be an important factor in the successful use of value-based management (VBM). In addition, recent research shows that financial managers play an important role in shaping management accounting, and especially VBM. Although this shows that the emphasis of financial managers has a positive effect on the successful use of VBM, empirical research that considers the distinguishing elements of VBM acceptors is scarce. Therefore, this study empirically examines the implications of director performance on VBM and the challenge of supporting VBM emphasis followed by financial manager replacement. To achieve this, they focused on a longitudinal sample of VBM acceptors and assessed the director emphasis on VBM based on his remarks during the company conference. Analysis of empirical evidence shows that director emphasis enhances the performance of VBM acceptors. However, the results of this study show that surrogate CFOs, who did not take responsibility for the initial implementation, often become an important issue for organizations. However, we know that the VBM effect of surrogate directors can be realized by connecting their compensation to the VBM. In line with this, additional experiments show the negative impact of surrogate director on the effectiveness of VBM only if VBM is not compensated.

3. Literature review

Ariela Caglio et al. (2018) highlighted the role of remuneration of directors with an empirical analysis of their applications. Considering remuneration of directors concerns, especially incentives, and considering the tension between financial managers' loyalty responsibilities and core membership in the

company's executive team, using the sample of European companies (FTE 500, 2005) 2009), determinants and the amount of payment to the CFO, the intensity of encouragement and closeness to the remuneration of directors in the company were investigated. First, they focus on the role of the remuneration of directors as a determinant of financial services compensation. As in previous work, they collected director roles using data collected from past professional training and experience, but supplemented these proxies with proprietary data to directly reflect the specific nature of the director Job in terms of similarity to acquire the CEO. So they argue how remuneration of directors can play a variety of roles that are similar to different levels of financial expertise and director. Second, they examined the effects of CFOs on director results in financial reporting.

It is obviously known that director financial expertise has a positive relationship with the quality of financial reporting, while long-term director payments increase motivation and closeness to the director has a negative relationship with the quality of financial reporting. In general, their results show that director are rewarded because of the CEO, and especially because of their resemblance to the CEO in terms of tasks and decision-making authority. But it is their financial expertise that has a positive relationship with the quality of financial reporting. At the same time, using more compensation and more similarity and closeness to the CEO seems to be detrimental to the quality of financial reporting. These results relate to the board involved in selecting highly specialized director and compensation committees that have the task of determining subsequent effective incentive compensation programs for those director.

Cooray et al (2020) in their study entitles “Does corporate governance affect the quality of integrated reporting?” Examine how governance mechanisms affect the quality of integrated reporting (IR), which serves as a tool to help firms understand their value creation process and communicate effectively with external stakeholders. They first created an index to assess the quality of integrated reports, and then 132 integrated reports from Sri Lankan public listed companies, reviewing content over a three-year period. Hypotheses related to the relationship between corporate governance and IR quality based on agency theory has been analyzed using multivariate linear regression and panel regression.

The results show that there is limited support for the corporate management system to provide quality information other than the level of the board and the availability of a separate risk management committee for stakeholders on the value creation process through IR, thus strongly emphasizing corporate governance requirements and mechanisms. The result shows that based on obligations of corporate governance and the related mechanisms, Sri Lankan companies are seriously required to do reporting compared to the voluntary reporting model such as IR. Since the management aspects of several companies are meant to meet mandatory reporting requirements, the results indicate that managers pay close attention to providing quality information through voluntary reporting methods such as IR, although they use resources to provide integrated reporting.

4. Research Hypotheses

- There is a significant relationship between remuneration of directors and the quality of financial statements
- Corporate governance plays a mediating role in the relationship between remuneration of directors and reporting quality
- Internal controls mediate the relationship between remuneration of directors and reporting quality

5. Methodology

This research is of applied type and in terms of classification of research is based on purpose, which is considered as a causal-post event type of correlation method. This research will be conducted in the framework of deductive-inductive reasoning. The present study is also of a survey type, because in addition to describing the current situation, it tests hypotheses in terms of prediction-based relationships and seeks to determine the effect of variables by inferential statistics. The scope of this research is 8 months, which includes the distribution and collection of questionnaires, data collection and analysis, which began in the fall of 2019 and continued until the summer of 2020. The statistical population of the study includes companies that have been listed on the Tehran Stock Exchange until the end of 2018. The statistical community unit consists of the financial managers of companies listed on the Tehran Stock

Exchange. Since the total number of companies listed on the Tehran Stock Exchange by the end of 2018 is equal to 296 people, the statistical population of the study is 296 financial managers. The statistical sample was selected from the statistical population using a simple random method. To measure the research variables from the statistical population, 167 financial managers from stock exchange companies were randomly selected according to Cochran's formula (with an error level of 5%) as a sample and a research questionnaire was sent to them. To evaluate the reliability of the questionnaire, a pre-test stage was performed. First, 30 questionnaires were distributed and collected in the target population and after entering the data, the reliability coefficient (Cronbach's alpha) was calculated using SPSS software. According to Rosner (1995) theory, if the reliability value is less than 0.4, there appears poor reliability, between 0.4 to 0.75, good reliability appears and above 0.78, excellent reliability comes in. The overall reliability of the research questionnaire was 90% which is a good reliability. Validity means that the scale and content of the tool or the questions contained in the tool accurately measure the variables and the subject under study; This means that both the data collected by the tool should not be in excess of the need for research and that part of the data needed to measure the variables in the content of the tool has not been deleted. The validity of a questionnaire states that the questionnaire should measure what the researcher wants. Formal validity was examined and confirmed through experimental implementation, and content validity through comprehensive literature review and expert judgment. Structural equations have been used to determine the construct validity of the research questionnaire. Amos software was used to analyze the data.

5.1. Definitions of research variables

Remuneration of directors: remuneration of directors is an expense that is considered by the investment manager to manage the investment fund. remuneration of directors is intended to compensate for the manager's time and expertise in stock selection and portfolio management. It can also include other items such as investor relations (IR) costs and fund costs (Chen, 2018). In this study, the remuneration of directors was assessed by 20 researcher-made questions based on the Likert scale.

Quality of Financial Reporting: The ability of financial statements to convey information about a company's operations and in particular its expected cash flows to investors based on the view that accruals improve the information value of profits by reducing the effect of volatile fluctuations in cash flows (Hesarzadeh and Modares, 1387). Providing high quality financial reporting information is important because of the positive impact it has on capital suppliers and other stakeholders in financing, crediting, and allocating similar resources (International Accounting Standards Board, 2006; Van Beth, 2008). The quality of financial reporting research has been measured by 8 researcher-made questions based on the Likert scale.

Corporate governance: Hasas Yeganeh (2005) believes that corporate governance is a variety of organizational and institutional mechanisms that exist to guide and control joint stock companies and their management, both internally and externally. Such controls are at various levels and include internal and independent auditing, the use of audit committees, the selection and role of non-executive (or external) directors, shareholders' voting rights, and the participation of institutional shareholders in the company's affairs. Corporate governance has been measured by 20 questions proposed by Davani (2014) based on the Likert scale.

Internal controls: A process designed by the board of directors, management, and other employees to provide reasonable assurance about the achievement of the business unit's goals in three groups of objectives (operational, reporting, and compliance). In this definition, the underlying concepts have been introduced. Accordingly, internal control is

A process which involves continuous tasks and activities and is a tool that continues to the end, not just an end in itself, and is not just about rules, policies, systems and methods, but also involves different people in the organization who exercise internal control.

Able to provide reasonable assurance to senior management and the board, but not absolute assurance. A tool for achieving goals in one or more operational, reporting and compliance goals. In this study, internal control was measured by 7 researcher-made questions based on the Likert scale. Considering that most of the questions in the questionnaire are researcher-made, in the following we will first assess the validity of the

items in each question and after confirming the validity, the structural equation is performed to measure the research hypotheses.

6. Findings

In order to accurately evaluate the validity of research structures, CR (latent variable reliability) and AVE (convergent validity) indices are calculated using standardized factor loads obtained from CFA. There are various opinions regarding the CR threshold. A value of 0.6 for composite validity has been proposed as a standard by Bagozzi and Yi (1988), and Fornell and Larker (1981) in their study emphasized a minimum value of 0.5 as the acceptance level of the AVE index. Therefore, the AVE index will also be reported in the validity review. Assessing the validity of the components of the remuneration of directors. The values of factor loads and T statistic for the significant components of remuneration of directors are shown in Table 1.

Assessing the validity of the components of the quality of financial reporting. Factor load values and T-test statistic for significant components of reporting quality are shown in Table 2.

Assessing the validity of internal control components

The values of factor loads and T-test statistic for the significant components of internal controls are shown in Table 3.

Assessing the validity of corporate governance components The values of factor loads and T-statistics for significant components of corporate governance are shown in Table 4.

Table 1: The values of factor loads and T statistic of remuneration of directors

variable	question	Factor load	Test statistics	AVE	CR
remuneration of directors	Remuneration of directors is determined based on the role of the financial manager in advancing organizational goals.	0.51	4.34	٠/65	**0.62**
	The remuneration of directors for the performance of duties is paid.	0.55	4.78		
	The structure of the remuneration of directors should be determined by the type of industry	0.48	4.08		
	The structure of the remuneration of directors based on the structure is unique to each company.	0.36	2.92		
	The remuneration of directors structure is based on the size of the company.	0.51	4.35		
	The structure of the remuneration of directors should be determined based on the type and scope of activity.	0.72	6.63		
	Elimination of uncertainty related to the calculation of remuneration of directors leads to maximizing the quality of financial reports	0.82	8.02		
	Uncertainty related to the calculation of remuneration of directors based on the company's profit and loss should be determined.	٠,۵٨	4.89		
	The right system for remuneration of directors had better be based on performance	0.68	5.64		
	The system of remuneration of directors is determined based on the experience of financial management	0.41	3.33		
	The remuneration of directors is determined according to the policies of the CEO	0.43	3.56		

Table 2: Factor load values and T-test statistic of reporting quality

variable	question	Factor load	t-test statistic	CR	AVE
quality of reporting	remuneration of directors affects the efficiency of financial reporting	0.71	6.06	0.65	**0.81**
	To what extent providing timely information in financial reporting can provide relevant information for remuneration of director's decision making.	0.95	9.13		
	To what extent can financial reporting be effective in providing useful information for remuneration of directors?	0.55	3.02		
	remuneration of directors affects the efficiency of financial reporting	0.75	4.26		

Table 3: values of factor loads and T-test statistic of internal controls

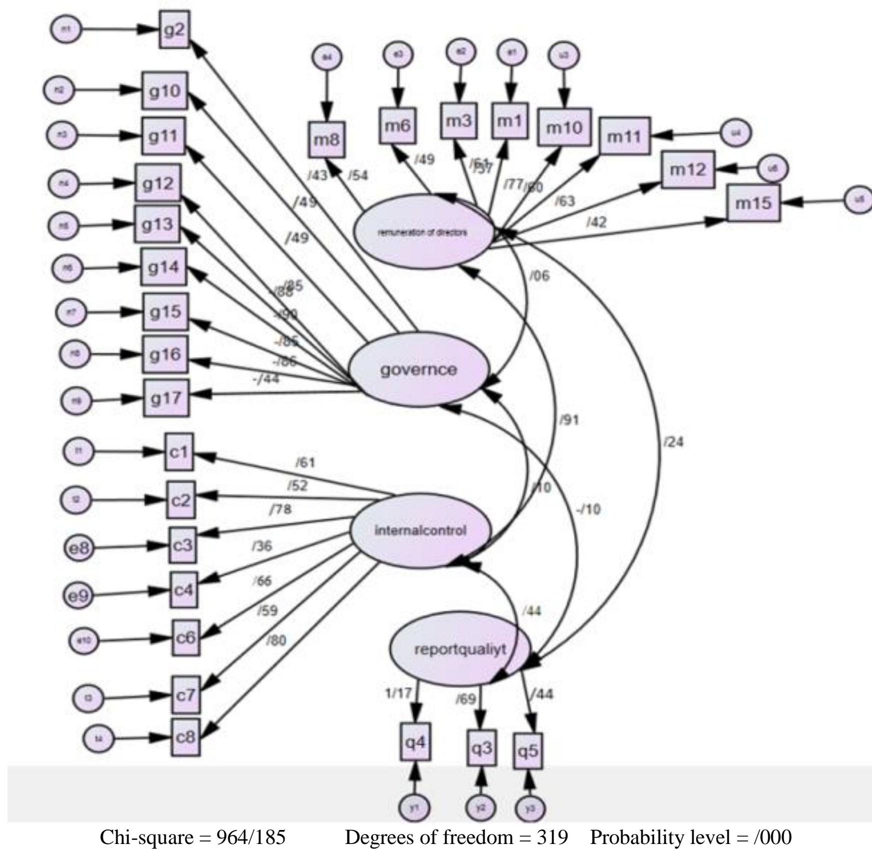
variable	question	Load factor	t-test statistic	AVE	CR
Internal controls	Through internal control systems, the remuneration of directors can be determined in an integrated manner based on ethical values.	0.59	4.79	0.75	**0.78**
	senior management supports the remuneration of directors through internal control systems	0.57	4.75		
	The role and responsibilities of the financial manager are clearly stated through internal control systems	0.47	2.17		
	Management creates structures, reporting lines and authorities and responsibilities related to the pursuit of goals through internal control systems under the supervision of the board of directors.	0.46	3.57		
	Through the internal control systems, organization has an organization chart with clear lines of reporting and policy	0.52	4.16		
	Through internal control systems, the representation of the commitment to attract, develop and retain competent people in accordance with the objectives is evident.	0.63	5.17		
	A strong internal control system increases the reliability of accounting information to determine the remuneration of directors	0.65	5.33		

Table 4: values of factor loads and T-statistics of corporate governance

variable	question	Factor load	t-test statistics	CR	AVE
Corporate governance	How effective have the CEO's decisions been in the company?	0.44	3.85	0.72	**0.73**
	What is the responsibility of the government towards the company for (board, members and CEO?	0.85	2.46		
	What is the ownership of the government in the company?	0.88	8.29		
	What is the level of board authority in the company?	0.88	9.36		
	How effective have board decisions been in the company?	0.89	9.62		
	What is the role of the board in the company in relation to (shareholders, government and board)?	0.88	8.2		
	What is the ownership of the board of directors in the company?	0.88	9.12		
	What is the level of authority of the CEO in the company?	0.89	2.4		

To examine the main hypothesis using structural equations, first the validity of the identified components and their contribution in explaining the latent variables of each variable is determined. For each of the estimates obtained from the structural analysis, goodness-of-fit indicators are reported. To examine the fitness of the model, the indicators proposed by Gefen, Straub and Boudereau (2000) are used. These indicators include the following: Good fit index (GFI), comparative fit index (CFI), in which values greater than 0.9 indicate the appropriate fit of the model, adjusted good fit index (AGFI), in which values more than 0.8 are acceptable, (PNFI), in which values greater than 0.6 indicate proper fit of the pattern and (RMSEA) in which values less than 0.08 indicate good fit of the pattern. These indicators are reported in the table. The indicators of goodness of fit are given in the table.

Based on the direct path coefficients, the indirect path coefficients have been calculated to measure the research mediating variables.



Chi-square = 964/185 Degrees of freedom = 319 Probability level = /000

Fig1: Research conceptual model Explanation of Research conceptual model

Table5: Fit indicators of final model

parameters	Chi-square	df	p-value	Chi-square /df	RMSEA	NFI	IFI	AGFI	CFI
values	964/185	319	0/000	3/023	۰/۰۰۶	۰/۹۷	۰/۹۲	۰/۹۸	۰,۹۷

Estimates are provided below: The study of relationships with path coefficients is also presented below

Table6: tables and coefficient of direct path of final model

relation	estimate	standard deviation	Critical value	Sig	coefficient of path	result
Quality of financial reporting <--> remuneration of directors	/123	/059	2/070	/038	/241	confirmation
Corporate governance<--> remuneration of directors	/008	/019	/416	/678	/056	rejection
Internal controls<-->corporate governance	/017	/024	/707	/480	/100	rejection
Quality of financial reporting<--> internal controls	/126	/072	1/753	/040	/201	confirmation
Remuneration of directors<--> internal controls	/213	/064	3/325	***	/907	confirmation
Quality of financial reporting <--> Corporate governance	-/039	/038	-1/037	/300	-/105	rejection

Table 7: relations and coefficient of indirect path of final model

relation	Coefficient of direct path	Coefficient of indirect path	result
remuneration of directors - Corporate Governance - Quality of Financial Reporting	0.006>0.024	0.1*0.06=0.006	rejection
remuneration of directors - Internal controls - Quality of financial reporting	0.4<0.24	0.44*0.91=0.4۰	confirmation

The test results of the hypotheses will be as follows

Hypothesis 1: There is a significant relationship between remuneration of directors and the quality of financial reports

Based on the relationships and fit tables obtained from the final implementation of the model, the relationship between remuneration of directors and the quality of financial reports has a significant relationship (sig <0.05) and a path coefficient of 0.24, which is a direct and significant coefficient (Table 7).

Hypothesis 2: Corporate governance has a mediating role in the relationship between remuneration of directors and reporting quality

Based on the relationships and fit tables obtained from the final implementation of the model, the mediating role of corporate governance is not approved because the indirect path established by the corporate governance variable firstly leads to two relationships: financial manager's corporate governance and corporate governance <--> internal controls, both of which are not at significant levels according to the estimates in Table 8, and on the other hand, the calculation and comparison of direct and indirect coefficients indicates the rejection of the research hypothesis, ie corporate governance in the relationship between remuneration of directors and the quality of reporting does not play a mediating role.

Hypothesis 3: Internal controls play a mediating role in the relationship between remuneration of directors and reporting quality. This hypothesis also leads to two sub-relationships, namely the quality of financial statements <--> internal controls and the remuneration of directors <--> internal controls, both of which are at a significant level (sig <0.05) and on the other hand, calculation and comparison of direct and indirect coefficients confirms the research hypothesis, ie internal controls have a mediating role in the relationship between the remuneration of directors and the quality of reporting.

Therefore, in addition to confirming the relationship between the remuneration of directors and the quality of reporting, it was found that the role of internal control systems in strengthening this relationship is very important and corporate governance has no mediating role.

1. Discussion and conclusion

The quality of financial reporting is directly related to the remuneration of directors, which addresses the concerns of decision makers and political regulators about overseeing and fulfilling their obligations to provide quality financial reporting. In line with previous work (e.g., Graham et al., 2005; Mergenthaler et al., 2012), it can be said that financial managers participate in decision making as a member of the senior executive team, are involved in strategy, and as business partners are managers. Agents are active and

also often attend board meetings. At the same time, due to the unique expertise and technical knowledge of the financial manager, they affect the company's financial reports more than the CEOs (E.g., Mian, 2001; Aier et al., 2005; Geiger & North, 2006) and are expected to guard the accuracy of financial information. This is similar to describing the role of the director as a combination of credible tasks on financial reporting and managerial involvement in decision making (Indejejikian and Matejka, 2009). This is in line with the theory of human capital and in line with agency theory.Companies may need to emphasize the CEO to create the right incentive for the director to stay focused on his custodial duties, because in fact the use of service compensation similar to executives has the potential to improve the quality of financial reporting.

Parameters that played a role in corporate governance of this study were the role of CEO decisions, government accountability to the company (board, members and CEO), government ownership in the company, the extent of board authority, board decisions, board role of director in the company in relation to (shareholders, government and board of directors), ownership of the board of directors in the company and the extent of the CEO's authority in the company. Proper corporate governance practice helps the company to give a credible opinion on the quality of director and accountability to the interests of all its financial stakeholders. A better understanding of investors may, in turn, affect its valuation and facilitate capital increases under favorable conditions. The performance of corporate governance in the financial sector also increases the level of comfort of legal and regulatory authorities. It can also be used as a check to determine the relative position of the company according to the existing criteria to help companies stay in the economy.

Although good governance is the key to gaining the trust of shareholders, in this study it did not play a significant role as a mediator that leads to improving the relationship between financial reporting and reporting quality, because corporate governance is beyond rules and regulations and the result of culture and an atmosphere of coherence, responsibility, fairness, transparency and effectiveness that is established in an institution.

The parameters involved in the company's internal controls were determining the remuneration of directors through internal control systems, supporting top management through internal control systems, and clarifying the role and responsibilities of the financial manager through internal control systems. director oversees the board, creates structures, reporting lines and authorities and responsibilities related to the pursuit of goals, through the internal control systems and the organization has an organization chart with clear reporting lines and policies, and through internal control systems represents a commitment to attract, develops and retains competent people in line with objectives, and a strong internal control system increases the ability to rely on accounting information to determine the remuneration of directors. Internal controls mediate the relationship between remuneration of directors and reporting quality. Internal controls are needed to ensure the completeness and accuracy of the disclosure of new information - especially if the required data has not already been collected, or has been collected for purposes other than financial reporting.

Institutions may need to design and implement new internal controls or modify existing controls to address risk points arising from new processes, judgments, estimates, and disclosures of new information. The implementation of the new standard will involve various groups of parties (eg tax, IT, legal, financial planning, investor relations, etc.), and institutions must have a governance structure to be able to identify and manage the changes needed. Therefore, establishing an appropriate remuneration of directors system for financial reporting is conditional on having a strong internal control system, which plays a very important role in improving this relationship.

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