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Competition in Industries, Corporate Governance; and Financial Reporting Quality

***Javad Zahedi*[1] * , *Ali Ramezani*[2]**

[1] *Lecture, Department of Accounting, Mashhad branch Islamic Azad University, Mashhad, Iran.*
2 *Department of Accounting, Mashhad branch Islamic Azad University, Mashhad, Iran*

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ABSTRACT

Objective: The present study aimed to investigate the impact of product market competition; corporate governance accounting restatements of the firms listed on TSE. This study applies accounting restatement criterion for identification of low quality of reported accounting information in past financial statements of the firms listed on TSE. For this purpose, according to literature and institutional environment we select a set of most important corporate governance mechanisms include ownership concentration, board of directors independence and audit firm size associated with some control variable include corporation size and liquidity ratio that can be related to FRQ, and then considered to relation with earnings restatements. This study applies the financial statements information of firms listed on TSE during 2007 to 2013. The results of logistic regression analysis based on 846 year-firm observations indicate that according to past research corporate governance have a positive effect and competition has a negative effect on financial reporting quality (FRQ), however their interaction effect indicate that accounting information quality is increased. Therefore, evidence of this paper supports this opinion that competition and corporate governance mechanisms are complementary.

1. Introduction

The present study aimed to evaluate the relationship between product market competition (PMC) and corporate governance with accounting restatements. The purpose of financial statements is presenting summarized and classified information about financial status, financial performance and financial flexibility of business unit as useful for wide range of financial statement users to take economic decisions (The committee of financial standards, 2009). Net earnings are one of the most important items of financial statements considered as the criterion of performance evaluation criterion and profitability of business unit. As the calculation of profit is affected by authority of managers to use consistency and fulfillment and estimation and prediction, the reported earnings can be manipulated by management to achieve specific goals (Khajavi and Ghadirianiarani, 2014).
Nowadays, firms and companies work in an ever-expanding and highly competitive environment. In order to survive, they have to take on numerous competitors in national or international scale. Only companies which are more successful in achievement of the designated organizational objectives would survive in such a condition; and of course, in order to achieve those objectives, they should devise an appropriate management system. These systems are generally focused on methods by which corporations are managed and controlled (Teymouri Jami et al. 2014). Due to their specific characteristics and organizational environment, companies implement certain systems of governance in order to reduce agency costs. Therefor it can be said that corporate governance mechanisms can minimize opportunistic behaviors, and improve the quality of the information in financial reports and disclosures through reducing agency costs (Chawla and Lamba, 2013).

Models presented in various studies suggest that firms in the more exclusive industries where there is a higher dependence on investors' strategies, prefer to have less information disclosure policies, because disclosure of the information by those companies may in the future be exploited by their competitors. In this regard, Verrecchia (1999) points out that preventing voluntary disclosure in competitive markets is a natural characteristic of competition in

* *Corresponding author:* Javad.Zahedi@gmail.com
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product market. On the other hand, there are growing studies which show mechanisms of corporate governance are solutions for improvement of financial reporting quality (e.g. Iqbal & Strong, 2010). Meanwhile a few studies have been conducted on the interaction effect between corporate governance and market competition on the quality of financial reporting. The present study seeks to use information in financial statements of companies listed in Tehran stock exchange market to examine the role of interaction between product market competition and corporate governance in enhancement of financial reporting with the use of earnings restatement criteria. Using information collected from a sample of 846 observations (firm-year being the unit of observation) between 2007 and 2013; this study concludes that as suggested by previous researches, corporate governance has a positive effect on financial reporting quality, while the effect of competition is negative; in the meantime their interaction effect enhances the quality of accounting information.

The remainder of the paper is based on four following sections. The first section is regarding literature and study hypothesis. The next section is about study method. Then, descriptive statistics and study results are elaborated and finally the conclusion and recommendations are presented.

1.2 Literature and hypothesis development

With separation of company's ownership from management, there is the probability of managers making decision which correspond to their own benefits and contradict shareholders' benefit. This conflict of interests which is known as "agency problem" is caused by two major reasons: first is that stakeholders in a public company have different interests, and the other is that they do not have complete information about efforts, knowledge, and preferences of each other (Jensen and Meckling, 1976).

Since the structure to compensate the claim made by different beneficiaries is different, coordination (co-arrangement) and meeting the requirements of all is difficult. This leads to potential contradiction among beneficiaries and these motivational contradictions are known as "agency problem (principal-agent)". Most scholarly researches in this area are focused on how corporate governance mechanisms are designed so that managers make the best choices for improvement of corporate performance. Very few studies have been conducted on the relationship between corporate governance mechanisms and accounting restatements especially in developing countries (Abdullah et al. 2010).

The power of capital market relies heavily on investors' trust; investors also rely on financial information of firms in order to make their decisions. Therefor effective monitoring of the credibility of financial reporting seems crucial. Corporate governance is a monitoring mechanism, which arouse discussions after collapse of large U.S firms such as Enron and WorldCom. There are various definitions for corporate governance. Narrow and wide views are on two sides of a spectrum. In narrow views, corporate governance is limited to the relationship between a firm and its shareholders. It is an old model explained in agency theory. On the other side of the spectrum, corporate governance can be considered as a network of relations not only between the company and its owners (shareholders), but also between company and numerous stakeholders including employees, customers, salesmen, bondholders etc. Such a view is presented in stakeholder theory. By definition, corporate governance is consisted of law, regulations, structures, procedures, cultures, and systems which serve the purpose of responsibility and accountability, justice, and observation of stakeholders' rights (Yeganeh et al., 2006).

Based on literature, accounting restatement is one of the signs of reported earnings low quality (Zandi and Shamszadeh, 2013). The restatement is significant mistake in financial statements of past years. The great amount of restatements in Iran capital market and its extension can raise this question that which factors can lead to them. There are growing studies which reveal that corporate governance mechanism is a solution for enhancing financial reporting quality (e.g. Iqbal & Strong, 2010). In most studies it has been revealed that good corporate governance mechanisms impose further monitoring over financial reporting and are associated with reported earnings with more information load (see: Pergola, 2006). Restating companies have weaker corporate governance structures (see: Efendi et al. 2004).

Ownership concentration is one of corporate governance mechanisms. According to Jensen and Meckling (1976) the ownership of the firm's directors in their shares helps putting the investors' interests in line with the directors'. In this relation, Shahiki Tash and Kazemi (2012) showed that there is a positive relation among the firm performance and the ownership of the biggest shareholders and institutional shareholders. Moradi and Rostami (2012) also showed that management and institutional ownership are directly dependent on firm performance. In the meantime, concentration of ownership may cause access of powerful shareholders to confidential information and disturb the symmetry of information between powerful and ordinary shareholders. In this regard, Hassas Yeganeh et al. (2008) have studied the relation between institutional investors and firm's value. In their research, they have examined different approaches such as efficient monitoring theory and interest convergence theory on institutional investors. The results point out efficient monitoring theory. Moreover, no significant relation between concentration of institutional ownership and firm's value has been observed and interest convergence theory is not accepted.

In relation to audit quality, the results show that the firms being audited by big audit institutions have less discretionary accruals compared to the firms using other auditors (Desai et al., 2006). On the other hand, high quality audit improves the validity of presented information and allow the investors to have exact estimation of firm value. With the help of experts and using regression analysis Nikbakht & Rafi (2012) have studied the factors contributing to accounting restatements. They have concluded that profiting, financial leverage, period of management, change of management, change of accountant, and the size of accounting institution are factors which contribute to restatement of financial reporting.

Also, some studies focused on the impact of product market competition on financial reporting quality have to some extent yielded contradictory results and observations. Numerous studies reveal that the regulatory role of product market competition is an important mechanism associated with incorrect reporting. Hart (1983) points out that product market competition can be effective in limiting incorrect managerial behavior. Numerous theoretical studies on potential channels through which product market competition can affect inefficient management have confirmed this idea (Schmidt, 1997). It seems that recent experimental studies support the idea that product market competition gives managers the incentive to approach and keep up with shareholders interest (Giroud and Muller, 2011).

On the other hand, Gal-Or (1985) and Gertner et al. (1988) found out that firms in more competitive industries tend to implement less statement and disclosure policies; and there is a higher probability of misreporting. Managers may attempt to misreport in order to increase stock value, and hence attain their personal interests (Burns & Kedia, 2006). Therefor some studies of the research literature suggest that the quality of financial reporting in the more competitive industries tend to be lower.

Regarding the relation between competitive product market and level of disclosure, Darrough & Stoughton (1990) have studied the competition in an entry game and have predicted that firms in a more competitive industry devise better methods of disclosure. The reason is that the withheld information might be interpreted by potential newcomers as good news, hence encouraging them to enter the market. Gertner et al. (1998) concluded that firms in more competitive industries have lower levels of disclosure. The underlying logic is that the disclosed information can be exploited by opportunist competitors; therefor it is desirable for firms to have less information disclosure. In the same manner, Wagenhofer (1990) has shown that higher product market competition inhibits disclosure in markets with mature competitors. Harris (1998) reveals that a firm's decision to present separate segment disclosure is positively related to the level of competition. However, Verrecchia and Weber (2006) report that the probability providing private (proprietary) information by a firm is negatively related to product market competition, measured by industry concentration. Healy & Palepu (2001) conclude that empirical studies on how product market competition is related to disclosure provide little evidence.

Several theoretical models analyzed the uses of product market competition for slackness of management and found out that the financial incentives are necessary for the directors (for example, Holmstrom, 1982; Hart, 1983; Giroud and Muller, 2011). In Hart's model (1983), product market competition reduces the management's slackness. It is assumed that the directors pay attention to reach the pre-determined goals. Thus, although the costs of inputs reduce, the directors will try less. Meanwhile, in a product competitive market, reduced expenses in firms is usual together with reduction of cost price of product. Under such circumstances, directors should try more to achieve the target profit. In the meantime, according to agency theory if managers fail to improve the performance in a competitive environment, they might attempt on manipulation of financial reports and statements in order to secure their own jobs.

That is why if corporate governance is weak, intensive product market competition could bring the director's goals in the direction of efficient production (Januszewski et al., 2002). In this connection, Hart, 1983 also found out that competition reduces the degree of management slackness. Economists often argue that the firms' directors in competitive industries have strong incentive to compete for reduction of waste of resources and maximized profit; otherwise, they will fade away from the scene of competition. That is why there is less necessity to motivate the directors through stronger governance methods. In return, the firms in non-competitive industries, where the directors' absent competitive pressure does not lead to better performance, the better governance could benefit them (Giroud et al., 2011). The presented evidences in the study conducted by Giroud and Muller, 2011 supports this hypothesis that non-competitive firms benefit more from good governance than the firms active in competitive industries. In this study, the researchers studied the role of corporate governance on the firms' performance taking the product market competition into consideration. Their results showed that the firms that are weakly governed, have lower stock return, worse operational performance and less value, but only in non-competitive industries.

Hence, based on the above-mentioned theory and evidence, the following hypotheses concerning the product market competition and corporate governance and their interaction effect on financial reporting quality are presented:

H1: There is a positive relationship between PMC and earnings restatements.

H2: There is a negative relationship between ownership concentration and earnings restatements.

H3: There is a positive relationship between auditor size and earnings restatements.

H4: There is a positive relationship between director board's independence and earnings restatements.

H5: PMC affects relationship between ownership concentration and earnings restatements.

H6: PMC affects relationship between auditor size and earnings restatements.

H7: PMC affects relationship between director board's independence and earnings restatements.

2. Materials and methods

2.1 Sample selection

The statistical population in the current study is all the firms that have been recognized by Tehran Stock Exchange (TSE) market since 2007 or before that. From temporal aspect, the term of this study was from 2007 to 2013. To determine the research sample, all available data were used. Meanwhile, the financial firms and institutions were deleted from the final sample of research due to the type of special reporting. Eventually to eliminate the effect of outliers, the observations having more than three standard deviation from the mean were deleted from the final sample. Considering the above conditions, only 846 observations of the final sample were selected for testing the research hypotheses. They are used further on to study the research hypotheses.

2.2 Research model and method to test hypotheses

The goal of this study is to investigate the relation among corporate governance and product market competition criteria and financial reporting quality performance. Thus, the following models are used to test the research hypotheses:

Model 1: To investigate first hypothesis: There is a positive relationship between PMC and earnings restatements.

$$Res_{it} = \alpha + \beta 1PMC_{it} + \beta 5Liq_{it} + \beta 6Size_{it} + \beta k\ Years + \beta j\ Industries + \varepsilon. \quad (1)$$

Model 2: We examine hypothesis 2 to 4 for effect of corporate governance on FRQ.

$$Res_{it} = \alpha + \beta 1Block_{it} + \beta 2Indep_{it} + \beta 3AuSize_{it} + \beta 4Liq_{it} + \beta 5Size_{it} + \beta k\ Years + \beta j\ Industries + \varepsilon. \quad (2)$$

Model 3: In this model we examine interaction effect of PMC and corporate governance mechanisms on earnings restatements as bellow:

$$Res_{it} = \alpha + \beta 1PMC_{it}\times Block_{it} + \beta 2PMC_{it}\times Indep_{it} + \beta 3PMC_{it}\times AuSize_{it} + \beta 4Liq_{it} + \beta 5Size_{it} + \beta k\ Years + \beta j\ Industries + \varepsilon. \quad (3)$$

2.3 Research variables

2.3.1 Dependent variable

In this study, FRQ is the dependent variable which is measured as a dummy variable equal to 1 if prior year's income is restated, 0 otherwise

2.3.2 Independent variables

Product Market Competition (PMC): In this study like the former studies (Cheng et al., 2013; Khajavi et al., 2013; Anvari Rostami et al., 2013) Herfindahl-Hirschman Index (HHI) are used to measure product market competition. HHI index is calculated by adding the second power of market shares (according to firms' sale criterion) of all the active firms in the industry:

$$HHI_{jt} := \sum_{i=1}^{N_j} s_{ijt}^2, \tag{4}$$

In which Sijt is the market share of i firm in j industry during t year. The market share of every firm is calculated by dividing the firm's net sale by total net sale of industry which is calculated for each industry separately every year. This index measures the degree of concentration by industry. The bigger this index is, the more the concentration and the less the competition in that industry will be, vice versa.

Ownership structure (Block): In this study, the concentration of ownership is measured through total percentage of the blockholders' ownership (owners of more than 5% shares of the firm).

Structure of Board of Directors: The used variable with regard to the characteristics of Board of Directors in this research is of Board of Directors' independence. Independence of Board of Directors (Indep) is also measured based on the number of independent members of the Board of Directors. And audit size is a dummy variable equal to 1 if the prior's year auditor is "Audit Organization", 0 otherwise

In this study in addition to the studied variables, a series of other variables according to the former studies were used as control variables including firm size, current ratio, year and industry. To measure this variable, natural logarithm of total sales of firms is used. The ratio of liquidity (Liq) is calculated through dividing the current assets by the current debts.

In the current study, the test of significance in regression model consists of significant test of regression and significant test of coefficients. Also, the test of pre-assumptions using regression model including Watson-Durbin test, multicollinearity test and normality test of errors was conducted.

3. Discussion and results

3.1 Descriptive statistics

Table 1 shows the descriptive statistics of the research variables. In this table, the minimum, maximum and average standard deviation of observations is presented. According to the observations of this study, in average 65 percent of observations have restated their earnings. The ownership means of over 5% is 74% in the capital market of Iran. Also, the minimum and maximum degree of competition concentration (according to Herfindahl-Hirschman Index (HHI)) among firms is about 6 and 60 percent respectively that could have been the maximum figure of 1 (or 100%). The mean of this index is about 22% that shows the low concentration of product market competition (more competition) in the capital market of Iran.

Table 1. Descriptive statistics

Variables	Min	Max	Mean	Std. Eror
Res	0	1	0.65	0.497
HHI	0.062	0.672	0.217	0.136
Block	0.00	99.90	74.122	18.511
Indep	1	5	3.27	0.963
AuSize	0	1	0.23	0.424
Liq	0.202	3.386	1.202	0.464
Size	9.414	16.825	12.722	1.253

3.2 The results

In this section the research hypotheses are examined and analysed. Test of statistical power of the model confirms its significance (p=0.000) which indicates model’s goodness of fit. Table 2 demonstrates the results on first model of the study. Based on obtained results it is concluded that product market competition has a positive and significant correlation with financial reporting quality. As indicated in the table below, at 5% significance this variable has a negative correlation with accounting restatements which is a negative criterion of financial reporting quality (p=0.031).These findings correspond to the predictions of the first model of the study, and also with findings of Gal-Or (1985), Gertner et al. (1988), and Wagenhofer (1990). Concerning the control variables, it is observed that size of a firm has a positive and significant association with accounting restatement (p=0.001). In other words, larger firms are more probable to attempt restatement.

Table 2. Results of first hypothesis statistics

Variables	β	Std. Eror	Wald Sta.	p-value

PMC	0.002	0.001	10.638	0.031
Size	0.399	3.659	9.099	0.001
Liq	0.016	0.201	0.006	0.467
Constant	0.811	1.463	0.307	0.289

Next, hypotheses 2 to 4 concerning the effect of corporate governance mechanisms (including ownership concentration, board independence, and auditor's size) on accounting restatement are examined. Based on the mentioned hypotheses it is expected that corporate governance minimizes accounting restatements. According to the results presented in table 2, among variables of corporate governance, ownership concentration and auditor's size are associated with accounting restatement; also, the results on control variables are the same as before. According to this table, ownership concentration has a negative and significant association with earnings restatement at 10% level (p=0.040). Hence, based on the hypothesis as ownership concentration is increased the probability of earnings restatement is reduced. This result is against that of Hassas Yeganeh et al. (2008). Also, size of the auditor has a negative and significant association with earnings restatement (p=0.034). In other words, the probability of earnings restatement in firms audited by Auditing Organization is lower; these results are against those of Desai et al. (2006).

Table 3. Results of hypothesis 2-4 statistics

Variables	β	Std. Eror	Wald Sta.	p-value
Block	-0.046	3.030	-2.058	0.040
Indep	7.210	1.854	1	0.318
AuSize	-2.021	0.854	-4.454	0.034
Size	0.389	0.338	1.789	0.041
Liq	3.065	0.245	3.451	0.234
Constant	10.67	3.659	9.099	0.003

In the final test, the simultaneous relation of product market competition and corporate governance mechanism (including ownership concentration, board independence, and auditor's size) with accounting restatement is examined. Based on the first hypothesis and obtained results, product market competition increases earnings restatement; however, based on hypotheses 2 to 4, corporate governance mechanisms reduce restatements. In this test, the simultaneous impact of these variables on earnings restatement is analyzed. It is expected that a combination of these market and corporate mechanisms enhances the quality of financial reporting. The results suggest that among the model's variables, only the interaction variable of auditor's size and product market competition along with the variable of firm size have a significant correlation with accounting restatement. The observations indicate that with intensification of competition as well as auditing by Audit Organization, the probability of earnings restatement plummets; this is in spite of the fact that product market competition alone would lead to increase in restatements, as proposed in the first hypothesis.

Table 4. Results of hypothesis 5-7 statistics

Variables	β	Std. Error	Wald Sta.	p-value
Block*PMC	-0.621	4.025	-3.428	0.11
Indep*PMC	0.094	2.036	4.988	0.385
AuSize*PMC	-0.112	1.982	-5.817	0.001
Size	0.064	7.201	3.149	0.002
Liq	-0.036	6.612	-1.938	0.412
Constant	-0.029	3.259	-2.371	0.018

4. Conclusion

In this study, the relationship between product market competition as well as corporate governance with accounting restatements in the firms listed in Tehran stock exchange market has been examined with the use of earnings restatement criterion. Prior studies have all presented clues as to the separate association of each factor with financial reporting quality; however, this research has studied their simultaneous effect as well, because previous studies have revealed that product market competition can also be a complementary mechanism to corporate governance. This research also adds up to the opposing results on the effect of product market competition on financial reporting quality. Frequent restatements in Iran's capital market have necessitated a study like this; it is crucial that the quality of auditing structure in those firms is evaluated. This research has used the collected data from financial reports of companies listed in stock exchange market between the years 2007 and 2013 to study this subject. As it has been the case with prior studies, the results of the hypotheses examination in the present research have revealed that corporate governance has a positive effect on financial reporting quality, while the impact of competition is negative. However, their interaction effect enhances the quality of accounting information.

The results of the study from theoretical aspect can deal with the review of literature of audit quality and PMC and it also can reveal their role in quality of firms financial reporting. On the other hand, from applied aspect, it can receive much attention from auditors, creditors and investors regarding their contracts with firm. For investors, investment in the firms with high restatement can lead to information asymmetry risk and it should be considered.

Suggestions for future studies:

- With regard to the expanding product market competition and considering firms' disclosure level, there are numerous subjects to be studied in future researches.
- In order to measure the competition in product market, other indices such as Boone indicator can be used; and the results can be compared and contrasted.
- Since in this research, the relationship between product market competition and disclosure level (voluntary, mandatory, and total) based on Herfindahl-Hirschman index could not be assessed, it is suggested that future studies examine this relationship for different time periods.
- It is suggested that the relation between information asymmetry and product market competition is studied

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