

Corporate Governance Practices and Analysts Forecast Accuracy Evidence for Romania

M. Ionascu and L. Olimid

Abstract—In the last few years, several steps were taken in order to improve the quality of corporate governance for Romanian listed companies. Higher standards of corporate governance is documented in the literature to lead to a better information environment, and, consequently, to increase analysts forecast accuracy. Accordingly, the purpose of this paper is to investigate the extent to which corporate governance policies affect analysts forecasts for companies listed on Bucharest Stock Exchange. The results showed that there is indeed a negative correlation between a corporate governance index – used as a proxy for the quality of corporate governance practices - and analysts forecast errors.

Keywords—corporate governance, analysts' forecasts, information environment

I. INTRODUCTION

RECENT years have brought a number of changes in the governance of Romanian public companies. In 2006 Companies Law was amended to improve board composition by including independent directors and to allow for a dualist governance system comprising a Supervisory Board and a Management board.

Following the implementation of Directive 2006/46/EC, Romanian listed companies are required to include in their Annual Report a Declaration of conformity or nonconformity with a corporate governance code of their choice. Bucharest Stock Exchange first adopted a Corporate Governance Code in 2001; as a result, companies complying with its provisions and other financial reporting and publication requirements were accepted on the Plus (transparency) tier, while maintaining its listing in the original tier. Only one company was ever listed on the Plus tier. In 2008, Bucharest Stock Exchange modified this code and adopted a new one, inspired by the Corporate Governance Code of the Warsaw Stock Exchange. The principles and the recommendations of the Code explain the role, the duties and the composition of companies' boards of directors and management and their relationships with different stakeholder groups. Companies admitted to trading on Bucharest Stock Exchange adopt and comply with the provisions of the new Corporate Governance Code on a voluntary basis, but issuers of securities must include a

Comply or Explain Declaration in the financial statements of the financial year 2009. The new code was hailed by the financial press as a step forward in the search for transparency. Although Romanian corporate governance and financial reporting systems received Anglo-Saxon influences in order to make them more transparent, we believe that Romanian managers are reluctant to embrace them and thus provide minimum disclosure only when reporting it becomes mandatory.

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II. CORPORATE GOVERNANCE IN ROMANIA

Romanian business associations, foreign investors and international organizations have repeatedly called for improving corporate governance (e.g. [9], [13], [15] etc). Higher standards of transparency and disclosure would thus become incentives for institutional investors to invest in companies complying with a corporate governance code. The first large scale corporate governance awareness project –The Corporate Governance Initiative for Economic Democracy in Romania – was supported by domestic business associations and sponsored by the Center for International Private Enterprise (CIPE), an affiliate of the US Chamber of Commerce, [13]. A Corporate Governance Voluntary Code emerged in 2000, but there is no information indicating the number of companies who have adopted the code or observed its provisions [4].

In 2001, Bucharest Stock Exchange (hereafter BSE) issued its own Corporate Governance Code. Listed companies adhering to BSE's code could apply for the plus (transparency) tier while maintaining their listing in the original tier. Annual and interim financial statements of plus tier companies had to be prepared according to both Romanian accounting regulations and IFRS and ought to be available on the issuer's website in Romanian and English. It was perhaps the lack of enforcement and the supplementary costs involved that did not make attractive the listing on the plus tier. [6] report that, in February 2006, there was only one company listed on the plus tier because it included BSE's corporate governance code in its Articles of Association, but its website did not feature any financial reports.

An analysis of Romanian corporate governance revealed a number of malfunctions, such as: neglecting minority shareholders' rights and a rather formal role of the boards which "stamped" management's decisions and were dominated by the majority shareholder, [13]. In many listed companies, the management team was made of administrators

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This work was cofinanced from the European Social Fund through Sectoral Operational Programme Human Resources Development 2007-2013, project number POSDRU/89/1.5/S/59184 „Performance and Excellence in Postdoctoral Research in Romanian Economics Science Domain”

assuming an executive role, suggesting a hybrid structure, since “the non-executive members of the board tend to assume more of a surveillance role” ([13], p. 88). This was similar to Korean boards, described as being functionally in between the dual-board system or two-tier system of Germany, and the single-board or one-tier system of the United States. Consequently, the “main shareholders dominated the affairs of the corporation, creating enormous agency costs and leaving Korean corporations structurally vulnerable and uncompetitive”, [12].

Romanian company law distinguishes between administrators and directors, where the former is the equivalent of an UK director and the latter refers to executive management. Administrators are responsible for the company's administration and should exercise prudence and due diligence while fulfilling their mandate. The Board of Administrators meets at least every three months. The duties associated with company administration may be delegated to directors, but the ultimate responsibility for them belongs to the administrators. Administrators may be appointed directors, but individuals not members of the Board of Administrators may also become directors. A number of responsibilities cannot be delegated to directors, such as:

- Deciding the main directions of the company’s operations and development;
- Choosing accounting policies, setting up the financial control system and approving financial planning;
- Appointing and dismissing directors and deciding their remuneration;
- Supervising directors’ activity;
- Preparing the annual report, organizing the AGM and carrying out its decisions;
- Filing for insolvency.

Among the amendments brought in 2006 to company law is the mandatory delegation to directors of current management in public companies whose annual accounts must be audited. While company law does not regulate the number of administrators of public companies, the above mentioned companies should have a minimum of three administrators. These public companies are represented in their relationships with third parties by the Director General. However, company law allows the Chairman of the Board of Administrators to be appointed Director General. The public debates of the 2000 Corporate Governance Voluntary Code concluded that this duality was optimal and appropriate, [11]. In practice, affiliates of foreign companies preferred to divide the top positions— chairman of the board or Director General— between its representative and a local “specialist” ([13], p.88).

A significant change was the requirement referring to public companies whose annual accounts must be audited to have a majority of non-executive administrators, namely, administrators that have not been appointed directors. Moreover, the AGM may appoint one or more independent administrators, that is, individuals that have not been employees or directors of the company or of its subsidiaries, company auditors or employees of company auditors in the last three years or significant shareholder of the company. The law also forbids independent administrators to receive other forms of remuneration in excess of the entitlements for being

an administrator and to hold this position for more than three consecutive terms. An independent director should also not have been involved in substantial transactions with the company during the previous year. Being independent is more a question of individual character and personal attitude, which cannot easily be prescribed by law. ([14], p. 44).

The Board of Administrators may set up consultative committees of minimum two members to investigate certain matters and to provide recommendations in areas like auditing, remuneration and nomination. At least one member of these committees should be non-executive and independent administrator. The auditing and remuneration committees should consist of non-executive administrators only and at least one member of the auditing committee should have accounting or auditing experience. Romanian companies seldom used such specialized committees and this is evaluated as reducing the effectiveness of the Board of Administrators. The audit committee does not replace the censors committee which has traditionally supervised the administration of certain Romanian limited companies. The former consists of board members while the latter is elected from the shareholders and includes an independent accountant.

The most significant change brought over in 2006 was the introduction of a two-tier administration system of public limited companies, modeled on the system traditionally used in countries like Germany and Austria. Since the first three countries in terms of direct foreign investments in Romania are Austria, The Netherlands and Germany we can expect that companies controlled by investors from these three countries choose the two-tier system. The system which provides for a Supervisory Board completely separate from the Directorate was already used by some of investment funds, the most noticeable being SIF IV Muntenia ([13], p.88). The press hailed the advent of the two-tier system, expecting an increase in the transparency of the decision making process, fraud prevention and healthier management, [10]. Listed companies were expected to benefit from increased transparency which in turn would boost the trust of smaller investors thus securing an important finance source for the development of public companies.

Under the two-tier system, the members of the Supervisory Board (made of three to eleven members) are designated by the Annual General Meeting who can dismiss them at any time with two thirds of the votes of the shareholders attending the AGM.

The supervisory board has the following duties:

- Exercises an ongoing control on company management by the directorate;
- Appoints and dismisses the members of the directorate;
- Provides checks of management acts against the applicable law, constitutive deed and AGM decisions;
- Reports at least annually to the AGM regarding its supervision activity.

Only in exceptional circumstances motivated by the interest of the company, may the Supervisory Board call the AGM. The Supervisory Board cannot receive managerial duties. Again, the constitutive deed may provide for its approval for certain transactions. In the event of disapproval, the directorate can appeal to the AGM who can override the

decision of the Supervisory Board by a majority of three quarters of the attending shareholders. The Supervisory Board may set up consultative committees of minimum two members to investigate certain matters and to assist the Board in areas like auditing, remuneration and nomination. At least one member of these committees should be independent and at least one member of the auditing committee should have accounting or auditing experience. The Head of the Directorate may be appointed member in the nomination committee without becoming member of the Supervisory Board. For those public companies with mandatorily audited financial statements setting up the auditing committee is compulsory.

III. THE CASE OF BUCHAREST STOCK EXCHANGE

2008 was BSE's year with the largest number of new issuers (10) since 1999, bringing at 68 the number of listed companies on Bucharest Stock Exchange by December 2008. Among neighbouring exchanges, BSE was the worst hit by the financial crisis that cut its market capitalisation by 69%, bringing down the ratio of market capitalisation to GDP from 17% in 2007 to only 5% in 2008 (see Table 1).

In 2008 the market was dominated by transactions with the shares of banks and energy companies: the most traded five companies were two banks and three national companies operating in the field of oil, gas and electricity, the last three with significant state ownership (BSE, 2008).

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IV. PREVIOUS RESEARCH

There is a recent stream of research showing that better quality corporate governance is associated with an increase in the overall quality of information possessed by financial analysts, which can reasonably be expected to lead to more accurate analysts forecasts.

For example, [1], using country level proxies for corporate governance transparency, showed that differences in transparency across 21 countries affect forecasts accuracy, when controlling for financial transparency. In addition, their results showed that the effect of corporate governance transparency on analyst forecast accuracy is larger when

financial disclosures are less transparent. The argument

TABLE I
MARKET CAPITALISATION OF BSE AND NEIGHBORING STOCK EXCHANGES

Stock Exchange	2007		2008	
	Market capitalisation (Euro millions)	Market capitalisation as percentage of GDP	Market capitalisation (Euro millions)	Market capitalisation as percentage of GDP
Athens Exchange	161.980,62	0,71	64.736,54	0,27
Bucharest Stock Exchange	20.637,20	0,17	6.474,07	0,05
Budapest Stock Exchange	30.025,70	0,30	13.325,60	0,13
Bulgarian Stock Exchange	8.965,32	0,31	6.371,03	0,19
Prague Stock Exchange	33.813,92	0,26	29.615,12	0,19
Warsaw Stock Exchange	122.725,30	0,39	65.177,59	0,18

Sources: www.fese.be, epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home

supporting these findings is that governance-related disclosure plays a role in improving the information environment of companies which leads to smaller errors in analyst forecast.

This rationale is backed by other research results, such as the ones provided by Karamanou and Vafeas [7], who documented that effective corporate governance is associated with higher financial disclosure quality. Karamanou and Vafeas [7] showed that more effective corporate boards and audit committees structures lead to more accurate management earnings forecasts, which can reasonably lead to a decrease in analysts' forecast errors.

Byard and Weintrop [2] have also discussed the association between corporate governance and the quality of information available to financial analysts. Their findings proved that the quality of corporate governance increases the quality of financial analysts' information about upcoming earnings.

The issue of the impact of corporate governance practices on analysts forecast accuracy in Romania has not been discussed elsewhere. Accordingly, as listed companies become more preoccupied with improving their corporate governance practices, the purpose of this paper is to investigate the extent to which more effective corporate governance leads to a decrease in analyst forecasts errors for listed Romanian companies.

V. METHODOLOGY

We used the results of Olimid *et al.* [8], who researched the characteristics of the boards of non-financial listed companies on BSE for the year 2008, eliminating those companies that do not provide complete data.

Following Garcia Lara *et al.* [5], Olimid *et al.* [8] calculated an aggregate index IndGov based on three characteristics of the board of administrators:

- (i) Board size, that is, we assume that a board of seven or more is a more representative forum for company administration than a board of 3 or 5, leaving more room for the nomination of non-

executive directors. We assign a value of 1 to the variable BOARD7ORMORE if the board comprises 7 or more members and 0 if 3 or 5 members.

(ii) The proportion of non-executive directors has been shown to positively influence board decisions ([5]).

(iii) The fact that the Chairman of the Board of Administrators is also the Director General is a sign of weak corporate governance because of increased implication in day-to-day management ([5]; [2]). We assign a value of 1 to CHAIRNONEXEC if there is no duality and 0 if the Chairman is also Director General.

At the same time, we tried to determine consensus forecast available on I/B/E/S for Romanian listed companies. The sample was comprised of 19 companies listed on the Bucharest Stock Exchange followed by financial analysts according to Thomson Reuters' I/B/E/S data base. We used monthly predictions for the period 2008-2010. The sample was finally comprised of 434 firm-month observations, as some of the data was missing, such as the actual earnings per share for the year 2010.

We used the following regression model to investigate if governance provisions are able to influence the accuracy of analyst forecast.

$$Error_{it} = \alpha_0 + \alpha_1 IndGov3_i + \varepsilon_{it}$$

Where:

Error The absolute difference between actual EPS computed under local GAAP and the monthly median consensus forecast scaled by stock price at the middle of the month.

$$Error_{it} = \frac{|ActualEPS_{it} - EstimatedEPS_{it}|}{P_{it}}$$

Error_{it} = error in analyst forecast for company *i* and period *t*
ActualEPS_{it} = actual earnings per share for company *i* and period *t*

EstimatedEPS_{it} = consensus forecast for earnings per share for company *i* and period *t*

VI. RESEARCH RESULTS

The values obtained after the operationalization of the variables are presented in Table II.

Regression results are summarized in Table III below. To avoid positive correlations of the residuals, we added two lags of the dependent variable, the value of the Durbin Watson statistic improving to 1,964.

As expected, the results showed that forecast errors were lower for listed Romanian companies with better governance provisions, the regression finding a strong negative correlation between the corporate governance index and the analysts' forecast errors.

TABLE II
DESCRIPTIVE STATISTICS

	Error	IndGov
Minimum	,002	,22
Maximum	15,080	1,00
Mean	,481	,675
Std. Deviation	1,414	,280
Observations	434	434

VII. CONCLUSION

The paper investigated the effect of corporate governance policies of listed Romanian companies on the analysts' forecast accuracy. The results confirmed the international trends, as Romanian listed companies which are better governed tend to have more accurate forecasts.

TABLE III
REGRESSION RESULTS

Variables	Coefficients	t	Sig.
(Constant)	,657	5,253	,000
IndGOV (-)	-,722	-4,387	,000
Lag1	,842	17,752	,000
Lag2	-,186	-3,993	,000
Observations		434	
Adjusted R square		,593	
F statistic	209,954 (sig. .000)		
Durbin-Watson		1,964	

The main limitation of the paper comes from the small number of listed companies followed by financial analysts and the limited period covered. Consequently, research is needed in order to further clarify the effect of the information environment on analysts' forecast accuracy for Romanian listed companies with an emphasis on the role plaid by financial reporting.

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