We examine the relation among directors’ incentive compensation, board independence and separation of control rights from cash flow rights of controlling shareholder in affecting earnings quality. We find that firms that award their outside directors with higher equity-based compensation and firms with higher proportion of outside directors on the board have higher earnings quality. We document that earnings quality is negatively associated with separation of control rights from cash flow rights of controlling shareholders. The negative association between separation of control rights from cash flow rights and earnings quality is less pronounced in firms that provide high equity-based compensation to outside directors. In addition, the negative association between separation of control rights from cash flow rights and earnings quality is mitigated by the proportion of outside directors on the board. Overall, our results suggest that outside directors’ incentive compensation and board independence are associated with better financial reporting outcome, especially in firms with high expected agency costs arising from misalignment of control rights and cash flow rights.

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