PROPOSING A MODEL FOR LIMITING EARNING MANAGEMENT PRACTICES: THE CASE OF JORDANIAN LISTED FIRMS

Dea'a Al-Deen Al-Sraheen*, Khalid Alkhatib**

*Al-Zaytoonah University of Jordan, Faculty of Economics and Administrative Sciences. Department of Accounting, Jordan
**Department of Computer and Information Systems, Jordan University of Science and Technology, Jordan

Abstract

The key objective of this paper is to propose a model for limiting earning management practices among manufacturing firms in Jordan. In order to do so, two independent variables are examined in this paper, namely, political influence and CEO Duality. Discretionary total accruals according to the modified Jones model (1991) was used in order to estimate the level of earnings management, which is the dependent variable. The sample comprised 64 companies for financial year 2013. The results suggest that a positive and significant association existed among both political influence and CEO duality and earning management. This means that both independent variables exacerbated earnings management. Further research is required to determine what urgent legislation should be developed to restrict the presence of members who have political connections in the board of directors. Also, the need exists for the separation of roles of Chairman and CEO to ensure the independence and complying with the requirements of corporate governance .

Keywords: Jordan, CEO Duality, Political Influence, Earnings Management

1. INTRODUCTION

Earnings management is deemed to be a choice of corporate managers to use for accounting policies such as voluntary disclosure, voluntary earnings forecasting, as well discretionary accruals in order to affect corporate earnings intentionally. Earnings management may harm the credibility and reliability of financial reports offering financial information to corporate owners in well-functioning capital markets (Man & Wong, 2013). Therefore, earnings management can be considered to be an opportunistic behavior that corporate managers employ to transfer wealth from the company to their own accounts (Anandarajan, Hasan & McCarthy, 2007).

For these reasons, earnings management has become an important research field. Previous studies such as that of Stocken and Verrecchia (2004) have offered evidence that earnings management can be employed as a “signalling mechanism” to enhance communication channels among outsiders and insiders. Earning management plays a vital role as a determinant of earning quality itself and is very useful to the regulators and standards setters in that they will assume that earning management will reduce the reliability and credibility of accounting information (Radzi, Islam, & Ibrahim, 2011).

Healy and Wahlen (1999) pointed out that the main reason for earning management was for both job security purposes and enhancing managerial compensation. They defined earning management as something that “occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers" (p. 368). In addition, numerous previous studies have documented that earnings management practices can harm the quality of financial reporting through decreasing its decision usefulness (e.g., Brown & Higgins, 2001; Van & Vanstraelen, 2005).

This current study used discretionary accruals as a proxy for earnings management. The key advantage of employing discretionary accruals as a proxy of earnings management is that they can be calculated according to the information extracted from annual reports.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1. Political Influence

Jordan is a small country in which political influence plays an important role in the capital markets as well as in the aspects of many business dealings. Mohammed, Ahmed and Ji (2010) documented that fact that political influence is one of the main variables that contribute to low financial reporting quality. In addition, companies that are subject to great political influence are seen as engaging in poorer corporate governance practices and have huge agency problems (Johnson & Mitton, 2003). The political influence aspect has also been found to impact the quality of reporting. In particular, Mohammed, Ahmed and Ji (2010) pointed out that political influence has a negative influence on accounting conservatism.

Previous studies have documented that a high level of conservative accounting practices are associated with a higher quality of financial report. Therefore, accounting conservatism is one qualitative characteristic of financial report quality. Earning management, which is deemed to be opportunistic behavior employed by corporate managers to transfer the firms' wealth to their own accounts, will, of course, damage the quality of financial reporting. Therefore, this paper proposes the following hypothesis:

*H_1: There is a positive relationship between political influence and earning management.

2.2. Chief Executive Officer (CEO)

CEO duality refers to a dual function of the managers in a company. Coombes and Wong (2004) documented that the phenomenon of CEO duality allows a corporate manager to occupy two positions simultaneously, those of the chairperson and CEO of the board. Such a duality concentrates power in the hands of one leader, which in fact will give discretionary power to the management team. Al-Sraheen (2014) mentioned that Agency Theory suggests that the separation of duties' between a CEO and a chairperson may lead to more effective monitoring of the management functions.

A dual role of manager in a firm paves the way to manage the earning, as well enables that corporate manager to control earnings and practice aggressive behaviour in the form of either decreasing or increasing income (Nugroho & Eko, 2012). Previous studies pointed out that a positive association existed between dual leadership and earning management (Davidson, Jiraporn, Kim, & Nemec, 2004; Nugroho & Eko, 2012). Therefore, this paper follows the previous research in proposing the following hypothesis:

H_2: There is a positive relationship between CEO duality and earning management practices.

3. METHODOLOGY

3.1 Sample and Data Collection

The sample of the current study includes data collected from 64 manufacturing firms listed on the Amman Stock Exchange for the fiscal year of 2013. The research used a quantitative approach, and the audited annual financial reports (secondary data) were used solely to collect the necessary data for analysis purposes.

3.2 Measurements of the Research variables

3.2.1 Earning Management

To measure earning management, the accounting accruals approach was employed by using Jones' (1991) model as revised by Dechow and Sloan (1996). Previous research have employed discretionary accruals (DA) also referred to as abnormal accruals, as a measurement for earnings management. Total accrual values are divided into two values (discretionary accrual and non-discretionary). Discretionary accruals (DA) are employed to prove that corporate managers transfer corporate earnings from one period to another. Therefore, managers can easily manipulate discretionary accruals. Non-discretionary accruals refer to the items of non-manipulated accounting accruals because such items are out of the control of the managers.

The value of non-discretionary accruals (NDAC) may be extracted from the discretionary accrual value (DAC) in the total accrual. The following calculations illustrate how to obtain the discretionary accrual (DAC) value:

The total accrual value (TAC) may be calculated using the following model:

$$\text{TAC} = \text{Net Income (NI)} - \text{Cash Flow from Operation (CF)} \quad (1)$$

The values of non-discretionary accruals (ND) and discretionary accruals (DAC) may be calculated by inserting the total accruals (TAC) value into the modified-Jones regression equation.

$$\frac{TAC_{it}}{TA_{i,t-1}} = a_1\left[\frac{1}{TA_{i,t-1}}\right] + a_2\left[\frac{\Delta REV_{it} - \Delta REC_{it}}{TA_{i,t-1}}\right] + a_3\left[\frac{PPE_{it}}{TA_{i,t-1}}\right] + e_i \quad (2)$$

Where TAC_{it} is the total accruals for firm i in year t; TA is the lagged total assets for firm i; ΔREV_{it} is the change in revenues for firm i in year t less revenue in year t-1; ΔAR_{it} is the accounts receivable in year t less accounts receivable in year t-1; PPE_{it} gross property, plant and equipment for firm i in year t. α1- α3 are the regression parameters while e equal error term.
The non-discretionary accruals may be calculated by using the following equation:

$$\frac{ND_{it}}{TA_{i,t-1}} = a_1\left[\frac{1}{TA_{i,t-1}}\right] + a_2\,[\Delta\text{REV}_{it} - \Delta\text{REC}_{it}] + \text{a3 PPE}_{it} \quad (3)$$

The discretionary accruals value may be calculated through using the following equation:

$$\text{DAC}_{it} = \text{TAC}_{it} - \text{NDAC}_{it} \quad (4)$$

Where DAC is discretionary accruals; TAC refers to total accruals and NDAC refers to non - discretionary accruals.

High values of discretionary accruals reflect the opportunistic behavior of managers, thus referring to a low quality of earning. Therefore, a high level of discretionary accruals acts as the indicator of earning management practices in this current study. This study used the modified Jones model to measure earning management because numerous previous studies have documented that the modified Jones model (1991) is the most accurate and powerful model in calculating discretionary accruals among the other existing models (Guay, Kothari, & Watts, 1996; Abed, Al-Badainah, & Serdaneh, 2012).

3.2.2. Political Influence

This paper uses alternative measures of political influence, rather than the percentage of board directors having a political position such as a minister, a member of parliament, a state assemblyman a head of state, or a person who is a government bureaucrat either currently or in the past. Namely, political influence is measured by using a dummy variable that is equal to one if at least one of the board members has a political position as mentioned above and zero otherwise (Poczter, 2011; Chaney, Faccio, & Parsley, 2010).

3.2.3. CEO Duality

A duality of roles occurs when the CEO also works as the chairman of board in the same firm. This paper used a dichotomous variable as a metric for this; the score was 1 if the roles of the CEO and chairman were combined and zero otherwise (Al-Sraheen, 2014; Ahmed & Duellman, 2007).

4.4 Results

4.4.1. Descriptive Results

The descriptive analyses for the research variables of the current study are shown in Table 1 below. The results show that firms' absolute value of earnings management had a mean of 0.0822 and a standard deviation of 0.217, and the values ranged from a maximum of 1.163 to a minimum of 0.0028. This result suggests industrial firms in Jordan are engaged in earnings management practices clearly in their financial statements.

Table 1. Descriptive Statistics

Variable	*Mean*	*Maximum*	*Minimum*	*Std. Deviation*
EM	.0822	1.16	.0028	.21778
POLINF	.1563	1.00	.00	.36596
CEO	.4219	1.00	.00	.49776

The results also showed that approximately 84.3% of the boards of directors in industrial firms had at least one member who served in a political role. This ratio indicates the increased likelihood that management facilitates the manipulation of financial figures using its political power. In addition, 42.19% of the CEOs served as the chairman of board in the same firm. Such a result also indicates that the industrial sector in Jordan is not in compliance with the requirements of corporate governance code.

4.4.2. Summary of Findings

OLS regression analysis was performed to determine whether political influence and CEO duality were significantly associated with earnings management among industrial firms in Jordan. Before conducting the analysis, the related regression assumptions (multicollinearity, homoscedasticity, normality and linearity) were examined in the current study to make ensure that these assumptions were not violated. They were not.

Table 2 below shows the results of the regression analysis. The research model used in the current study was highly significant (F = 5.924, Sig-Value = 0.004) with an adjusted R2 of 13.5%, which suggests that the independent variables (board size and CEO duality) explained around 13.5% of variation of the dependent variable (earning management).

As for the first research hypothesis, political influence were posited to have a positive and significant influence in leading the firms to practice earning management, which, in turn, leads to a reduction of the earning quality of the firms. This result was consistent with expectations; thus, H1 is accepted.

Table 2. Regression Results

	Unstandardized Coefficients		*Standardized Coefficients*		
Model	**B**	**Std. Error**	**Beta**	**T**	**Sig.**
POLINF	.194	.071	.327	2.736	.008
CEO	.135	.052	.308	2.578	.012
Model Sig	0.004		N	64	
F Sig	5.924		DV	EM	
R^2 Change	13.5%				

The results of regression analysis presented in Table 2 above show that a positive and significant association exists between CEO duality and earnings management. This result is consistent with that of Bergstresser and Philippon (2006). In conclusion, the findings of independent variables tend not to conflict with the expectations derived from the literature review in this study.

5. CONCLUSION

The basic idea of this paper was to capture the association between political influence and CEO duality and earnings management practices for industrial firms listed on the Amman Stock Exchange (ASE) for the fiscal year of 2013. The results showed that a significant positive relationship existed among political influence and CEO duality and earnings management practices. In addition, the findings pointed out that some Jordanian firms did not follow the regulations for Jordanian corporate governance. Therefore, this study suggests that policy makers should motivate firms to apply the principles of corporate governance via legislative action.

This study contributes to the literature of earnings management through documenting evidence that political influence and duality of the roles between CEO and chairperson help to increase earnings management practices. The present study suggests that future research should be conducted to examine the moderating role of an audit committee in limiting the negative effects of political influence on the management of earnings.

REFERENCES

1. Abed, S., Al-Badainah, J., & Serdaneh, J. A. (2012). The level of conservatism in accounting policies and its effect on earnings management. International Journal of Economics and Finance, 4(6), 78-85.
2. Ahmed, A. S., & Duellman, S. (2007). Accounting conservatism and board of director characteristics: An empirical analysis. Journal of Accounting and Economics, 43(2), 411-437.
3. Al-Sraheen, D. A. O. (2014). The relationship between corporate governance mechanisms and company attributes and accounting conservatism of Jordanian listed companies. (Doctoral thesis). Universiti Utara Malaysia, Sintok, Malaysia.
4. Anandarajan A., Hasan, I., & McCarthy, C. H. (2007). Use of loan loss provisions for capital, earnings management and signaling by Australian banks. Accounting and Finance, 47(3) 357-379.
5. Bergstresser, D., & Philippon, T. (2006). CEO incentives and earnings management. Journal of Financial Economics, 80(3), 511-529.
6. Brown, L.D. and Higgins, H.N. (2001). Managing earnings surprises in the US versus 12 other countries. Journal of Accounting and Public Policy, 20(4) 373–398.
7. Chaney, P. K., Faccio, M., & Parsley, D. (2010). The quality of accounting information in politically connected firms. Journal of Accounting and Economics. doi: 10.1016/j.jacceco.2010.07.03c
8. Coombes, P., & Wong, S. C. -Y. (2004). Chairman and CEO - One job or two? The McKinsey Quarterly, 2, 42-47. Retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=897485
9. Davidson III., W. N., Jiraporn, P., Kim, Y. S., & Nemec, C. (2004). Earnings management following duality-creating successions: Ethno statistics, impression management, and agency theory. The Academy of Management Journal, 47(2), 267-275.
10. Fan, J. P. H., Wong, T. J., & Zhang T. (2007). Politically connected CEOs, corporate governance, and post-IPO performance of China's newly partially privatized firms. Journal of Financial Economics, 84(2), 330-357.
11. Guay, W.R., Kothari, S. P., & Watts, R.L. (1996). A market-based evaluation of discretionary accruals models. Journal of Accounting Research, 34, 83-105. http://dx.doi.org/10.2307/2491427.
12. Healy, P., & Wahlen, J. (1999). A review of the earnings management literature and its implications for standard setting. Accounting Horizons, 13(14), 365-383.
13. Nugroho, B. Y., & Eko, U. (2012). Board characteristics and earning management. Bisnis & Birokrasi Journal, 18(1), 1-10.
14. Man, C. K., & Wong, B. (2013). Corporate governance and earnings management: A survey of literature. Journal of Applied Business Research (JABR), 29(2), 391-418.
15. Poczter, S. (2011). On the persistence of political and economic institutions in banking. http://abfer.org/Annual-Conference/2015/Conference-Slides/day-1/aut-on-the-persistence-of-political-and-economic-institutions-in-banking.pdf/
16. Radzi, S. N. J. M., Islam, M. A., & Ibrahim, S. (2011). Earning quality in public listed companies: A study on Malaysia exchange for securities dealing and automated quotation. International Journal of Economics and Finance, 3(2), 233-244.
17. Stocken, P.C. & Verrecchia, R.E. (2004). Financial reporting system choice and disclosure management. The Accounting Review, 79(4) 1181-1203.
18. Van Tendeloo, B., & Vanstraelen, A. (2005). Earnings management under German GAAP versus IFRS. European Accounting Review, 14(1), 155-180.