

# IMPACT OF INTERNAL OWNERSHIP ON THE MONITORING AND MITIGATING MECHANISMS OF EARNINGS MANAGEMENT PRACTICES

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## Abstract

This paper attempts to review on how the effectiveness of board of directors and the executive compensations are moderated by internal ownership such as managerial and family ownership to mitigate earnings management. Most of prior studies focused on the traditional interaction among corporate governance mechanisms and earnings management, thus neglected that the variance of these practices that can be attributed to the business environment and the nature of ownership structure. This paper revisits the literature on the relationship between the factors of effectiveness of the board of directors in the individual level such as board independence, size, meeting frequency, CEO duality, audit and nominations-compensations committees, directors financial expertise, tenures and multiple directorship etc. and as a bundle through creating a score of effectiveness on the earnings management practices. It also reviews on whether the managerial and family ownership can moderate the relationship between the factors of effectiveness of the board of directors (as a score) and the total executive compensation with the earnings management practices. Panel data analysis method will applied over the data collected for ASE for the Jordanian listed firms for the period after the issuing of the Jordanian corporate codes in 2009. This paper's contributes to the existing literature by providing an in-depth review of corporate governance mechanisms and earning management.

**Keywords:** Earnings Management, Corporate Governance, Board of Directors, the Competency of the Members, Executive Compensations, Internal Ownership

**JEL Classification:** G32, G34, M12, M41

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## 1. INTRODUCTION

Under the accounting system, earnings are considered as one of the most important outcomes for this system (Graham et al., 2005; Lara et al., 2012). It is extensively used in the decision-making process via the decision makers comprising of users of the financial statements, whether internal or external. The reported earnings are the fulcrum for the company in order to formulate corporate policies that correlate to increasing capital, executive compensation and debt covenants (Muchoki, 2013).

Therefore, the level of earnings quality would be doubtful when managers have financial and economic incentives to manage earnings aggressively, which is described as an opportunistic behaviour if that is done in order to meet the managers' interests. This ability comes from the flexibility of accounting principles and treatments that in turn provide extensive powers of discretion to managers in reporting earnings, principally with regard to accrual. This judgment might be exploited to generate features in order to influence decision making for financial statements users (Ronen & Yaari, 2008; Beneish et al., 2013).

Aggressive earnings management is one of the biggest problem that is faced by modern economy recently as this kind of financial fraud has no techniques that can be used to determine the

magnitudes for this practice. Be it aggressive or not, the idea of exploiting power itself is unacceptable. There is a common perception that the firms' managers used the opportunistic practice to maximize their own benefits instead of considering the benefits of the stockholders. Managers using the flexibility in the accounting standards and legislations in order to achieve their goals thereby create deformities in the earnings that have been reported (Jiraporn et al., 2008). Thus, many studies are adopted in the attempt to explain this practice and how to mitigate it via using the effective corporate governance mechanisms (Dibia & Onwuchekwa, 2014).

The significance of Anti-earnings management is believed to have many facets. So, it's considered as one of the aspects, which receives much attention in the agency theory. Prior studies have documented that earnings management can be avoided through applying laws and regulations properly such as the recommendation of corporate governance, which minimizes the agency conflict through limiting the opportunistic behaviors of managers (Ball & Shivakumar, 2005; Lin & Hwang, 2010). Moreover, the usefulness of corporate governance in the agency relationship eventually improves the usefulness of financial statements and also the value of the company through the ability of its characteristics to monitoring (Abed et al., 2012;

Ikechukwu, 2013). Also, its minimize the divergence gap by aligning the interest of contracting parties through appropriate executive compensations (Shiyab et al., 2013).

However, the creditability and reliability of financial statement become questionable after the global economic fallout for listed companies in financial markets, including ASE firms (Hamdan, 2012). Therefore, it is necessary to find solutions to restore the confidence of financial reporting and enhance its quality. This will led to the direct attention of the organizations, regulators, professionals and academicians to recommend procedures and reforms through optimizing the corporate governance mechanisms in an ideal manner, focusing on the accounting principles. This will in turn help controlling the contractual content of the contract such as executive compensation, and also, increase the external and internal audit quality (Chau & Gray, 2010; Chen et al., 2011; Abed et al., 2012; Hassan & Ahmed, 2012; Abed et al., 2014). For example, Enron's scandal happened as Downes and Russ (2005) reported because there were weaknesses in its corporate governance, which of it formed a lack of independence of the audit committee in the main.

In addition, previous studies showed that corporate governance mechanisms is an effective tool for mitigating and monitoring the managerial opportunistic behavior (Klein, 2002; Xie et al., 2003; Niu, 2006; Shah et al., 2009; Ngamchom, 2015); such as opportunistic earnings management. Many researchers recommended that the pressure in order to comply with the underlying mechanisms of corporate governance would provide significant discouragement for the company to be engaged in the manipulated earnings. Therefore, it may be argued that corporate governance is one of the ways to prevent earnings management, but its mere presence of this conviction is unlikely to be implemented. This is so since it is unable to completely restrict these practices depending on other affecting factors such as business environment, culture, firm size, company ownership structure, the performance of the company and the level of entry into force of the companies act in the business environment (Chahine & Tohmé, 2009; Desender, 2009). Also, the process of examining the effectiveness level of the corporate governance mechanisms separately from each other can be used as an explanation for weakness of these practices where the effectiveness of one of the mechanisms may rely on another mechanism (Ward et al., 2009).

Basically, the effectiveness of a certain mechanism may rely on the effectiveness level of other mechanisms (Rediker & Seth, 1995). Thus, the impact of these mechanisms should be complementary to each other; which means that the effectiveness of any factors or corporate governance as a whole may be carried out through dissimilar channels (Cai et al., 2015). According to Davis and Useem (2002) corporate governance mechanisms react in a reciprocal manner with each other for the formation of comprehensive effectiveness.

However, corporate governance plays an important role in mitigating opportunistic behaviours of managers, but until now there is no inclusive evidence. Despite the multiplicity of studies, the debate is still without stopping in the

midst of the varying results, which in turn suggests that there is no conclusive substantiation on the role of corporate governance (Gulzar & Wang, 2011; Mohamad et al., 2012). Furthermore, previous evidence showed that the quality of accounting information is not only affected by the inaccurate implementation of the accounting standards but also through a weakness of implementing the governing protection role for investors and the poorness in the governance system (Ball & Shivakumar, 2005). Thus, studying whether corporate governance mechanisms work to decrease the supply of earnings management practices in an emerging market, such as Jordan in an effective manner is potentially significant and interesting to regulators, investors, and academicians.

## 2. CORPORATE GOVERNANCE AND EARNINGS MANAGEMENT

Healy and Wahlen (1999, p. 368) mentioned that "Earnings management 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". However, Earnings management is considered as a concern and one of the most critical ethical situations, which accountants and others confront in everyday practices throughout the world (Ronen & Yaari, 2008). In all events, earnings management as a concept is difficult to define and measure. Apparently that there is no generally accepted definition since there is no consensus among researchers to determining a single and accurate definition of earnings management (Beneish, 2001). However, earnings management as a practice is attributed to the methods by which financial information is manipulated to provide a good impression of the firm's performance and financial position. This may involve using many accounting treatments that are considered as conservative or aggressive for its role in misleading the users of financial statements, where these treatments are not accommodated under the Generally Accepted Accounting Principles "GAAP" (Xiong, 2006; Goel, 2012).

Consequently, several corporate governance mechanisms can be used in order to monitor and mitigate the managerial opportunistic behaviours; therefore, minimizing the level of earnings management (Jensen & Meckling, 1976; Vafeas, 2005). For instance, the board of directors is one of the most important elements of the internal corporate governance mechanism. Consistent with Zahra and Pearce (1989); Xie et al. (2003); Benkel et al. (2006); Niu (2006); García Lara et al. (2007); Akhtaruddin and Haron (2010); Abed et al. (2012); Hassan and Ahmed (2012) the essential institution of the internal corporate governance in the company is the board of directors, which provides the business monitoring key that deals with agency problems. The agency theory expects that boards will enhance the honesty of the financial reporting through scrutinized management since corporate boards are accountable for scrutinizing management actions. Particularly those related to performance,

financial disclosure, and responsibilities delegated to sub-committees (Vafeas, 2000). Fama and Jensen (1983) stated that the board of directors will be able to reduce agency conflicts through using its power to scrutinize and control management based on the awareness that the managers may have personal preferences and these preferences may not always be in consistent with shareholders' expectations. Thus, the board of directors must be control them (Limpaphayom & Connelly, 2006; Nahandi et al., 2011).

Overall, the ability of the board of directors and its effectiveness in monitoring the managers can be improved through the enhancement of the board independence, board size, board frequency meeting, CEO non-duality, board committees and the competency of the board members that can be achieved through financial expertise, tenure, multiple directorships (Kiel & Nicholson, 2003; García Lara et al., 2007; Goh, 2009; Akhtaruddin & Haron, 2010; Hassan & Ahmed, 2012; Chen & Zhang, 2014; Ngamchom, 2015). Therefore, corporate governance structure depends on combining different characteristics to work effectively. This in turn will minimize the agency cost. Thus, it's better to handle with corporate governance mechanisms as a bundle (Rediker & Seth, 1995; Grosman & Wright, 2015). Especially there is a fluctuation in the evidence of prior studies for the monitoring role carried out by these factors, which contravene or consistent with the Agency Theory, for instance (Chtourou et al., 2001; Abdul Rahman & Ali, 2006; Sarkar et al., 2008; Gulzar & Wang, 2011; Kouki et al., 2011; Abed et al., 2012; Nugroho & Eko, 2012; Dibia & Onwuchekwa, 2014; Uwuigbe et al., 2014; Ngamchom, 2015).

Comparatively, Firms in ASE are still in infancy of the activation of corporate governance (Al-khabash & Al-Thuneibat, 2009; Al-Najjar, 2010; Bawaneh, 2011; Abed et al., 2012). In addition, the poorness in the controlling system is considered as the outcome of the weakness of corporate governance structures and the lack of clarity of the corporate schemes, objectives, and strategies. So, it will maximize the risks that may be faced by the investors and shareholders in the Jordanian market (Abdullatif & Al-Khadash, 2010).

Moreover, it should be mentioned that the company's institutional structure has a significant impact on the effectiveness of the board of directors as another expected reason for variance of evidence (Desender, 2009; Desender et al., 2013). In other words, power and responsibilities of the board and most of the factors that constitute its level of effectiveness depend on the company's institutional structure. The board of directors often follow the controlling shareholders (Young et al., 2008). Therefore, the ability of the board to monitoring managerial behaviours depend on the ownership structure of the firm because there is some type of interaction between them can explain the disparity of monitoring and effectiveness patterns (Desender et al., 2013). The board members may be chosen and appointed as legal fiction (Kosnik, 1987). Also, in corporate governance context, if the findings of prior studies are not consistent, Hill (1999) pointed out that the role of managerial ownership and family ownership should be taken into consideration to be examined.

In the Jordanian listed companies, family's ownership is concentrated in the financial and industrial sectors or the largest shareholder is the chairman (Al-Najjar, 2010). Families owned around 51% of the firms share outstanding in ASE (Jaafar & El Shawa, 2009). Thus, under these controlling ownerships, the board of directors may be affected by this control depending on the attitudes of the controllers. Grosman and Wright (2015) suggest that the effectiveness of the board of directors must be considered in the light of probabilities related to the nature of the firm's ownership structure. While, Whidbee (1997) pointed out that the composition of the board of directors reflects the nature of the firm's ownership structure. Therefore, the voting rights could be exploited by internal controllers when they have a significant equity stake in the companies, in order to appoint and dismiss the directors as they wish. Controlling shareholders trying to invest with lower equity and obtain most of the company interests through a cross-shareholding method and pyramid structure. Thus, creating divergence gap between controlling rights and cash-flow rights (Wu et al., 2016). In fact, managers did not suffer from job concerns when they have a significant proportion of equity thus the board of directors becomes susceptible to be compromised in firms under family or single insider control (Chen & Jaggi, 2001). The necessity of board monitoring becomes lower as a consequence of the ability of the shareholders to involved in managerial operations. Since, they can acquire the information that they need. Whilst it's, become very important for minority shareholders in this case because the majority shareholders and managers are the same persons which in turn increase the probability of exploiting their interests.

The agency conflict is more likely to be arising between inside and outside shareholders in firms with the insider control without holding substantial equity, while the outside shareholders are also dispersed to use their control rights (Berle & Means, 1932) cited in (Ayyagari et al., 2011, p. 2). Therefore, the nature of agency conflict can shift from traditional agency problem to central agency problem as a result of the controller shareholders engagement in management thus the majority expropriation the minority (Manzaneque et al., 2016). In developing countries the central agency problem could be more severe as a result of spread the business group of family or single insider control (Shleifer & Vishny, 1997; Ayyagari et al., 2011).

In firms that dominated by insiders either managerial or family, the effectiveness level of board of directors could be feeble and their monitoring role in managerial behaviour may be weaker (Chen & Jaggi, 2001; Mak & Li, 2001; Jaggi & Leung, 2007; Jaggi et al., 2009). For instance, external directors could be elected as who appear to be an independent but are in reality not independent in real meaning when the controlling shareholders dominate the inside operations and the board of the company in order to maintain their influence (Wu et al., 2016).

Jaggi et al. (2009) using a sample of 770 firm-year listed on the Hong Kong for the period between 1988-2000. Documented that the effectiveness of corporate boards in performing their monitoring

role has been moderated in firms that are controlled by families. In family-controlled firms the effectiveness of independent corporate boards in monitoring earnings management becomes lower. This means that the attempt to enhance the strength of the board's monitoring role through increasing the proportion of outside directors is unlikely to be efficient in family-owned firms. Li and Hung (2013) have shown that the managerial overconfidence in firms that are controlled by families becomes lower, which means that the positive relationship that arise between the managerial overconfidence and earnings management practices have been negatively moderated effects from the families' control. Moreover, Chen and Jaggi (2001) provided evidence that the effectiveness of the board of directors (Or as they referred to as the responsiveness) in firms with family ownership can possibly become weakened. Thus the weakness of the monitoring role can attributed to the presence family member in the board (Jaggi & Leung, 2007).

Furthermore, Shiyab et al. (2013) mentioned that the executive compensations is one of the best means to ensure the reliability of accounting information as one of the corporate governance mechanisms. Actually, executive compensations from the perspective of the agency theory ensures the harmonization between the interests of executive managers and those of the shareholders. Executive compensation received little attention in the developing countries' prior studies where most of the studies have been conducted in the U.S and U.K and other developed countries, which are characterized by presenting relatively similar institutional contexts (Gaver et al., 1995; Shrieves & Gao, 2002; Baker et al., 2003; Cheng & Warfield, 2005; Sun & Hovey, 2013; Hassen, 2014). In developing countries, markets commonly have dissimilar institutional settings, particular attention to corporate governance rehabilitation, ownership structures and executive compensation incentives. The relationship between executive pay and earnings management practices can prospectively be different from what has been noted in developed countries. Especially since Abed et al. (2014) found in their investigation that the results of CEO executive compensation in Jordanian firms are consistent with the various guidelines for the developing corporate governance codes that were issued recently in 2009.

On the other hand, it can be assumed that the internal control may affect the executive compensation level, where controlling shareholders have together the ability and the motivation to reduce costs of agency contracts (Jiang et al., 2009). In fact, for managers a low level of compensation could be accepted if enjoy a high level of job stability this arise when family and managerial control existed in the company (Amoako-Adu et al., 2011). However, the opposite may happen as a result of the attempt of the controlling shareholders to expropriate the minority interest through compensations (Crocini et al., 2012). Often the dominant family attempts to use its power to overpay their members as an executive (Basu et al., 2007). Managers with holding a small percentage of share of capital attempts to increase the percentage of compensations in order to align their interest with the outside owners interest but when the central agency problem existed the loopholes could

be exploited to transfer the minority interests to their own (Hassen et al., 2015). Basically, majority ownership with control could be an incentive to shareholders to manage the business according to their benefits where they will be able to access the information or prevent some of the information from reaching external ownership.

Tsao et al. (2015) documented that the family ownership structure has been treated as a moderator variable on the sensitivity of executive compensation in research and development investment. It is known that the firms can reduce the opportunistic managerial behavior regarding the exploitation of research and development investment through the sensitivity of executive compensation towards it. Thus, they documented that the sensitivity of executive compensation in the firms with family ownership is higher than firms without family ownership.

However, the central agency problem is more likely to exist especially that the Jordanian listed firms used upwardly earnings management (Al-Fayoumi et al., 2010). A gap of vulnerability arise as a result of this problem, thus, the majority of shareholders can exploit this gap to migrate the benefits of minority shareholders to their own benefit (Wang, 2006). Therefore, this study introduces the insider's ownership, namely managerial and family ownership as a moderator variable in the attempt to substantiate whether this perspective is accepted or not. The internal ownership structures have an effect on both relationships between the board of directors' effectiveness in monitoring the opportunistic behaviour on one hand, and the executive compensation on the other hand, with the earnings management.

In Jordan, a few studies were conducted to associate corporate governance with earnings management practices. This did not exceed about two studies, to the best of our knowledge, although there is evidence of earnings management practices in the developing countries and existence of the corporate governance practice in the developing markets (e.g. Abed et al., 2012; Al-Fayoumi et al., 2010). Therefore, this study provides an optimal arrangement of corporate governance and its mechanisms' roles in monitoring and reducing the earnings management based on the costs, benefits and explanation of these factors in accordance with developing countries like Jordan.

### 3. CONCLUSION

Even with the multiplicity of studies, to some extent, the researchers noted different evidence and results concerning the roles of corporate governance mechanisms and other factors in minimizing the earnings management practices. This is so as they reflect various experiences and expertise whether in the industrial or developing markets where there are vivid differentials in political, cultural, social and economic situations between countries. Therefore, the existence of the few studies that are likened to experimental investigations or surveys that have been implemented in the Jordanian environment may be referring to the inability and limitations of the studies that were applied. So, this study aim to provide more understanding for the applying

corporate governance in the developing countries, especially Arab region such as Jordan. In addition, most of previous studies of corporate governance often ignore the linkages between various mechanisms and disregard the complementary or substitutive effect of each other on firm outcomes. Thus, this study is subjected to exploring the accumulative impact of the board of directors' characteristics through create a score to determine the effectiveness of board complying with Jordanian corporate code. Furthermore, it will be examining the association for each of the board's characteristics individually with the earnings management practices in order to verify the level of following the regulations and instructions for corporate governance in the listed companies especially after the adoption of the Jordanian corporate codes in January, 2009.

Also, most of the prior studies don't take into consideration the specific institutional context of each company which could be another reason for the fluctuation in the effectiveness level of various corporate governance practices. As well as, prior studies incapable of explaining the relationship among variables through the explanation of correlations via the agency conflict between the majority and minority shareholders, and the agency problem between agents and principals at the same time. Consequently, shedding new light to reconsider the interpretation of variations in the previous studies that could attributable to the formation of the ownership structure through investigating the internal patterns of ownership structure as moderator variables that can influence the relationship between the board's effectiveness and the earnings management.

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