THE MODERATING EFFECTS OF THE INTERNAL OWNERSHIP ON THE RELATIONSHIP BETWEEN THE EFFECTIVENESS OF BOARD OF DIRECTORS AND EXECUTIVE COMPENSATION WITH EARNINGS MANAGEMENT IN THE AMMAN STOCK EXCHANGE

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LIST OF ABBREVIATION

ASE	Amman Stock Exchange
ADF	ADF-Fisher Chi-Square Test
Aggressive EM	The Aggressive Earnings Management
AIC	Association of Investment Companies in UK
AuCO_PR	Audit Committee Presence
AUD	Audit Firm
BDIND	Board Independence
BDMG	Board Meetings
BDSZ	Board Size
CBJ	Central Bank of Jordan
CCD	Jordanian Companies Control Department
CEO	Chief Executive Officer
CEODY	CEO Duality
CFO	Chief Financial Officer
CFOp	Cash Flow From Operation
CLERP	Corporate Law Economic Reform Program
CSRC	Chains Securities Regulatory Commission's
DAC	Discretionary Accruals
DFEx	Directors Financial Expertise
DTEn	Director Tenures
EM	Earnings Management
EX_COM	Executive Compensation
FAM_OW	Family Ownership
FIN_LEV	Financial Leverage
FISZ	Firm Size
FT	Number of Firms Traded
GAAP	General Accepted Accounting Principle
GCGF	Global Corporate Governance Forum
GLS	Generalized-last-squares
HS	Hold up Sample
IFC	International Finance Corporation

IFRS	International Financial Reporting Standers
IMF	International Monetary Fund
IPS	Im, Pesaran and Shin Test
JIC	Jordan Insurance Commission
JSC	Jordanian Securities Commission
LLC	Levin, Lin and Chu Test
MAN_OW	Managerial Ownership
MDs	Multiple Directorships
MIT	Ministry of Industry and Trade in Jordan
NCFFR	The National Commission Fraudulent Financial Reporting
NCionCO_PR	Nomination-Compensations Committee Presence
NDAC	Non- Discretionary Accruals
NSE	The Nairobi Securities Exchange
OECD	Organization for Economic Cooperation and Development
OLS	Ordinary-least-squares
PAC	Positive Accounting Theory
R&D	Research and Development
ROA	Return on Assets
Score_BDeF	Effectiveness Score Of Board Of Directors
SDC	Jordanian Securities Depository Center
SECty	Sector Type
SEO	Seasoned Equity Offerings
SMEs	Small And Medium-Sized Enterprises
TAC	Total Accruals
TOL	Tolerance Factors
VIF	Variance Inflation Factor

Kesan Penyederhanaan Pemilikan Dalaman Pada Hubungan Antara Keberkesanan Lembaga Pengarah Dan Pampasan Eksekutif Dengan Pengurusan Penrolehan Di Amman Bursa Saham

ABSTRAK

Matlamat utama kajian ini adalah untuk menentukan tahap amalan pengurusan perolehan (EM) dalam pasaran modal Jordan dan peranan keberkesanan tadbir urus korporat dalam mengurangkan amalan-amalan ini terutamanya selepas mengamalkan kod korporat Jordan pada tahun 2009. Oleh itu, kajian ini dilihat semula kesusasteraan pada hubungan antara faktor-faktor keberkesanan lembaga pengarah di peringkat individu dan mewujudkan nilai keberkesanan kepada sembilan lembaga pengarah faktor. Kajian ini turut meneroka bagaimana keberkesanan lembaga pengarah dan pampasan eksekutif adalah pemboleh ubah sederhana dari pemilikan dalaman "pemilikan pengurusan dan keluarga" ke pengurangan EM. Dalam istilah ini, empat teori membentuk teori asas kajian ini. Teori agensi, teori sumber daya bergantung dan teori perakaunan positif meramalkan bahawa amalan tadbir urus korporat akan memainkan peranan penting dalam meningkatkan pelaporan kewangan melalui peranan pemantauan, peranan ketergantungan sumber dan keupayaan untuk menggabungkan kepentingan pihak berkontrak. Walau bagaimanapun, teori institusi merujuk kepada kemungkinan bahawa amalan ini sebagai tiruan untuk "isomorfisme" pasaran dan tekanan sosial kemudian mencapai peraturan yang dikehendaki. Kebanyakan kajian lepas memberi tumpuan kepada interaksi tradisional antara mekanisme tadbir urus korporat dan EM, justeru, belum ada kajian melihat varians amalan-amalan ini yang boleh dikaitkan dengan EM dan jenis struktur pemilikan. Oleh itu, kajian ini memberi gambaran mengenai apakah masalah agensi pusat atau tradisional wujud. Lebih-lebih lagi, untuk mencapai objektif kajian ini Kothari et al. 2005 model digunakan sebagai proksi EM. Tiga model telah dibangunkan dan diuji untuk menjawab persoalan kajian. Model-model ini telah diuji menggunakan kaedah analisis data panel atas sampel 798 firma-pemerhatian yang dikumpul daripada syarikat bukan kewangan Jordan yang disenaraikan di ASE dari 2009 hingga 2015. Hasil model pertama (Random-kesan) menunjukkan setiap kebebasan lembaga, kekerapan mesyuarat, dualiti ketua pengawai eksekutif, jawatankuasa audit, tempoh pengarah dan pampasan eksekutif behubung kait secara ketara dengan amalan EM. Manakala, saiz lembaga, jawatankuasa pencalonan-pampasan, kepakaran pengarah kewangan dan beberapa kepengarahan didapati tidak signifikan dengan EM. Dari segi pembolehubah kawalan, hanya jenis sektor dan firma jenis audit didapati signifikan. Model kedua (tetap-kesan) menunjukkan hubungan yang signifikan antara keberkesanan lembaga pengarah (sebagai skor a) dan EM. Tambahan pula, model ketiga (regresi hierarki) menunjukkan kesan signifikan yang sederhana terhadap pemilikan keluarga berhubung kait antara keberkesanan lembaga pengarah dan jumlah pampasan eksekutif dengan EM. Manakala, pemilikan pengurusan menyederhanakan hubungan antara pampasan eksekutif dan EM dengan ketara. Selain itu, dapatan kajian menunjukkan bahawa tadbir urus korporat memainkan peranan penting dalam mengurangkan tingkah laku oportunis dan jurang perbezaan di bawah masalah agensi tradisional di mana ianya telah menjadi sebagai fiksyen undang-undang apabila masalah agensi pusat wujud.

The Moderating Effects of The Internal Ownership on The Relationship Between The Effectiveness of Board Of Directors and Executive Compensation with Earnings Management in The Amman Stock Exchange

ABSTRACT

The primary goal of this study is to determine the level of earnings management (EM) practices in Jordanian capital market and the effectiveness role of the corporate governance in mitigating these practices especially after adopting the Jordanian corporate code in 2009. Therefore, this study revisits the literature on the relationship between the factors of the effectiveness of the board of directors at the individual level and as a bundle through creating a score of effectiveness for nine board of directors factors. This study also investigates how the effectiveness of board of directors and the executive compensations are moderated by internal ownership "managerial and family ownership" to mitigate EM. In this term, four theories formed the theoretical foundation of this study. The agency theory, the resource dependence theory and the positive accounting theory predict that corporate governance practices would play an important role in improving the financial reporting through the monitoring role, resource dependence role and ability to combining the interest of the contractual parties. However, the institutional theory refers to the possibility that these practices can be as an imitation for the market "isomorphism" and social pressure then achieve the desired regulation. Most of the prior studies focused on the traditional interaction among corporate governance mechanisms and EM, thus, neglected the variance of these practices that can be attributed to the business environment and the nature of ownership structure. Consequently, this study sheds light on whether the central or traditional agency problem existed. Moreover, to achieve the objectives of this research Kothari et al. 2005 model is used as a proxy of EM. Three models were developed and tested to answer the research questions. These models were tested using the panel data analysis methods over a sample of 798 firm-observation collected from the Jordanian non-financial firms listed in the ASE during the period of 2009-2015. The findings of the first model (Random-effect) provides each of the board independence, meeting frequency, CEO duality, audit committee, directors tenures and the executive compensations significantly affect the EM practices. While, the board size, nominations-compensations committee, directors financial expertise and multiple directorships found to be not significantly related with EM. In terms of the control variables, only the sector type and the audit firm type are found to be significant. The second model (fixed-effect) shows a significant relationship between the effectiveness of the board of directors (as a score) and the EM practices. Furthermore, the third model (hierarchical regression) shows significant moderating effect of the family ownership on the relationships between the effectiveness of the board of directors and the total executive compensation with the EM practices. While, the managerial ownership significantly moderated the relationship between executive compensation and the EM practices. The findings indicate that the corporate governance plays a pivotal role in mitigating the opportunistic behaviors and minimizes the divergence gap under the traditional agency problem while it has become as legal fiction when the central agency problem existed.

CHAPTER 1

INTRODUCTION

1.0 Background of the Study

Earnings are one of the most important outcomes of a financial accounting system (Graham, Harvey, & Rajgopal, 2005; Lara, Juan, Garcia Osma, & Penalva, 2012). Earnings are extensively used in the decision-making process by decision makers comprising users of financial statements, whether internal or external. Reported earnings act as the fulcrum for the formulation of corporate policies that correspond to increasing capital, executive compensation, and debt covenants (Muchoki, 2013). Meanwhile, they provide a predictive and feedback value to the setters of accounting standards regarding the effectiveness of accounting standards and currently used treatments. This provision eventually affects economic growth and sustainable development (Schipper & Vincent, 2003; Kieso, Weygandt, & Warfield, 2010).

Therefore, the level of earnings quality becomes doubtful when managers have financial and economic incentives to manage earnings aggressively “described as an opportunistic behavior if done to serve the managers’ interests” (Healy & Wahlen, 1999; Rahman, Moniruzzaman, & Sharif, 2013). This ability arises from accounting practices and treatments that provide extensive powers of discretion to managers in reporting earnings, particularly with regard to accrual. This judgment might be exploited to generate features to influence the decision making of financial statement users (Ronen & Yaari, 2008; Beneish, Capkun, & Fridson, 2013). Moreover, the separation between ownership and control provides managers additional advantages for greater control compared with external information users. Such advantages encourage managers to control earnings opportunistically by exploiting the flexibility of accounting principles and treatments in accordance with their interests (Krishnan, Raman, Yang, & Yu, 2011; Habib, Bhuiyan, & Islam, 2013).

Academicians, practitioners, and regulators consider earnings management one of the most controversial accounting issues (Dechow & Skinner, 2000; Dechow, Hutton, Kim, & Sloan, 2012). Earnings management leads to distortion of the real financial performance of a company and creates different visions of reality. These visions influence the expectations of financial statement users by making the future financial performance of a company excessively optimistic (Krishnan et al., 2011). The escalating seriousness of earnings management logically stems from the uncomplicated functions that accounting earnings could play for a wide range of users (Ronen & Yaari, 2008). This condition guided several researchers to adopt positive accounting theory to explain the current state of accounting and the present behavior of accountants (Scott, 2009). The condition also explains the effects of these issues on the people and the optimal exploitation of resources (Jensen & Meckling, 1976).

Even in the late 1990s, most studies focused on revealing the irregularity of “abnormal accruals” in determining the aggregate accruals of firms (Dechow et al., 2012). Other studies focused on the inherent motivation to manage these accruals through firm managers prior to devoting greater attention to the constraints of managing earnings and the consequences and ramifications of these constraints (Healy & Wahlen, 1999). Generally, earnings management has been investigated as an unstructured form of databases (as a random sample or with the entire market) to identify correlations between different related proxies or factors and earnings management (i.e., Klein, 2000; Klein, 2002; Phillips, Pincus, & Rego, 2003; Park & Shin, 2004; Osma & Noguer, 2007; Lin & Hwang, 2010; Abed, Al-Attar, & Suwaidan, 2012).

Many alternative treatments under accounting standards have been adopted for similar situations (such as that in the conservatism concept and/or revenue and expense recognition). These treatments have been used in many situations where accountants encounter different measurements. Thus, firm managers could exploit the flexibility of accounting principles and standards in an opportunistic manner (Gibson, 2009; Onalo, Mohd, & Ahmad, 2014). Several treatments could be directed to affect the current period by undervaluing net assets. This scenario causes future earnings to be overstated as a result of the underestimation of future expenses.

The significance of anti-earnings management is believed to be multifaceted. Thus, anti-earnings management has received much attention in agency theory (Abdul-Rahman & Ali, 2006; Ikechukwu, 2013; Islam, 2014). Prior studies have documented that earnings management can be avoided through proper implementation of laws and regulations, such as the recommendation of corporate governance, which minimizes agency conflict by regulating 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 the value of the company through its monitoring ability (Abed et al., 2012; Ikechukwu, 2013). Likewise, corporate governance minimizes the divergence gap by aligning the interests of contracting parties through appropriate executive compensations (Shiyyab, Girardone, & Zakaria, 2013).

Previous studies have shown that corporate governance mechanism is an effective tool for constraining and monitoring managerial opportunistic behaviors, such as opportunistic earnings management (Klein, 2002; Xie, Davidson, & DaDalt, 2003; Niu, 2006; Shah, Butt, & Hassan, 2009; Ngamchom, 2015). Many researchers have indicated that the pressure to comply with the underlying mechanisms of corporate governance discourages companies to engage in manipulated earnings (i.e., Klein, 2000; Klein, 2002; Phillips et al., 2003; Park & Shin, 2004; Osma & Noguer, 2007; Lin & Hwang, 2010; Abed et al., 2012).

Therefore, corporate governance is one of the means to prevent earnings management. However, mere presence of this conviction is unlikely to lead to implementation because it is unable to completely restrict such practices depending on other factors, such as the business environment, culture, firm size, company ownership structure, company performance, and level of entry into the force of the companies, acting in the business environment (Chahine & Tohmé, 2009; Desender, 2009). Examining the effectiveness of these corporate governance mechanisms separately can explain the weakness of such practices, in which the effectiveness of one mechanism relies on that of another mechanism (Ward, Brown, & Rodriguez, 2009).

Notably, the corporate governance concept has been considered after the financial scandals in the global market that have attributed to the collapse of a number of major companies (Chen & Zhang, 2014). These financial scandals such collapse of the HealthSouth Corporation in 2003; Bristol-Myers Squibb in 2002; Enron in 2001 and WorldCom in 1990 in the US; One-Tel in 1995; HIH in 2001 and Harris Scarfe in 2001 in Australia; Parmalat in 2003 in Italy and Lernout & Hauspie in 2000 in Belgium; the global business in 2002 in Jordan. Therefore, many regulators and academicians have focused on improving earnings quality through accounting quality and corporate governance (Uwuigbe, Peter, & Oyeniyi, 2014). Evidence on the principal causes of these collapses point to earnings management and the weakness of corporate governance (Downes & Russ, 2005). For example, Downes and Russ (2005) reported that Enron's scandal transpired as a result of weaknesses in the company's corporate governance, mainly the lack of independence of the audit committee. Another reason is the continuous use of inappropriate and unsystematic earnings management practices for long periods (Ronen & Yaari, 2008).

Amid these repercussions, various organizational changes have occurred worldwide to enhance the corporate governance practice. Examples include the Sarbanes–Oxley Act (Sox) 2002 in the US and the Corporate Law Economic Reform Program Act (CLERP9) 2004, both of which necessitate audit reform and corporate disclosure (Cottrell, 2009). In 2004, corporate governance practices in Jordan were evaluated by the World Bank and the International Monetary Fund (IMF). The report revealed several impairments in the Jordanian corporate governance framework and showed the comparatively immature stage of implementation of corporate governance. This was a major reason for the emergence of new corporate governance codes for Jordanian listed companies in 2009 (JSC, 2009b; Al-Najjar, 2010).

Principally, the conflict of interest between shareholders and managers can be resolved through several corporate governance mechanisms, thus minimizing the level of earnings management (Jensen & Meckling, 1976; Fama & Jensen, 1983; Vafeas, 2005). However, no conclusive evidence exists at present to show that corporate governance mitigates the opportunistic behaviors of managers. Despite the multiplicity of studies, the debate continues amid varying results, suggesting that the role of corporate governance is unsupported (Gulzar & Wang, 2011; Mohamad, Rashid, & Shawtari, 2012). Furthermore, previous evidence has shown that the quality of accounting information is affected by the inaccurate implementation of accounting standards, weak implementation of the governing protection role of investors, and inadequacy of the governance system (Ball & Shivakumar, 2005). Thus, studying whether corporate governance mechanisms can effectively decrease earnings management practices in an emerging market (e.g., Jordan) is potentially significant and interesting to regulators, investors, and academicians.

1.1 Research Problem

The creditability and reliability of financial statements became questionable after the global economic fallout of listed companies in financial markets, including the firms in the Amman Stock Exchange (ASE) (Hamdan, 2012). Therefore, solutions must be obtained to restore the confidence in financial reporting and enhance its quality. This situation will lead to the direct attention of organizations, regulators, professionals, and academicians on recommending procedures and reforms by ideally optimizing corporate governance mechanisms, with focus on accounting principles. In turn, such optimization would help control the contractual content of contracts, such as executive compensation, and increase the external and internal audit quality (Chau & Gray, 2010; Chen, Chen, Lobo, & Wang, 2011; Abed et al., 2012; Hassan & Ahmed, 2012; Abed, Suwaidan, & Slimani, 2014).

The financial information obtained from company annual reports that represent the company earnings affect the financial statement users decisions and views (i.e. investors, creditors, regulators and many others), because it’s a powerful indicators for the activities of the firm in the added-value business (Ronen & Yaari, 2008). In fact, managers used their personal judgments depending on the discretion power inherent in applying and interpreting many of the accounting principles and treatments. Thus, the opportunistic behaviors for managing accounting earnings would arise through different techniques such as the cookie jar reserve, accelerating revenue recognition, big bath charges, discretion on the accounting estimates and accounting choices, flushing investment portfolio and big bet in future (Rahman et al., 2013).

Earnings management considers as deliberate management practices followed for the preparation and presentation of the annual reports in accordance with the flexibility inherent in the Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standers (IFRS). These are intended to influence the firm's income on the short run, either upwards or downwards income, to achieve specific objectives according to informational implications, such as financial analyst expectations and the economic consequences, whether in the attempt to increase the managers or the majority shareholders interests "i.e., who are internal" (Healy & Wahlen, 1999; Schipper & Vincent, 2003; Roychowdhury, 2006; Xiong, 2006; Ronen & Yaari, 2008; Goel, 2012). In other words, these practices are used intentionally to manipulate earnings of the current period to achieve the predetermined goals of the firm management (Kuang, 2008; Rahman et al., 2013). Earnings management practices considered as an opportunistic behaviors followed to transfer the wealth to managers or the majority shareholders. However, these practices arise as a result of complying with accounting choices, violating or lack of the accounting choices as a type of earnings manipulation and fraud (Watts & Zimmerman, 1990; Healy & Wahlen, 1999; Dechow & Skinner, 2000; Yaping, 2005). Therefore, earnings management practices would be in the form of structuring the firm transaction of revenues and expenses, changing in accounting choices and estimation, obscuring the actual economic performance "accruals management" or violating and changing in accounting principles "fraudulent accounting". The motivations behind the earnings management practices is not easy to be determined but no doubt that there is a victim of such practices (Yaping, 2005). Firms management in most of the cases attempts to manipulate earnings in the ways that reflect on the economic performance in their firms which in turn will misled financial