
The Relationship between Ownership Structure and External Audit towards Accruals Earning Management among Palestine Listed Companies

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Abstract: The report from prior study predicted in developed markets such as the European Union and the United States of America revealed mixed result on ownership structure and accrual earnings management. Thus, institutional settings such as ownership concentration, managerial ownership, institutional ownership, and external audit and regulatory oversight bodies differ around the world. Accordingly, the sustainability of agency theory predictions might also differ. Therefore, this study examines the influence of ownership structure and external audit and accruals earning management on improving align interests of managers with shareholders. Furthermore, the study explains the importance of external audit as a function that lends credibility to the information disclosed in financial reports in Palestine exchange (PEX). These models were tested using the Palestinian Company listed data on the PSE during the period 2008 to 2011. The results show that dominant shareholders are effective in reducing the manipulation of entitlements, manipulating sales, and manipulating production costs. As for the manipulation of estimated expenditures, the results indicate that only high levels of institutional ownership could effectively deter abnormal discretionary expenditures. Companies that prevent them from managing their profits through entitlements do not exercise reporting ethics due to enhanced scrutiny of the five non-adult auditors, manipulating sales, manipulating production costs or manipulating estimated costs as an alternative to achieving the required levels of reported profits. The study provides understanding and extension for agency theory literature focused on earnings management. It highlights challenges to applicability of agency theory in emerging markets where corporate governance mechanisms are supposed to mitigate the practice of earnings management. However, these findings will be helpful to investors and other stakeholders in making rational contractual decisions. Furthermore, the Palestine Exchange can impose the corporate governance codes to promote internal corporate governance mechanisms to restrain accruals and real activities in companies.

Keywords: Accruals Earning Management, Ownership Concentration, Managerial Ownership, Institutional Ownership, External Audit, and Palestine exchange

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I. Background of Study

For more than two decades, the increase and growth of the knowledge-intensive economy have established significant interest as far as the role of Earnings Management (EM) in organizations is concerned. Against this backdrop, Earnings Management (EM) and value creating process are identified as fundamental equipment for organizations to maintain their competitive advantage and keep adding accountants, tax experts, internal and external auditors and other users of financial statements to accrue appropriate knowledge and understanding of the concepts of Earnings Management (EM).

Be that as it may, such knowledge gives a better understanding of the real importance of net income of an organization, since it has to do with reporting to companies' shareholders and investors generally and for contracting. Net income serves as one major factor that brings a decrease in the risk, which usually is imposed on the manager in every financial statement.

Earnings Management (EM) in accounting literature has constituted a significant area of concern for academic researchers. Earning management, according to Bhasin (2016), is a deliberate intervention amidst an external financial report process to acquire some specific gain. In the extant literature, the concept is defined in several methods by different scholars and from different perspectives. Moreover, the common characteristic in all the definitions established is that profit management is associated to the application of discretionary or subjective financial reporting in order to change the organization's income or profits for predefining management objectives, analysts' expectations, or even a more sustainable profit pattern in order to achieve some exceptional gains. The literature on firm accruals earning management determinants in emerging markets

is somewhat limited, as discovered in most of the empirical studies conducted in the USA and other developed nations, which also includes the role of corporate governance performance in Palestinian firms.

Zureigat (2014), observed that some scholars argued that the economic instability in Palestine is enormously due to the absence of application of corporate governance appropriately. Indeed, the World Bank and the International Monetary Fund (IMF) (2004), have collectively evaluated the status of corporate governance in Palestine and concluded that corporate governance of Palestine companies remains at a relatively immature stage.

Abdullatif and Al-Khadash (2010), Ajeela and Hamdan (2011), and Bawaneh (2011), have also observed that the liquidation of firms could be attributed among other factors to the weak corporate governance practices. However, structural reforms which include the introduction of effective corporate governance mechanisms as well as the emphasis on quality of the audit, have been recommended to solve the problem (Hamdan, 2012a). Hence, Palestine provides a good account for the study of corporate governance mechanisms, such as ownership concentration, managerial ownership, institutional ownership, and external audit, and for assessing the effectiveness of the mechanisms on accruals earning management, thereby contributing to the existing literature.

Furthermore, on ownership concentration and managerial ownership, Al-fayoumi, Abuzayed and Alexander (2010), opines that a high proportion of shares in Palestine firms are owned by managers, raising the concern of the protection of investors' rights due to agency problems. Also, buttressing this fact, Isik, Gunduz, and Omran (2005) observed that the external audit in Palestine is negatively associated with efficiency, which implies that the closely-held and family-owned businesses do not have efficient structures. Equally, Zureigat (2011) reported that many firms in Palestine are family-owned companies; thus, these families may consider a family related factor in appointing an auditor which could have a hazard impact on the accruals earning management.

The monitoring role of managerial ownership in companies in Palestine also depicted as weak, limiting accruals earnings management might induce more costly real activities earnings management (Zang, 2012). However, this influence managers to implement real activities earnings management in substitute for the reduction in accruals earnings management (Filip, & Raffournier, 2014; García-Meca, et al., 2015; Kazemian & Sanusi, 2015; Rathke, et al., 2015; Habbash, et al., 2014; Grove, et al., 2014; Abbad, et al., 2016).

In the light of this, corporate governance embedded in Palestine firm as a refurbished effort to establish more attractive investment environment and protect investors interests (Farooq, & AbdelBari, 2015; Arsov, & Naumoski, 2016; Hamza, & Bannouri, 2015). For instance, empirical evidence leads to an enhanced corporate governance structure in Palestine, which can help the capital market to obliterate hardship in convincing investors that their investments are managed responsibly.

Though, in the US, earnings management research is typically established (Bhasin, 2016; Commerford et al., 2018; Miko, & Kamardin, 2015; García-Meca et al., 2015). Thus, there is a little body of research that have been conducted and investigated on the impact of corporate governance monitoring mechanisms on accruals earnings management in the markets. Therefore, there is a motivation to empirically and critically examine these relationships in Palestine. Based on previous studies and findings, the current study put forth a research framework which examines the relationship between managerial ownership, ownership concentration, institutional ownership, and external audit with accruals earning management in Palestinian exchange (PEX).

Significance of the Study

This study investigates accruals-based earning management and real activities-based. Also, this study examines if earning management methods are used to surrogate or complement research in this specific area as it is rare, specifically in Palestine Exchange (PEX). More so, the examination of real earning management determinants together with accruals-based earning management contributes to literature since many studies in earning management concentrates on the latter. Owing to the fact that studies which investigate the causes of earning management behavior focus on organizational level factors. However, studies about the factors which influence the choice of a specific type of earning management method, whether it is opportunistic or efficient remains underdeveloped.

Objectives Of Study

In line with the research questions posed, this study's main objective is to examine the relationship of affecting variables on earnings management. To answer the set questions; this study attempts to achieve these objectives:

- a) To identify the relationship between the ownership concentration and accruals earning management in Palestine Exchange (PEX).
- b) To examine the relationship between the managerial ownership and accruals earning management in Palestine Exchange (PEX).

- c) To examine the relationship between the institutional ownership and accruals earning management in Palestine Exchange (PEX).
- d) To identify the relationship between the external audit and accruals earning management in Palestine Exchange (PEX).

Study Hypotheses

In this study, based on the literature reviewed, researchers can examine the relationships between earnings management and ownership structure mechanisms. However, it should have a constraining effect. The external audit should also have a similar effect on accruals and an ambiguous, if any, on real activity earnings management. To examine these relationships, five hypotheses are designed for each type of manipulation, which results in twenty sub-hypotheses formulated in correspondence with the number of dependent and independent variables. That is, the relationship between ownership concentration, managerial ownership, institutional ownership, foreign ownership, and auditor size is examined with each of abnormal accruals, abnormal cash flow from operating activities, abnormal production costs and abnormal discretionary expenses.

Ownership Concentration on Earnings Management

Despite both views being sound and accurate, there should be a significant association between ownership concentration and earnings management. However, no prediction for the coefficient sign of ownership concentration made. Consequently, with previous studies, the following sub-hypothesis of this research proposes:

H1a: There is a significant relationship between ownership concentration and abnormal accruals.

H2a: There is a positive relationship between levels of ownership concentration and abnormal cash flow from operations.

H3a: There is a negative relationship between levels of ownership concentration and abnormal production costs.

H4a: There is a negative relationship between levels of ownership concentration and abnormal discretionary expenses.

The relationship of Managerial Ownership on Earnings Management

Due to the inconclusiveness of evidence and data limitation, the predicted relationship between the controlling shareholder (i.e. managerial ownership) and earnings management in Palestine will be drawn from the theoretical perspective of the agency theory and the from empirical evidence that supports the incentive alignment effect. Therefore, the following sub-hypotheses posit,:

H1b: There is a negative relationship between managerial ownership and abnormal accruals.

H2b: There is a negative relationship between managerial ownership and abnormal cash flow from operations.

H3b: There is a negative relationship between managerial ownership and abnormal production costs.

H4b: There is a negative relationship between managerial ownership and abnormal discretionary expenses.

Institutional Ownership

This finding reveals that institutional investors serve as an effective corporate governance mechanism. However, the results of Al-Fayoumi, Abuzayed, and Alexander (2010) reveals no relationship between levels of institutional ownership and discretionary accruals in Palestine. However, because this research differs from Al-Fayoumi et al.'s (2010) in terms of the period of study and discretionary accruals estimation model, it is expected to find a negative relationship between discretionary accruals and institutional investors in Palestine. On the premise that institutional investors are defined as the percentage of shares owned by institutions, the following sub-hypothesis states:

H1c: There is a negative relationship between institutional ownership and abnormal accruals.

H2c: There is a positive relationship between institutional ownership and abnormal cash flow from operations.

H3c: There is a positive relationship between institutional ownership and abnormal production costs.

H4c: There is a negative relationship between institutional ownership and abnormal discretionary expenses.

Foreign Ownership

The fact that the findings of abovementioned studies provide limited indications, both views are still sound, and there should be a significant association between foreign ownership and earnings management. However, no prediction for the coefficient sign of foreign investors can be made. Accordingly, the following sub-hypotheses propose:

H1d: There is a significant relationship between foreign ownership and abnormal accruals.

H2d: There is a significant relationship between foreign ownership and abnormal cash flow from operations.

H3d: There is a significant relationship between foreign ownership and abnormal production costs.

H4d: There is a significant relationship between foreign ownership and abnormal discretionary expenses.

External Audit Hypotheses

The outcome of these studies provide confirmatory evidence supportive of large audit firms constraining discretionary accruals more than smaller audit firms. In other words, the results reveal that clients of big auditors report lower levels of discretionary accruals than those of non-big auditors. Hence, following previous research, the following sub-hypothesis states,

H1e: There is a negative relationship between abnormal accruals and the biggest 5 audit firms.

H2e: There is a positive relationship between abnormal cash flow from operation and the biggest 5 audit firms.

H3e: There is a positive relationship between abnormal production costs and the biggest 5 audit firms.

H4e: There is no relationship between abnormal discretionary expenses and the biggest 5 audit firms.

II. Methodology

Population and sample of the study

The study population comprises of all Companies highlighted on the Palestine Stock Exchange (PEX) for the fiscal year from 2008 to 2011. Information about these companies was collected from the companies' annual reports for the year 2012 and from the Jordanian Shareholding Companies Guide for the year 2013 issued by the Palestine Stock Exchange and that the following conditions are available:

-End of its fiscal year on 31/12.

-The annual financial report of the company available for the year 2008 to 2011.

Session of 19/08/2018					
Market	CLOSED				
Al-Quds Index	541.71(▲ 0.03%)				
Value (\$)	539,945				
Volume	691,654				
Trades	128				
Listed Securities	48				
Up	4	Down	5	UnChanged	5

III. Analysis results

While earnings management proxies are regarded in absolute terms in the main analysis, these proxies mattered with their actual signs. Within each analysis, descriptive statistics are discussed, and univariate analyses are conducted and discussed. Afterward, multiple regression analyses are conducted to test the research hypotheses. Thereafter, results derived are then presented, and interpretations are drawn. Finally, theoretical and practical implications for the association between earnings management practices and ownership structure and external audit mechanisms are demonstrated.

IV. Conclusion

Primarily, this study examines the influence of ownership structure and external audit and accruals earning management on improving align interests of managers with shareholders in Palestine Exchange (PEX). Accordingly, the four research objectives of this study are as follows: (1) To identify the relationship between the ownership concentration and accruals earning management in Palestine Exchange (PEX). (2) To examine the relationship between the managerial ownership and accruals earning management in Palestine Exchange (PEX). (3) To examine the relationship between the institutional ownership and accruals earning management in Palestine Exchange (PEX). (4) To identify the relationship between the external audit and accruals earning management in Palestine Exchange (PEX). In order to achieve these objectives, data were collected from annual reports of the listed companies on the PEX.

Hypotheses Tests on Relationships Between Earnings Management Proxies and Both Ownership Structure and External Audit

No.	Hypothesis	Predicted Sign	Actual Sign	Result
H1a	Ownership concentration and abnormal accruals	?	+	NS
H1b	Managerial ownership and abnormal accruals	-	-	Sig
H1c	Institutional ownership and abnormal accruals	-	-	NS
H1d	Foreign ownership and abnormal accruals	?	-	NS
H1e	Abnormal accruals and the big 5 auditors in Palestine	-	+	Sig
H2a	Ownership concentration and abnormal operating cash flow	+	+	Sig
H2b	Managerial ownership and abnormal operating cash flow	-	-	Sig
H2c	Institutional ownership and abnormal operating cash flow	+	-	NS
H2d	Foreign ownership and abnormal operating cash flow	?	-	NS
H2e	Abnormal operating cash flow and the big 5 auditors in Palestine	+	-	NS
H3a	Ownership concentration and abnormal production costs	-	-	NS
H3b	Managerial ownership and abnormal production costs	-	-	Sig
H3c	Institutional ownership and abnormal production costs	+	+	NS
H3d	Foreign ownership and abnormal production costs	?	-	NS
H3e	Abnormal production costs and the big 5 auditors in Palestine	+	-	NS
H4a	Ownership concentration and abnormal discretionary exp.	-	-	NS
H4b	Managerial ownership and abnormal discretionary exp.	-	+	NS
H4c	Institutional ownership and abnormal discretionary exp.	-	-	Sig
H4d	Foreign ownership and abnormal discretionary expenses	?	-	NS
H4e	Abnormal discretionary exp. and the big 5 auditors in Palestine	No relation	-	NS

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