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BOARD OF DIRECTORS AND EARNINGS MANAGEMENT AMONG JORDANIAN LISTED COMPANIES: PROPOSING CONCEPTUAL FRAMEWORK

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Abstract — **Recently, high profile scandals and financial crises in the United States, Europe and East Asia, have brought corporate governance issues to the forefront in developing countries, emerging markets and transitional economies. These scandals shake the integrity of accounting information and resulted in a drop in investor confidence. This has made companies need to achieve significant progress to the corporate governance perform in order to recuperate the investors' confidence of financial reporting quality. To achieve that, this paper proposes a conceptual framework to investigate the relationship between board characteristics (Board independence, size, CEO duality, meetings, and financial expertise) and earning management among industrial companies listed on the Amman Stock Exchange (ASE). Evidence from prior studies suggested that boards of directors are an important part of the firm's structure and responsible for monitoring the quality of the information contained in financial reports. It is argued that effective board can reduce earnings management.**

Keywords— Board of directors, earnings management, Jordan.

1. Introduction

Concerns about corporate governance in many emerging markets emerged as a result of a series of recent corporate accounting scandals across the United States, Europe and East Asian (e.g. Enron, HealthSouth, Parmalat, Tyco, WorldCom, and Xerox). A central part of these accounting scandals was usually the phenomenon of earnings management [41]. Studies on earnings management (Thereafter, EM) are becoming the subject of many recent researches in financial economics. Moreover, it has been a great and consistent concern among practitioners and regulators and has received substantial consideration in the accounting literature [4].

The nature of accrual accounting according to FASB (1985) that "attempts to record the financial effects on an entity of transactions and other events and circumstances that have cash consequences for the entity in the periods in which those transactions, events, and consequences occur rather than only in the period in which cash is received or paid by the entity." This gives managers a significant amount of discretion in determining the actual earnings a firm reports in any given period [4, 49]. Therefore, [44, p. 6] define earnings management as occurring:

"When managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholder about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers".

Financial statements provide value-relevant information to the external and internal parties of the organization. Additionally, market efficiency is based upon the information flow to capital markets. When the information is incorrect, it may not be possible for the markets to value securities correctly. Hence, earnings management may obscure real performance and lessen the ability of shareholders and investors to make informed decisions. Moreover, the recent collapse of some large companies resulting partially from accounting manipulation has raised serious questions about the role of different monitoring devices presumed to protect investors' interests and control managerial opportunistic behavior. One of the most important of these devices is board of directors. In fact, the board of directors is an important internal control mechanism designed to monitor the actions of top management and monitoring the quality of the information contained in financial reports.

This paper proposes a conceptual framework to investigate the relationship between board characteristics (board independence, size, CEO duality, meetings, and financial expertise) and earning management among industrial companies listed on Amman Stock Exchange (ASE). The remainder of the paper is organized as follows: Introduces the background of the study in section 2. Literatures review in section 3, the conceptual framework and hypothesis development presented in section 4. Summaries and concludes this paper in section 5.

2. Background

Jordan is a developing Arab country with a centralized state system. It is very attractive for foreign investments, due too many reasons such as safety, political stability and its central location in the Middle East despite the on-going conflicts in the Middle East region. It seeks for afford a safe environment for its listed securities at the same time as protecting the rights of the investors. In view of the fact that, Jordan is one of the countries where users depend on accounting numbers intended for making decisions, it is of enormous significance to consider the area under discussion of EM to protect those users from being misled. Also, by reason of the lack of studies about EM in Jordan, So, this study intends to investigate the role of the board of directors in constraining earnings management.

3. Literature Review

According to agency theory, separation of ownership and control leads to a divergence of interests between managers and shareholders [48], and thus monitoring managerial decisions becomes essential for boards of directors to assure that shareholders' interests are protected [36] and to ensure reliable and complete financial reporting. The role of the board of directors is to monitor and discipline a firm's management, thereby ensuring that managers pursue the interests of

shareholders [48]. Hence, the board of directors plays an important oversight role in controlling the quality and reliability of financial reporting [9, 29, and 23]. Moreover, one of the major responsibilities of the board of directors is to ensure that shareholders and other stakeholders are provided with high quality disclosures on the financial and operating results of the entity that the board of directors has been entrusted with governing [78]. Board monitoring of the financial reports is important because managers often have self-interested incentives to manage earnings, potentially misleading shareholders.

Based on previous literature, Earnings management can be seen as a potential agency cost since managers manipulate earnings to mislead shareholders and fulfill their own interests. Therefore, the board of directors should play an important role in constraining the level of earnings management. Furthermore, prior similar researches suggest that effective board monitoring helps to maintain the credibility of financial reports. Thus it is reasonable to hypothesize that an effective board of directors will help to limit the earnings management. Several studies [e.g. 9, 52, 7, and 72] have provided evidence regarding the importance of the role of the board of directors in monitoring financial reporting, and therefore mitigating the manipulation of accounting information.

The role of the board of directors is paramount in Jordanian corporate governance. In the following section, board characteristics, such as board independence, size, CEO duality, meetings and financial expertise that may be applicable in the Jordanian institutional background, are discussed for their impact on earnings management in literature review.

4. The Conceptual Framework and Hypothesis Development

The characteristics of board of directors and their relation with EM are integrated in one conceptual framework. Figure (1) explains the propose framework. In this conceptual framework, board characteristics and EM are independent and dependent variables respectively. The current study thus attempts to bridge the gap by providing a basis for discerning the impact of board characteristics on EM. Sections 4.1 till 4.5 will discuss the hypotheses that are developed from the conceptual framework.

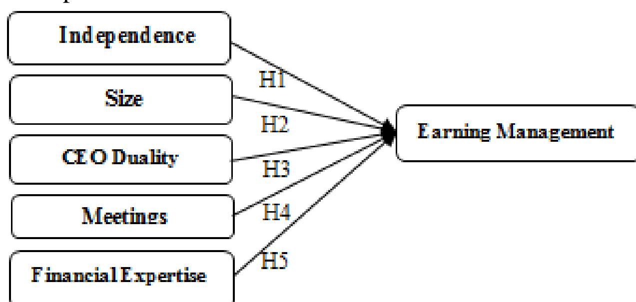

Figure (1) Board of Directors and Earnings Management

4.1 Board Independence

Previous studies have supported the notion that the independence of directors would reduce the likelihood of financial statement fraud [9, 73], and constrain earnings management [52, 84, 27, 65, 32]. Both [52] for the U.S. and [65] for the U.K. find that independent directors play an important role in constraining earnings manipulation by using data from 1991 to 1993 from a sample of 687 U.S. firms and a sample of 1,271 firms for fiscal year 1993 to 1995 in UK, respectively.

Existing research shows that a negative association between board independence and earnings management [84, 61, 31, 67, and 82]. [84] find evidence between board independence and the extent of earnings management by using a small sample of 110 US firms, they indicate there is negative relationship. Moreover, based on a sample of Canadian firms [61] find that the level of independence of board composition is negatively associated with the level of abnormal accruals.

Most recently, [31] who investigate the impact of board independence on earnings management using a sample of 97 non-financial firms listed on the Athens Stock Exchange in Greece for the years 2000 through 2004, show that board independence is negatively associated with earnings management practices. Additionally, [67] find that presence of independent directors in the board of directors may significantly restrict of earnings management. The study takes a sample of 200 large manufacturing firms listed on National Stock Exchange in India for a period of three years. Likewise, [82] investigate the influence of corporate governance and firm specific characteristics on earnings management by Kenyan listed companies. Using panel data of 148-firm years obtained from the annual reports of the 37 companies listed on the Nairobi Stock Exchange, the study find that firms with more independent boards are less likely to manage their earnings. In Egypt, [57] find a negative relationship between board independence and earnings management by using a sample from corporations listed on the Egyptian Stock Exchange from the years 2008-2010.

Others provide empirical evidences to support a positive relationship between board independence and earnings management [5, 75]. Using a sample from Palestine companies, they find the board independence was positively related with earnings management [5]. Likewise, [75] supported this relation where he finds a positive relationship between board independence and earnings management by using samples from Thai companies.

On the other hand, some others studies have not observed a statistically significant correlation between board independence and earnings management [77; 39, 83 and 74]. [39] find that no significant association between board independence and earnings management by using samples from Chinese companies. Similarly, [83] find that inclusion of independent directors did not enhance monitoring of earnings management in manufacturing Chinese listed firms, [74] shows that the ratio of independent board members is not significantly related to earnings management by using samples from Egyptian companies over the period 2007-2010.

From the aforementioned discussion, it is argued that there is a potential relationship between board independence and earnings management. Thus, the following hypothesis is developed:

H_1: The independence of the board of directors is negatively related to earning management among Jordanian listed industrial companies.

4. 2 Board Size

Board size has been shown to be a significant part of the ability of boards to effectively monitor management and to work efficiently together to oversee the running of the business [66]. Previous studies have used board size as a determinant of earnings management, but the influence of board size has received mixed results in previous studies. On one hand, a

large board may have more experience, knowledge, and opinions from different sources; therefore, this can strengthen its monitoring function [19, 26]. Some studies [35, 33, and 84] find that larger boards are associated with lower levels of discretionary accruals.

Proponents of larger boards argue that performance increases since there are more people on whom to drawn [80]. [52] extended this argument by saying that board monitoring is positively associated with larger boards because of their ability to distribute the workload to many people. In UK, [65] find that having a large board is better in reducing earnings management compared to smaller boards. Likewise, [74] find that earnings management is negatively related to board size in Egypt.

Furthermore, [85] indicate that small boards seem more prone to failure to detect earnings management. One interpretation of this effect is that smaller boards may be more likely to be “captured” by management or dominated by block-holders, while larger boards are more capable of monitoring the actions of top management. Studies such as [28] in Mexico and [38] in Brazil, find that if the size of the Board is very small, the monitoring of the management team is smaller too, so they tend towards greater discretion in receiving higher remuneration, a greater chance of earnings management and are more prone to information asymmetry [37, 6, and 13]. Thus, a larger size of board assumes a better supervision of the management team and a higher quality of corporate decisions [64].

On the other hand, [16] retain that board size mustn’t be neither too big nor too small and suggest that the optimal size is between five and nine members. [53] examine the influence of corporate governance mechanisms on earnings management and state board size that should be neither too large nor too small in order to avoid diverting opinions that profit on the manager and allow earnings management. They find finds that the board size is positively and significantly correlated with earnings management. Moreover, [51] examine the relationship between board characteristics and earnings management in Taiwan. They find that large board size is related to a higher extent of earnings management. Also, [1] find that earnings management is positively related to the size of the board of directors in Malaysia.

Additionally, some studies find that firms with a small board are associated with higher market value or higher performance [30, 45]. [6, 46] indicated that larger board size might be less effective in monitoring management activities. The implication is that if board size improves performance, it would reduce earnings management. [83] investigate the relationship between board composition and earnings management in Manufacturing Chinese listed firms. They find that small boards are more effective in constraining income-increasing earnings management than a large board. This suggests that smaller boards can be more effective than larger boards. Consequently, small boards might be more effective in monitoring managerial behavior. Corroborating this argument, [47] find that board size is positively related to earnings management based on a sample of 770 Hong Kong firms from 1998 to 2000.

In contrast, [76] show that there is no significant relationship between board size and earnings management in Chinese listed firms, also, based on a panel of 480 observations from 2001 to 2008 in Iranian companies, [60] examine the influence of the board size on earnings management in Iranian companies, they did not get any statistically significant relationship between board size with earnings management.[62] studied the effect of board characteristics on earning management in companies listed in the Indonesian Stock Exchange during the 2004-2008 periods. They discovered that the board size does not affect earning management practices in the above companies.

Considering the earlier discussion, we find that there is a difference in the form of the relationship between the size of the board and earnings management. Thus the following hypothesis is proposed:

H_2: The size of board of directors is negatively related to earning management among Jordanian listed industrial companies.

4.3 CEO Duality

According to the agency theory, the separation of the CEO and chairman is to ensure that the CEO does not have too much power over the board. Separating these roles is likely to reduce earnings manipulation because the CEO is monitored by an independent chairman, which in turn, reduces the likelihood of the CEO disregarding the interests of shareholders. This conjecture is supported by the U.S and U.K's regulatory recommendation that a board be chaired by an independent director [see 15, 71]. At the same time, it is usually assumed that the monitoring ability of the board is less if the CEO in a firm is also a chairman of the board in the same firm [42]. In particular, this dual role may increase agency costs between management and shareholders because they create reserves depending on their compensation [11, 34] and may impede the monitoring function of the board [14].

In addition, the companies with CEO duality did not perform as well as their competitors. [2] support that by saying companies with CEO duality did not perform well and incline to do earnings management. [12, 21] find that the dual position of CEO and chairman reduces the checks and balances on the top managers leading to higher fraudulent behaviors and earnings management. Furthermore, [29] show that companies characterized by CEO duality share less earnings information and violate GAAP. [81] show that CEO duality is associated with lower quality disclosure by using a sample of 1954 Chinese firm for years 2001-2004.

Based on a sample of 384 listed companies in the manufacturing sector in the Indonesia Stock Exchange over the period 2005-2007, [59] investigate the role of good corporate governance in reducing earnings management. His findings indicate that a higher rate of duality is associated with high earnings management practices. In the same context, [62] find that CEO duality affects the earning management practices. According to [69] find a negative relationship between board CEO duality and earnings management by using a sample 196 firms listed on the Tehran Stock Exchange between 2004 and 2008. Additionally, [43] find the similar results in a recent study using data of 81 firms from major sectors are available in Bursa Malaysia. Additionally, [20] find that CEO has impact on earnings management by 20 anonymous listed Tunisian firms during the 2000-2009.

In contrast, [52] tested if earnings management is positively related to the CEO duality and find a significant positive relationship between these variables. [18] show that CEO duality is positively associated with the probability of financial statement fraud. [70] provide evidence that firms with CEO duality is positively related with earnings management in Malaysian firms. In Hong Kong [50] find that there is a strong

positive association between CEO duality and earnings management. [60] find the similar results in Iranian companies. Furthermore, [42] supported that there is a significant positive relationship between CEO duality and earnings management based on a sample of 1009 Chinese listed firms over the period 2002-2006. Similarly, [74] find the same results in Egypt.

However, empirically, most authors do not find any significant positive relation between CEO duality and earning management. So it seems not to support this theory [84, 10, 65, 25, 27 and 1]. Both [10, 84] find no association between CEO duality and earnings management. Similarly, [65] examine this association between CEO dominance and earnings management in the UK and find no association. Furthermore, [1] using a sample 97 Malaysian listed firms and they did not find any significant positive relation between CEO duality and earning management. Similarly, A meta-analysis study by [40] using the data of 35 empirical studies, they find no relationship between CEO duality and earning management. Additionally, [58] find that the CEO duality is not significantly related to earnings management in listed companies on Tehran Stock Exchange during 2006-2009.

Based on the above discussion, it is argued that there is a potential relationship between CEO duality and earnings management. Thus the following hypothesis is proposed:

H$_3$: CEO duality is positively related to earning management among Jordanian listed industrial companies.

4.4 Board Meetings

Another characteristic related to the board of directors is board meetings. The degree of board interaction and activities has influence on earnings management. Boards that meet frequently are more likely to solve the problems of the company effectively [55]. According to [24, 79], the greater the meeting frequency, as proxy by the number of board meetings, the more effective will be the board's monitoring function. They evidence that if companies have fewer board meetings than necessary, the firm's value will decrease. In terms of earnings management, [84] argue that when board meetings are rare, issues such as earnings management may not be on the priority list due to paucity of time. In such cases, the function of the board is reduced to a mere rubber stamp to sign off management plans. In other words, they find that earnings management was significantly negatively related to the number of board meetings. This shows that board meetings affect performance, and it is an important factor in constraining earnings management.

Additionally, [21] suggested that the higher frequency of board meetings reduce the possibility of fraud since regular meetings allow the directors to identify and resolve potential problems. [24] suggested that more frequent board meetings improve the effectiveness of the board. The meetings are a key dimension of board operations and an indicator of the effort put in by the directors [68]. Active boards that meet more frequently are more likely to perform their duties in accordance with the interests of the shareholders and put more effort in monitoring the financial reporting integrity. [72] in a study of 500 manufacturing firms in India find that board diligence i.e. number of meetings attended by the independent directors has a significant negative association with earnings management.

An opposing view is that board meetings are not necessarily useful because routine tasks absorb much of the limited time that directors and CEO's spend together to set the agenda for board meetings [56]. [42] find a significantly positive association between earning management and board meetings. In Egypt, [57] find that a positive relationship between board meetings and earnings management. It is worth pointing out that the studies conducted to investigate board meetings and earnings management have been low-key, thus their claims cannot to be generalized. Therefore, further investigation is needed in order to determine whether this element is effective or not. Bearing in mind the above conflicting views, this study still believes that there is a potential relationship between board meeting and earnings management. Thus the following hypothesis is proposed:

H$_4$: The number of board of directors meeting negatively related to earning management among Jordanian listed industrial companies.

4.5 Board Financial Expertise

Board financial expertise is viewed as another element in board characteristics that may have an effect on earnings management. To monitor the financial reporting process, the directors must have accounting knowledge, in order to control manipulation and to make information more transparent. Empirical studies show that financial expertise is an important determinant of quality financial statement. [8 p.61) suggested that to do their tasks effectively the boards must have the ability for "asking management tough questions, actively helping to set corporate strategy, monitoring risk management, contributing to CEO successions plan and ensuring that companies set and meet their financial and operating targets". So far, this can only be achieved if the board has the vital expertise to fully embrace such duties.

The findings of [3] on the US firms highlighted the importance of accounting knowledge among the outside directors in reducing the probability of financial restatements only if they had financial expertise. Very few studies have explored a financial expertise on the board, as they focused mainly on the financial expertise of the audit committee. Thus, there is a scarcity in studies on the relationship between board financial expertise and earnings management.

[84] indicate that earnings management is less likely to occur in firms that are run by a board of directors which have a corporate and financial background. They also suggested that boards with diverse knowledge are more effective for constraining earnings management. Additionally, [63] indicate that the presence of officers from financial intermediaries in the board can limit abnormal accruals as the unmanaged earnings are below the target. They said that experienced outside board members able to understand the firm and its people better and consequently improve their governance competencies. [17] suggested that the boards of directors' members who have more experience in terms of higher number of directorships are more likely to demand high-quality audit work. Further, [22] claimed that the directors with a higher tenure of board experience are less likely to be associated with earnings management. Both studies concluded that higher level of board expertise lead to higher monitoring incentive. In addition, [54], employing meta-analytic techniques to the data from nearly 48 empirical studies, find a negative relationship between board financial expertise and earnings management. In contrast, [57] show that a positive relationship between board financial expertise and earnings management.

In summary, all of the above studies recognized that the boards of directors who have specific knowledge and experience are

useful in monitoring management. The accounting and financial knowledge are beneficial to boards of directors to understand better financial statements and financial reporting issues. It can be said that there is a potential relationship between board financial expertise and earnings management. Thus the following hypothesis is proposed:

H_5: The financial expertise of the board of directors is negatively related to earning management among Jordanian listed industrial companies.

5. Summary and Conclusions

The ability of managers to manage reported earnings opportunistically is constrained by the effectiveness of internal monitoring such as corporate boards. Boards of directors are responsible for monitoring the quality of the information contained in financial statements, and thus they control the behavior of managers in order to guarantee that their actions are aligned with the interests of stakeholders. Therefore, this study discusses one of the elements of corporate governance which is board characteristics.

In particular, this paper intends to investigate the roles of the board of directors on EM among industrial companies listed on ASE. To achieve this five board characteristics are proposed, namely, board independence, board size, board CEO duality, board meetings and board financial expertise. In turn five hypotheses are developed to validate the hypothesis survey research will be undertaken.

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