

Cosmetic Accounting Practices among Jordanian Firms? The Role of Ownership Concentration and Political Influence

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Abstract. *Cosmetic accounting is a process used by accountants who have a vast knowledge of accounting rules to address the figures reported in the financial reports. This study focuses on the crucial role of the concentration of ownership and the political influence on the quality of earnings among Jordanian industrial firms listed on the ASE during the period 2014-2017. The results of regression indicate that there is a negative impact of both of ownership concentration and political connection on the quality of earnings reported in financial reports. This means that the most significant shareholders use their power, and the political role of board members to manipulate earnings to be consistent with their interests. The study found that other important factors may affect the quality of earnings such as foreign ownership, especially with the migration of some capital to Jordan as a safe environment for investment, particularly under the political and economic tension in neighboring countries.*

Keywords: Cosmetic Accounting, Earnings Quality, Ownership Concentration, Political Influence

JEL Codes: M41

1. Introduction

Creative accounting is also referred to as earnings management, income smoothing, cosmetic accounting, and financial engineering. All these terms apply to the exploitation of the flexibility found in some accounting rules to show the figures in the financial reports according to the needs of the company's management (Karim, Fowzia & Rashid, 2011).

Persakis (2018) reported that the earnings quality falls in a financial crisis, and this is consistent with Li (2011) who found that managers of companies that go bankrupt often managers exhibit opportunistic behaviors. This diminishes the quality of the earnings of companies around the world; additionally, managers are less able to predict earnings and tend to reserve accruals receivables and manipulate earnings. Also, Persakis (2018) noted weakness in the earnings quality in companies that have offered weak protection mechanisms for investors, which is consistent with Dimitrios et al. (2013). Dechow, Ge & Schrand (2010) considered the impacts of earnings quality on corporate continuity and bankruptcy and the cause of

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bankruptcy of many companies around the world is the earnings quality. High earnings quality reflects the increased reliability of the information in financial reports and provides information on the financial performance of a company. This protects decision-makers with regards to earnings quality and reduces bankruptcies.

Hashim and Devi (2008) mentioned that low earnings quality was the reason for the occurrence of the Asian financial crisis of 1990. In no small measure, this was the product of inadequate corporate governance mechanisms, which weakened the application of the system and laws to managers in Asian companies. Earnings quality is critical in measuring the continuation of companies and preventing companies from falling into bankruptcy. Empirical evidence reveals that firms with higher ownership concentration are more apt to engage in earnings management practices (Darmadi, 2016). The structure of ownership in the United Kingdom and the United States firms is highly disbursed, unlike Jordanian firms, where it is highly concentrated. This phenomenon may impact earnings management activities because high ownership concentration leads to agency problems (Al-Sraheen & Al-Daoud 2018).

Al-Sraheen and Alkhatib (2017) stated that Jordan is a small nation in which political influence plays a critical role in the capital markets in many business dealings aspects. They also documented that political connection contributes to a decrease in the quality of financial reporting. Besides, Mohammed, Ahmed, and Ji (2010) reported that political influence has a negative contribution to accounting conservatism. They have documented that a high level of accounting conservatism practices is related to a higher quality financial report, and thus, conservative accounting is a qualitative characteristic of high-quality reporting.

Managing earnings, it's also called cosmetic accounting practices, which is considered an opportunistic behavior that managers utilize to transfer the corporate wealth to their accounts. Will, by extension, harms the financial reporting quality; therefore, the board members who have power and political connections facilitate the practicing the earnings management in the firms to achieve their interests such as incentives, rewards and attract the investors (Kumar, Goyal & Mitra, 2019).

The findings that are expected from this study generally will enhance the understanding of the importance of the agency theory in interpreting the behavior of the governance practices and financial reporting in the Jordan business environment. In addition, this study provides evidence that supports a tenant of agency theory that posits that an effective board of directors is a useful instrument for decreasing agency conflicts.

2. Literature Review and Hypotheses Development

2.1 Concentration Ownership and Cosmetic Accounting Practices

Al-Jaifi (2017) stated that corporations with a high-level of concentration ownership have contradictions in the financial information provided to traders when both informed and uninformed, which harms the liquidity of the stock market. In addition, one possible explanation for firms that have a high level of earnings management practices experiences greater liquidity is that companies might manage their earnings to offer special information to improve the earnings' information content. In general, the evidence suggests that earnings manipulating reference information informatively, especially in a country with a higher concentration level of ownership and a higher likelihood of expropriating minority interests.

Wang and Shailer (2015) pointed out that the concentration of ownership has a negative relationship with corporate performance across countries. In general, higher concentrated ownership leads to low levels of information disclosure. At present, the disclosure of financial and non-financial information among

Jordanian firms Jordanian is still in the integration stage between compulsory and voluntary disclosure. High level of equity concentration means that the controlling shareholders utilize their voting rights and power in controlling the chairman, directors, and managers, which lead to a decrease in the degree of information disclosure. In general, the higher ratio of the ownership concentration offers a limited level of information disclosure which reduces the quality financial report and its reliability (Al-Sraheen & Al-daoud 2018).

In general, evidence suggests that earnings manipulation informally refers to information asymmetry, especially in a country with a higher ownership concentration and a higher likelihood of minority shareholders being expropriated (Al-Jaifi, 2017). In addition, Al-Sraheen, Fadzil, and Ismail (2014) mentioned that conservatism is a key attribute of financial reporting quality that participants in the capital market often use to benchmark the earnings quality of firms. In addition, Bouvatier, Lepetit, and Strobel (2014) mentioned that ownership concentration can be associated with either lower or higher levels of earnings management.

Maswadeh (2018) is another research that focuses on ownership concentration in the Jordanian context, the result of the paper shows a significant effect of ownership concentration in imitating earnings management practices in Jordanian industrial companies. Thus, the first research hypothesis is presented as follows: *H1: The relationship between ownership concentration and earning quality is negative.*

2.2 Political influence and Cosmetic Accounting Practices

Al-Sraheen and Alkhatib (2017) noted that the Hashemite Kingdom of Jordan is a small nation in which political influence serves a critical role in the various aspects of business markets. Mohammed, et al. (2010) stated that political influence contributes negatively by offering a low quality of financial information. In particular, they (Mohammed et al., 2010) pointed out that political influence limits the practices of accounting conservatism in presenting the financial information, where the previous research has stated that a high level of conservatism practices offers a higher quality of the accounting figures in financial statements. Therefore, conservative accounting is deemed as a qualitative characteristic of the quality of financial reports. Earning management, which is considered as an opportunistic behavior that corporate managers utilize to transfer the corporate wealth to their own interests, which in turn will harm the financial reporting quality; therefore, a negative relationship exists between political influence and earning quality (Al-Sraheen & Saleh, 2017).

Liu, Li, Zeng and An (2017) documented that politically connected companies practice a high level of earnings management and thus have a low quality of earnings. Also, Rozanski, (2017) found that earnings manipulation was more common in firms that have higher levels of political activity that are by CEOs possessing relatively high levels of hubris. Managing earnings is more likely to exist in firms that having many political activities and opportunistic managers. Therefore, based on the results of the previous research that stated the political influence harms the quality of accounting information provided in the financial statements. The following research hypothesis is presented as follows: *H2: The political influence has a negative association with quality earnings.*

3. Research Elaborations

The next subsections highlight the research methodology and technique used to select the research sample, data collection process, the measurements of research variables and data analyses.

3.1 Sample and data collection

The initial research sample includes all industrial firms whose stocks were listed in the Amman Stock Exchange (ASE) over the period 2014 to 2017. There were 62 listed firms, and after excluding the firms that did not have enough data, the final sample that entered to the analysis process included 56 firms, which comprised 90% of the initially selected sample. This process leads to 224 firm-year observations in total over four years. The required data was hand-collected from the annual financial reports of the firms which are available through the Amman Stock Exchange website.

3.2 Models and Measurements of the Variables

This current study has one main research model, which is used to test the relationship between ownership concentration and political influence on the cosmetic accounting practices in the context of Jordan. In order to reach the research objectives, a regression analysis is used to test the research hypotheses and ascertain the effects of these variables in the Jordanian business environment. The research model is presented as follows:

$$CAP_{it} = \beta_0 + \beta_1 OWCON_{it} + \beta_2 PIONF_{it} + \varepsilon_{it}$$

Where:

CAP Cosmetic Accounting Practices
 OWCON Ownership Concentration
 PIONF Political Influence

The cosmetic accounting practices term refers to the earnings management or earnings manipulation policy, which in one way or another means that companies that managed their earnings offer low-quality financial information and therefore imply the lower quality of earnings. Thus, the current study uses the modified Jones model, developed in 1991, to measure earnings management, which is a synonym term for cosmetic accounting practices, which also reflects the quality of earnings. This measurement used by previous research such as (Al-Shaheen & Alkhatib, 2017). The non-discretionary accruals (ND) is calculated using equation (1):

$$\frac{TA_{it}}{LTA_{i,t-1}} = \alpha_1 \left[\frac{1}{LTA_{i,t-1}} \right] + \alpha_2 \left[\frac{\Delta REV_{it} - \Delta REC_{it}}{LTA_{i,t-1}} \right] + \alpha_3 \left[\frac{PPE_{it}}{LTA_{i,t-1}} \right] + \varepsilon_i \quad (1)$$

Here, TA refers to Total Accruals; LTA = Lagged Total Assets; ΔREV = Change in Revenues from the preceding year; ΔAR = Change in Accounts Receivable from the preceding year; PPE represents firm's gross property, plant and equipment. Meanwhile, α_1 - α_3 entail the regression parameters and ε refers to equal error term.

Discretionary accruals (DA), equation (2) below, are calculated as the residual value after deducting non-discretionary accruals from the total accruals.

$$DA = \frac{TA_{it}}{LTA_{i,t-1}} - \left[\alpha_1 \left[\frac{1}{LTA_{i,t-1}} \right] + \alpha_2 \left[\frac{\Delta REV_{it} - \Delta REC_{it}}{LTA_{i,t-1}} \right] + \alpha_3 \left[\frac{PPE_{it}}{LTA_{i,t-1}} \right] \right] \quad (2)$$

As for ownership concentration, this study uses 10% or more as a threshold for classifying companies as concentrated ownership. Such types of measurement were used by prior studies such as Al-Sraheen, Al-Daoud and Aleqab (2019).

A dummy variable was used to measure the political influence that is equal to (1) if at least one of the board members has a political position (such as a member of parliament, minister, a state assemblyman, a person who is a government bureaucrat or head of state, either currently or in the past) and a value of (0) otherwise (Al-Sraheen and Alkhatib, 2017; Faccio, 2006).

4. Results

Before conducting the regression analysis and hypotheses testing, the regression assumptions were tested to make sure that the data of the study is free from any severe violation that may harm the results. Therefore, Outliers have any serious effect on the whole research model; Cook's Distance value was checked to test the Outliers' assumption. The ratios of Skewness and Kurtosis were examined to check the Normality assumption and Linearity assumption was also checked to show the linear relationship between independent and dependent variables in the research model (Hair, Black, Babin, Anderson & Latham, 2010).

The Pearson Correlations matrix that is shown in Table 1 provides was presented to test the multicollinearity that occurs if the correlation between independent variables is more than .90. Durbin-Watson value is used to check for autocorrelation in the residuals of regression analysis. It was concluded that none of these assumptions were violated.

Table 1: Pearson Correlations matrix

	EM	OWCON	POINF
EM	1		
OWCON	-.314	1	
POINF	-.398	.426	1

4.1 Descriptive Statistics

The average value of the EM is 48%. This value is higher than the average of Nawaiseh (2016), who documented that the mean value of EM was 41.5%. This implies that the majority of Jordanian firms practice earnings management in their financial statements. The current research uses descriptive statistics to transform the data into the meaningful interpretation.

Table 2: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
EM	224	.00	1.00	.4839	.50382
OWCON	224	.00	1.00	.7419	.44114
POINF	224	.00	1.00	.8710	.33797

Jordanian companies suffer from the problem of ownership concentration, which negatively affects the quality of the financial statements (as it will be explained later). Where the average of ownership concentration is 74%, which indicates 74 out of 100 companies have it so that the ownership is concentrated significantly among the Jordanian companies. Also, statistics show that 87% of Jordanian companies have at least one person with political influence that harms the quality of the financial statements, as shown in the results of the regression test.

4.2 Basic Regression Results

Table 3 below shows that the research model is statistically significant based on the value of ($F=8.984$; Sig .000). The findings also show that the R^2 and adjusted R^2 are 0.233 and .207, respectively, these values mean that the model explained approximately 23.3% of the variation of earnings quality in Jordanian industrial firms. These results imply the model of the study provides a proper compensation of variables that contributes positively in explaining the variance in the earnings quality.

Table 3. The Result of OLS Regression Analysis

Variables	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
OWCON	-.315	.131	-.276	-2.409	.019
POINF	-.550	.171	-.369	-3.221	.002
R^2	.233	F sig.	.000		
Adjusted R^2	.207	F Value	8.984		

As seen from Table 3, ownership concentration (OWCON) has a negative direction, as predicted in the first research hypothesis and it is statistically significant at 5 % ($t = -2.409$, $P = .019$). The evidence shows that the OWCON contributes negatively to the earnings quality. This result has been supported by Al-Sraheen et al., (2019) who document that the higher concentrated ownership leads to a low level of earnings quality, which supports the first hypothesis of the current study.

As for political influence (POINF), the regression analysis shows that it has a negative and significant association with earnings quality ($t = -3.221$, $P = .002$). This result is consistent with the second research hypothesis that stated the (POINF) serves as a motivation to corporate managers to practice the earnings management and thus, harm the quality of earnings. This result has also confirmed by Al-Sraheen and Alkhatib (2016) who documented that the political influence positively affects the earnings management practices among Jordanian firm, which reflected negatively on the quality of earnings.

5. Conclusion

This study offers various new contributions. First, the findings of the current research may contribute through limiting the agency conflict, where the ownership concentration may have an essential and clear role on the process of financial reporting and therefore expected to harm the earnings quality by facilitating the practices of earnings management. Second, Jordan is essential in this context because the concentration of ownership is high, which disrupts the monitoring tools. Such ownership concentration exists in various countries, and thus, the findings of this research are generalizable.

The findings of this paper may help decision makers in offering a set of rules and requirements to ensure the accounting information quality through restricting the negative influence of ownership concentration on

that information. The role of foreign ownership is a significant potential opportunity to be considered in the future research in this field especially after the migration of Syrian and Iraqi capitals and investors to Jordan due to the security and political complications those countries suffer from.

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