

THE RELATIONSHIP BETWEEN OWNERSHIP STRUCTURE AND EARNING MANAGEMENT PRACTICE: THE CONCEPTUAL FRAMEWORK

Ali Hassan Ibraheem Aljadba
Faculty of Economics and Muamalat (FEM)
Universiti Sains Islam Malaysia (USIM)
Bandar Baru Nilai, 71800, Nilai, Negeri Sembilan, Malaysia
Email: ah.jadba@alauqa.edu.ps

Norhaziah Binti Nawai
Faculty of Economics and Muamalat (FEM)
Universiti Sains Islam Malaysia (USIM)
Bandar Baru Nilai, 71800, Nilai, Negeri Sembilan, Malaysia

Nur Hidayah Binti Laili
Faculty of Economics and Muamalat (FEM)
Universiti Sains Islam Malaysia (USIM)
Bandar Baru Nilai, 71800, Nilai, Negeri Sembilan, Malaysia

ABSTRACT

Allah forbade financial fraud in verse 29 in Al-Nisa'a Surah. This verse considered as evidence to constrain managers in engaging in earnings management (EM) and a command to mitigate the conflict between owners themselves to prevent EM. The objective of this paper is to investigate the role of political instability on the relationship between ownership structure (OS) and EM in the Palestinian context. By revering the prior literatures, the political circumstances influence the formation of OS. Agency theory and political theory were used to develop the hypotheses. Accordingly, it can be observed that OS and EM practices affected by political instability particularly in Palestine. Unlike most of the previous literatures on the developing countries, this study uses the political instability as a moderating variable to investigate the relationship between OS and EM in Palestine which is characterized by high level of political instability.

Keywords: Corporate Governance, Ownership Structure, Earnings Management, Political Instability, Palestine.

INTRODUCTION

The issues of corporate governance (CG), ownership structure (OS) and earnings management (EM) have received a significant attention from government regulators, auditing and accounting profession, practitioners, policy makers, academic bodies and the public, especially following the high-profile corporate scandals in advanced countries such as the financial scandals in US and Europe. During the last two decades, the financial distress in advanced countries have brought a major sensibility of the need for more transparency and credibility for the sake of protecting the interests stockholders and stakeholders alike (Abbadi

et al., 2016; Aziz et al., 2017 & Fearnley & Beattie, 2004). Thereby, the target of this paper is to investigate the association between OS and EM in Palestinian listed companies.

Indeed, Palestine is a developing country that needs to enhance its national economy by attracting new local and foreign investors, lenders, suppliers and other participants in business sector. The Palestine Exchange (PEX) is committed to good CG; it believes that its success on the long term is related to its responsibilities toward its stockholders and stakeholders. As an essential part of its commitment its CG structure complies with the Palestinian Code of Corporate Governance (PCCG) which was issued by the Palestine Capital Market Authority (PCMA) in 2009 and was applicable and active in the same year. As a component of the national economy, the PEX feels that it has an obligation in enhancing the PCCG mechanisms, and it looks for to create a model in this aspect through managing a market which is orderly, fair in its structure and transparent, impartial in its information, (PEX, 2018).

Actually, OS considered one of the most important mechanisms of the CG of the companies listed in any stock markets particularly PEX as an emerging one. The nature of the relationship between top management and stockholders is a critical issue of the CG mechanisms. Several studies addressed the issue of OS, for example, the study of Omran et al. (2008) found that ownership resort to be highly concentrated in Arab countries. This confirms that ownership concentration is considered as a fundamental characteristic of CG in Arab countries to get over the weakness of legal protection of investors. According to Abu-Siam et al. (2018) studied only industrial listed companies on Amman stock market. They suggest further OS variable to be investigated such as foreign ownership and institutional ownership.

Palestine is one of the Arab countries, but it solely occupied state by Israeli long run occupation. Palestine also considered as one of the newest emerging economy in Middle East and North Africa Countries (MENA). Regarding to the above reasons, we believe that Palestine offers a unique political and economic characteristics different from those of other emerging economies. One of the important features of the Palestinian business environment is the high degree of political and economic instability. Indeed, the Palestinian economy has been suffering from ups and downs of growth for several years. Following the Oslo Accords and the foundation of the Palestinian Authority (PA), the Palestinian economy have enjoyed strong annual growth with average of %9 between 1994 and 1999, this is due to large inflows of private and public capital and increased the private investment. This case was dramatically interrupted after the outbreak of the second Intifada in 2000 when the Israel as an occupation authority physical, institutional, and administrative restriction that crumb the Palestinian occupied territories into small cantons lacking most forms of economic resources, pushing the annual growth rate to %-9. In the following years, growth picked up to an annual average of %8 between 2008 and 2012 due to large amounts of donor funding, equivalent to 32 percent of Palestinian GDP in 2008. The 2014 war in Gaza and a drop-in donor aid has led to a severe deterioration in the economic conditions in Palestine in recent years. The latest war in Gaza had severe social consequences and a devastating impact on private sector activity causing the Palestinian economy to slip into recession in 2014. However, growth had been slowing since before the war due to a significant drop in donor aid. As a result, real GDP growth slowed down to an annual average of %2 between 2013 and 2016, and dropped to a mere %0.7 in the first quarter of (world bank, 2017).

Based on the aforementioned, the current study provides an opportunity to conceptualize the role of OS in constraining EM in the context of Palestine which characterized by political instability and high agency conflicts comparing with other developed and developing economies. To the best knowledge of the researchers, very limited studies to date have addressed the CG and EM in Palestine. This current study will alert the

policy makers by shedding the light on the status and the limitations of the current CG code. In addition, the researchers are motivated to help expand the very limited existing research on an environment characterized by severe political and economic circumstances and a lack of control over major economic and fiscal policy instruments (Hassan & Hijazi, 2015). According to the previous arguments and the limitations in the prior literature, Palestine context is a fertile environment to study OS and EM.

Accordingly, there are few studies have been conducted in Palestine addressed OS (i.e. Abdelkarim & Alawneh, 2009; Abdelkarim & Ijbara 2010; Kutum, 2015; Anastas, 2017; Dwaikat & Queiri 2014; Hassan et al., 2016). Abdelkarim and Ijbara (2010) and Abdelkarim and Alawneh (2009) showed that the ownership concentration is existed in the Palestine shareholding companies, which in turn leads to restrict the development of CG mechanisms. Therefore, the purpose of this paper is to conceptualize the influence of political instability towards OS and EM. The remainder of the article is structured as follows. In Section 1, it provides an introduction of the relevant literature regarding CG, OS and EM under instable political environment. Section 2 is the literature review. In section 3 is the development of hypothesis and conceptual framework is discuss in section 4. Finally, the section 5 is the conclusion of the current study.

LITERATURE REVIEW

EM is a process of using the flexibility in accounting policies and choices that allow managers to affect reported earnings opportunistically, causing reported income to be larger or smaller than it will be (Zouari, Lakhali, & Nekhili, 2012). The study by Jaggi and Tsui (2007) has found that managers practice EM to achieve specific goals such as losses avoidance, cover market expectations, avoiding the violations of debt covenant etc. They documented that high level of EM practices drive to impair earnings quality and mislead the stakeholder, particularly the users of financial reports. The adoption of international accounting standards and auditing standards by the developed countries has been failed to provide enough assertions that financial statements are free from the practicing of EM (Pornupatham, 2006). According to the study of Al-khabash and Al-Thuneibat, (2009), they argued that EM practices have several victims, for instance, investors, creditors, vendors, regulators, customers and other stakeholders.

Chang and Sun (2009) demonstrate that investors' trust based on the strength of the capital market associated with various monitoring tools such as CG mechanisms which have received material attention in several developing countries. CG mechanisms play a vital role in encouraging corporations and economies to attract new investments and provide appropriate credibility in financial reports. Therefore, Cornett, Marcus, and Tehranian, (2008) identified that CG mechanisms have a fundamental impacts on EM practices. However, some academic researches argued that the influence of CG diverge from country to another country regarding to the concentration of ownership and various factors. In other words, the structure of firm ownership may provide a vital monitoring tool by affecting the composition of the BOD and related committees. For instance, Wei (2007) confirmed that divergence in CG practices between countries attributed to divergence of OS which in turn is playing a pivotal role in enhancing CG systems.

OS is a well-known terminology as a CG mechanism involved ownership components, ownership concentration, and separation of ownership. Ownership component refers to the identity of the stockholder. Ownership concentration refers to the number of shares that a holder owned. Separation of ownership refers to the separation of control rights and cash-flow rights of a large stockholder (Hu & Zheng, 2015). The concentration of OS differs from country to another. Several of them are widely held and dispersion, while others shares

concentrated in the hand of blocks holders. Berle and Means (1932) documented that the ownership “Generally, dispersion of OS is popular in the United States”.

Based on prior literatures, EM can be seen as a potential agency cost since managers manipulate earnings to mislead shareholders and fulfil their own interests. Therefore, the shareholders should play a key role in constraining the level of EM by electing a very effective BOD in order to decrease the agency costs and maintain the credibility of financial reporting system. So, this study will focus on the role of OS in preventing the EM practices according to previous studies. According to prior literatures, the ownership concentration has a positive role in the firms in advanced countries. Despite the positive impact of ownership concentration in some developed countries, the dispersion of ownership is still better. The ownership is held widely particularly in USA and UK (LaPorta et al., 1999). This current study will focus on some characteristics of OS such as ownership concentration, institutional ownership and foreign ownership). Indeed, these characteristics are appropriate to be investigated in Palestine context due to the ownership concentrated is very clear in Palestinian corporation.

In fact, the concentrated ownership usually measured by the existence of large stockholders in a corporation (Thomsen & Pedersen, 2000). Porta et al. (1999) and Hassan et al., (2016) argued that there is a conflict between majority and minority stockholders exists due to the agency problems emerged by ownership concentrated. Subsequently, high ownership concentration provides opportunity to majority stockholders to use the company’s resources at the account of the minority stockholders (Shleifer & Vishny 1986).

According to agency theory perspective, institutional ownership would enhance the monitoring system in order to control the management behaviors. Ping and Wing (2011) have argued that the large stockholders will benefit from the strong monitoring system other than small stockholders. Moreover, large stockholders and due to large shareholding they have such as institutional owners may practice the monitoring function on the management behavior stronger and more effective than the board members who have small or non-shareholding in the company (Shleifer & Vishny, 1986). On other words, the high level of institutional ownership leads to reduce the agency problems which in turn meet the expectation of the small stockholders (Naser et al. 2006), and increase the monitoring on the firm overall performance (Crutchley et al., 1999).

Foreign ownership and its relation with EM have been examined by several prior studies an important mechanism of the effectiveness CG. Foreign owners usually have more various experiences rather than their local counterparts. Therefore, foreign owners have the ability to monitor management behavior more effectively due to their experiences. Subsequently, based on high level of foreign ownership several issues will be improves such as increasing the quality of the financial reports and mitigating agency cost to the lowest level (Hassan et al., 2016).

By reviewing the prior literatures, this study will be the first study employs the political effects as a moderator in order to conceptualize the relationship between OS and EM. In addition, all previous studies which have conducted in Palestine have never used the political instability effects as a moderator or independent or dependent variable. On the other hand, Several prior studies addressed the effects of financial crisis and political matters on EM, firm performance and income smoothing (Attia et al., 2016; Filip & Raffournier, 2014; Habib et al., 2013; Harymawan & Nowland, 2016; Hsiao et al., 2016; Mangena et al., 2012; Nguyen et al., 2013; Obaidat, 2017). This study will be different in addressing the political effect in order to investigate whether its role moderate the association between EM and OS. This will be a contribution to fills the gap in the literature. This could be used to better understand the relationships among the variables under review. This study fills the literature gaps by focusing on the OS issues more especially in emerging markets in general and in PEX

as an emerging one in particular, yet volatile economies such as Palestine where literature of the kind is lacking. In addition, improving the image of the Palestinian economy as a unique case operating under political and economic unrest at the regional and international levels, which will help to achieve preferences companies that are committed to the rules of governance.

THEORETICAL BACKGROUND

Most of CG literature to EM have addressed the agency theory such as Fama and Jensen (1983) and Jensen and Meckling (1976). In this study, employing political theory will be better beside the main theory applied which is agency theory. Political theory has been applied by current study in order to effectively capture the political context where the study has been conducted (Gourevitch, 2003; Roe, 2003). Political theory which has been first proposed by (Roe, 2003; Gourevitch, 2003; Pagano & Volpin, 2005), argued that the social and political circumstances in any country affect the company in important and several ways. It elaborated that to which extent the firms react with the political and social environment in order to protect current and prospective investors.

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) have argued that agency problems may be at the minimum level due to the strong legal system which in turn protects the investors' rights. Berglöf and Claessens (2006) argued that the absence of effective legal system due to political instability may lead to replace weak legal system by the CG. Effective CG will constrain managers' ability to abuse the wealth of stockholders. In other words, agency costs depends on the political and social pressures in any country (Mangena, Taurigana, & Chamisa, 2012).

Positive accounting theory which was developed by Watts & Zimmerman (1978) sheds the lights on the world events such political, economic and social events. More specifically, positive theory suggested that the companies' managers are facing several political conditions that affected their decisions. These conditions lead managers to manipulate the reported earnings (Watts & Zimmerman, 1978). It is possible to understand that companies tend to engage in EM due to potential political regulatory, legislative conditions in the periods of increased political actions (Watts and Zimmerman, 1986). This theory have anticipated that managers engage in EM due to internal contractual incentives which are driving employ different accounting choices (Alghamdi, 2012). In addition, Watts and Zimmerman (1986) have argued that major corporations are more responsive and sensitive to political circumstances than small companies. This argument is inconsistency with the positive accounting theory perspective which has proposed that the larger companies is less likely to engage in EM practice than smaller ones due to a political and social reasons (Ngamchom, 2015).

DEVELOPMENT OF HYPOTHESES

Ownership Concentration

The concentration of Ownership is a measurement of the proportion of large stockholders in a company (Thomsen & Pedersen, 2000). Porta et al. (1999) and Hassan et al., (2016) have suggested ownership concentration may generate a real conflict due to the agency problem created by concentration of ownership. The high level of ownership concentration provides a good opportunity for majority stockholders to exploit the firm's resources by ignoring minority stockholders (Shleifer & Vishny 1986). Fan, and Wong (2002) has reported that the concentration of ownership was associated negatively with the quality of earnings. Yunos et al. (2011) have found that ownership concentration was associated to lower accounting

conservatism. A study by Rahman and Mohamed Ali (2006) has offered an evidence from Malaysia that board independence was not significantly associated with the practice of EM due to high ownership concentration. On the other hand, a study by Kamardin and Haron (2011) have suggested that high ownership concentration in Malaysia may lead to effective monitoring techniques which ensure the interests of the majority and minority stockholders. In contrary, Guerrero-Villegas et al. (2018) have documented that the sever conflict between minority stockholders and majority stockholders may emerged by ownership concentration. So, the basic conflict between owners and managers will be transferred to a conflict between the stockholders and their counterpart for the same company.

Klai and Omri (2011) have studied the association between CG mechanisms and the quality of financial reports of the listed companies in Tunis Stock Exchange. They have reported that block ownership decrease the financial reports quality. Abdelkarim and Alawneh (2009) indicated that the negative correlation between concentrations of ownership in Palestinian firm listed and firm performance. The study of PCMA (2015) elaborated that 11% of the total stockholders of listed companies PEX can apply for membership of the BOD, otherwise, 89% of total stockholders cannot be nominated. This is an evidence of the high level of ownership concentration in Palestine. According to aforementioned arguments and consistent with agency theory, the following hypotheses suggested:

- H1 : There is a positive relationship between Ownership concentration and EM in the Palestinian listed non-financial companies.

Institutional Ownership

Institutional ownership is considered a key mechanisms in controlling the management discretions which in turn leads to mitigate agency costs and problems (Gonzalez & Garcia-Meca, 2014). Institutional investor play a vital role in monitoring management behavior and hence, institutional investors as a large stockholders may have more power other than small investors to get benefits from overusing management (Ping & Wing, 2011; Hassan et al., 2016 and Aljifri and Moustafa, 2007). According to Attia, Lassoued, and Attia (2016), institutional investors are efficient in monitoring managers and reduce their manipulation actions of the accounting numbers presented in the financial reports.

Several studies have reported that the institutional investment tends to invest their money in the firms who have more independent directors in the BOD (Al-Jaifi, 2017). Relatedly, Bao and Lewellyn (2017) have argued that institutional investors are more sophisticated and rational stockholders, and thereby they will be able to analyze the companies' performance accurately and be more capable in detecting the accounting misreporting. According to Hassan et al. (2016), the firm financial performance will be affected positively by the high number of shares held by the institutional and thus, minimizing the agency cost.

The previous studies have received mixed results by investigating the relation between EM and institutional ownership. A study by Farouk and Bashir, (2017) have found that there was a negative association between EM practices and institutional ownership. Accordingly, Almasarwah (2015) have conducted a comprehensive study in Jordan and address the majority of CG mechanisms and their relation with the level of EM practices. He has found that there is a negative relationship between the percentage of institutional ownership and EM practices. Bao and Lewellyn (2017) have also found a negative association between institutional ownership and the activity of earnings.

On the other hand, Lemma, Negash, Mlilo, and Lulseged (2018) have found that the relationship between institutional ownership and real EM was significantly positive. That

means the institutional investors may focus on the short-term earnings which in turn make pursuer on managers to practice more EM. Relatedly, the current study will address the institutional ownership in Palestine in order to explore its effects on EM practices. And According to aforementioned discussion and consistent with agency theory, the following hypotheses proposed as shown below:

H2 : There is a negative relationship between institutional ownership and EM in the Palestinian listed non-financial companies.

Foreign Ownership

In fact, foreign ownership is another mechanism has been used by the EM prior studies. Foreign investors are expected to have different and more experience than local investors. Foreign owners usually have more various experiences rather than their local counterparts. Therefore, foreign owners have the ability to monitor management behavior more effectively due to their experiences. Subsequently, the high level of foreign ownership leads to mitigate the agency cost to the lowest level (Hassan et al., 2016).

The prior empirical evidences on the association between foreign ownership and EM practices were mixed. Isa and Farouk (2018) have reported that the exercising manipulative practices by managers will be likely constrained by the high foreign ownership proportion. Conversely evidence has been stated by Farouk and Bashir (2017) that foreign ownership has a positive and significant influence on EM activities. While Parveen et al. (2016) found that director ownership negatively and significantly influences the tendencies of manipulative activities of the managers while foreign ownership positively and significantly influences the tendencies of manipulative activities of the managers.

In Palestine, foreign owners are very important for PEX as an emerging market working under a complicated political situation. Foreign investors will provide Palestinian stock market with various experiences and innovative ideas in order to maximize the productivity and overall performance of the list firms. Indeed, the PEX performance has much developed over last two decades, however, it still need fundamental reforms of CG matters and comprehensive disclosure (Hassan et al., 2016).

The high degree of ownership concentration in the Palestinian firms affected the firm performance negatively. Consequently, the Palestinian economy suffering from liquidity shortage, this shortage will cause a lack of confidence in the PEX. Hence, the Palestinian economy required to open up corporate in order to attract additional foreign investments and in turn improves quality and effectiveness of CG (Abdelkarim & Alawneh, 2009). Therefore, according to aforementioned discussion and consistent with agency theory, the following hypotheses proposed as shown below:

H3 : There is a negative relationship between foreign Ownership and EM in the Palestinian listed non-financial companies.

The Moderating Effect of Political Instability on the Relationship between OS and EM

Several prior studies addressed the financial crisis, political matter and their effect on EM and income smoothing (eg. Wang 2011; Attia, et al., 2016; Hsiao, et al., 2016; Obaidat 2017; Harymawan and Nowland 2016; Anon 2008; Filip and Raffournier 2014; Habib, et al., 2013 & Harymawan & Nowland, 2016). The study of Hsiao, et al., (2016) finds that USA oil & gas

firms have engaged in EM practice during the Arab Spring. Furthermore, Obaidat (2017) indicated that the firms practice income smoothing more likely in the political crises periods. Mangena et al. (2012) examined the association between BOD and OS and company's performance in severe political environment and economic crisis. They use the political theory which has been developed by Roe (2003) to investigate the relationship. They find that during the period of post-presidential election, BOD size, executive directors' ownership and ownership concentration increased, while the proportion of non-executive directors decreased. Firm performance is positively related to board size and ownership concentration in the post-presidential election period, but not in the pre-presidential election period. We document that the relationship between performance and executive directors' share ownership is positive in the pre-presidential election period, but negative in the post-presidential election period. Overall, they suggested that large boards and ownership concentration are more important in an environment of severe political and economic crisis. Finally, they recommended the academic bodies to do more studies to examine several issues such as disclosure and EM in the instable political environment. Based on political theory and positive accounting theory the hypotheses will be suggested as below:

- H4 : Political instability moderates the relationship between ownership concentration and EM in Palestinian non-financial listed firms.
- H5 : Political instability moderates the relationship between institutional ownership and EM in Palestinian non-financial listed firms.
- H6 : Political instability moderates the relationship between foreign ownership and EM in Palestinian non-financial listed firms.

THE FRAMEWORK OF THE STUDY RELATE TO THE THEORIES

The framework was constructed and developed according to prior studies and CG theories such as agency theory, political theory and positive accounting theory. Moreover, study adopted the political theory to discuss the moderating effects of the unrest political effects on the relationship between OS and the level of EM practices. Figure1 shows the main model of this study, which elaborated relationship between OS (namely; ownership concentration, institutional ownership, and foreign ownership) and EM. Moreover, the following framework shows the moderating effect of the political instability on the relationship between OS and EM practices. It is expected that high political instability may lead to weaken the association between OS and EM practice in the countries characterized by high political instability such as Palestine.

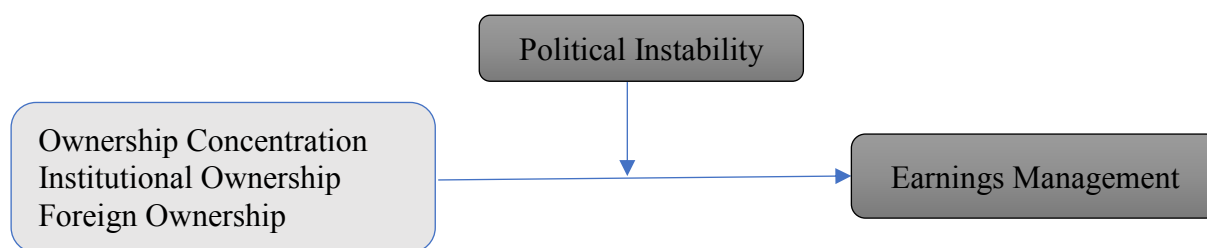


Figure1: Framework of the study

RESEARCH DESIGN AND METHODOLOGY

The data set of this current study consists of the Palestinian non-financial companies listed on PEX for 8 consecutive years of reporting periods from 2011 to 2018 (www.pex.ps). There are

some reasons for addressing this period started from the year 2011 and ended by the year of 2018. Firstly, to ensure the availability of data related to CG factors and EM accounting elements in annual financial statements. Secondly, to guarantee uniformity in the practice of CG in all listed non-financial companies on PEX after established the PCCG in 2009 and to study the political effects as a moderating variable. So that the period from 2011 to 2018 has many critical events serve this moderator such as there were happened tow devastating wars in Palestine during this period. The effects of global financial crisis which has occurred in 2008 still remain and Arab spring has just demonstrated in spring of 2011. Finally, at the other end of the period study, the year 2018 is chosen because the latest available data on overall variables of the research when this study was initially conducted.

This research was addressed the non-financial listed companies for the following justifications: Firstly, the managements of non-financial firms can choose between a number of accounting choices to treatment the same accounting transaction among the flexibility which provided by the International Financial Reporting Standards (IFRS) (Idris, 2012). Secondly, the non-financial sector is considered as a cornerstone for the Palestinian economy and plays a key role also, that because it comprises 33 companies out of 48 by percentage 69% of the total listed firms on PEX. Thirdly, financial sector is excluded because it is subjected to the Palestinian monitory Authority corporate governance code, which is different from the Palestinian Capital Market Authority code that applies to the non-financial sectors. So, the total observation will be 264.

The data of non-financial listed firms are manually collected from online annual reports (secondary data) that are publicly available in PEX website during the period of study from 2011-2018. Each listed firm on PEX has two files produced by PEX. The first file includes financial data involved in statement contains balance sheet, income statement, cash flow statement and a number of financial ratios. Thereby, Thomson Reutter One website had used to collect some financial data related to EM and control variables. Therefore, the missing financial data were collected manually from the published annual report. The second file consists of non-financial data. Thus, the non-financial data regarding to independent variables of OS were collected manually from the annual reports. Sekaran (2003), suggested that the secondary data technique may provide a lot of real data that can be useful in problem solving, thus the current study had chosen this technique.

CONCLUSION

This paper highlighted the OS in public listed companies in Palestine. The objective of this paper is to conceptualize the relationship between OS and EM. Indeed, the high degree of ownership concentration in the Palestinian firms affected the firm performance negatively and leads to increase the level of practicing EM. Consequently, the Palestinian economy suffers from liquidity shortage. This shortage will cause a lack of confidence in the PEX. Hence, the Palestinian economy required to open up corporate in order to attract additional foreign investments and in turn improves quality and effectiveness of CG.

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