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The association between earning management and corporate governance – a survey from Egypt

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Abstract:

This research paper aims to examine the relationship between earning management and corporate governance in Egypt by sending a survey online ,the response obtain demonstrated that there is a negative relationship between earning management and corporate governance mechanism

Keywords: Egypt – governance – earning management

Introduction:

The end of the 1990 "s and the beginning of the 2000"s has witnessed a series of recent corporate accounting scandals across the united state and Europe (eg: Euron, HealthSouth, Palamalat, Tyco, world com and Xerox) .The core of these accounting scandals was usually the phenomenon of earning management (Groncharow, 2005).

Earning management (EM) has been a great and consistent concern among regulators and has received considerable attention in the accounting literature.

It has been argued that earning management behavior masks the true financial results and position of business and obscures facts that stakeholders ought to know (Habbash et al. 2012)

While there is an extensive literature on opportunistic earning management in response to specific incentive to achieve one results or another , research looking at the impact of corporate governance on earning management is quite limited (Ayguin et al, 2010).

This current research aims to investigate the relationship between earning management and corporate governance mechanism in Egypt

Previous studies have examined some characteristics in mitigating earning management but this is a unique study using a variety of corporate governance characteristics together in transition country such as Egypt

The remaining of this paper is structured as follow, section 2 literature review, section 3, methodology and data analysis, and section 4, summary, conclusion and suggest for future research

Section 2: literature review

Earning management definitions:

According to Healy &Wahlen(1998)" earnings management occurs when management when managers use judgment in financial reporting and in structuring transactions to alter financial report to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting number ."

Earning management and internal audit function quality:

Firm established the internal audit function to provide it with an assurance and consulting services, which can improve the effectiveness of their risk management control and governance process.

An international audit function also expected to facility the operation and effective functioning of the audit committee as the goals of audit function are closely aligned with the financial reporting oversight the responsibilities of the committee (Scarborough et al 1998, Goodwin and Yeo 2001, Goodwin 2003). The formation of an internal audit function is endorsed by governance reports although traditionally internal audit focused more on controls and operational risks there has been increasing emphasis in the professional literature on the need to also focus on earning management and inappropriate financial reporting (Eighme AND Cashell 2002, martin et al 2002).

In addition sherron Watkins, former eron vice president believes that internal auditors should look for warning signs such as undue pressure from senior management to meet earning target and compensation arrangements that might encourage employee to manipulate earning in order to receive financial results.

According to Clikeman 2003 that internal auditors should not only be actively involved in detecting earning management but that they should take a proactive approach to educating managers and directors about the dangers of the practice .furthermore Eighme and Cashell 2002 regard the role of internal audit in detecting earning management as being a

Complementary one that of external audit. .

they believe that both should be actively involved in the detection of inappropriate earning management , thereby providing two unrelated opinion to the audit committee (Davidson et al 2005, pp.247-248)

Furthermore prawitt et al 2009 aim to examine the relationship between internal audit quality and earning management , they measure the internal function quality based on SAS 65 which include :the average experience of the internal auditors , the percentage of internal auditors that are professionally certified , the amount of time spent training during the year , the amount of time spent training during the year , the amount of financial work the IAF perform , the reporting relation of the head of the IAF and the size of the IAF relative to its industry , they measure earning management using two different proxies : the absolute value of abnormal accruals as determined by the performance adjusted modified Jones model reported in Kothari , Leone and wasley (2005) and the propensity of companies to meet versus just miss analyst " consensus earnings forecasts . They found evidence that internal audit function quality is associated with a moderation in the level of earning management as measured by both proxies.

Earning management and auditor's size:

many studies(beker et al 1998 , Francis et al 1999 , lin et al 2006) show that the use of brand name (auditor size) reduce earning management (lin and hwang , 2010)

Earning management and board size:

Board size on financial reporting and hence , information quality will be higher for those firm with a small board size .this may be due to the possibility of better discussion of financial reporting , numbers among the member of a small board compared to a large board , inversely , a larger board is expected to be less effective as the monitoring responsibility will be diffused among many directors (Vafeas , 2000)while several authors found that a smaller board size could enhance the quality of earning (Beasley , 1996 ,vafeas 2000, ahmed at al 2006)

Other found no relationship or a negative relationship between board size and earning management (chtourou et al 2001, xie et al 2003, peasnell et al 2005) as cited by Mohamed et al 2012

Earning management and audit committee:

According to the blue ribbon committee report, audit committee report serves as an ultimate monitor of the financial reporting system, the committee selects the outside and question management, external auditor and internal auditor to determine whether they are acting in the best interest of the company. one of the primary function of the audit committee is to safe cards the independence of external auditor , given the strong economic or personnel affiliation of inside directors with the company or its management audit committee that have a majority of affiliated directors will be more likely to side with management in any disputes with the auditor (Ebrahim , 2007)

In addition Klein(2002 a) finds that an independent audit committee and active audit committee are associated with lower levels of discretionary , earning management is negatively associated with a committee composed only of independent directors , that meet more than twice a year .(Siregar &Utama(2008)

Earning management and CEO duality:

The board exist in order to keep management accountable for the power its wield , when the chairman of the board is the CEO, management is accountable to a body led by management , the CEO is then put the position of evaluating his own performance , creating a clear conflict of interest when the CEO control the quality , quantity and timing of the information that is presented to directors , they cannot be assured of getting what is needed for true independent oversight (monks and minnow (2001), additionally , when the CEO is also the chairman , he has incentive to tilt decisions and agenda toward protecting and advancing his career interest .

Jensen 1993 argue that directors are more likely to acquiesce to the CEO desire when the CEO is also the chairman of the board , separation of the role of chairman and CEO is also the chairman of the board , therefore should lead to more objective evaluation of the CEO and management and greater accountability (Hochberg 2003)

Earning management and the board of directors meeting:

Vafeas 1999 has demonstrated that board meet more often during periods of turmoil and the board meeting more often show improved financial performance. A board that meets more often should able to devote more time to issue such as earning management. A board that seldom meets may not focus on these issue and may perhaps only rubber – stamps management plans .(Xie et al , 2001)

Earning management and ownership construction"

An institutional ownership:

One increasing important issue relating to investor concerns the role of institutional shareholders activism by pension funds and issuance companies such institutional investors often buy large stakes in firms and could take an active role in monitoring management, prior studies (del 1996, chung et al 2002) present that ownership by institutional investors is positively related to earning performance and corporate value (Mitanni, 2010)

Section 3: Methodology and data collection:

Used an online survey sent through the website (www.esurveyspro.com) during the period 29\6\2012 to 31-7-2012, I received 34 response whish they been from the following categories:

27 from academics

3 from external auditors

1 from economists' expert

1 from real estate management

2 from financial management

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34 total response of the survey

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In the following I propose the questions included in the surveys and the response for them:

1. **There is a negative relationship between number of board of director (board size) and earning management**

   5.88% of the sample strongly agree, 47, 6 % agree, 35, 29% neutral, 8, 82% disagree and 2, 94% strongly disagree.

2. **There is a negative relationship between the number of board of directors meeting and earning management**
   5.88% of the sample strongly agree, 44, 12%agree, 29, 41% neutral, 14, 71%dissagree and 5.88%strongly disagree
3. **There is a negative relationship between the board director duality and earning management**
   20, 59% strongly agree, 44, 18% agree, 26, 47% neutral an 11, 76% disagree
4. **There is a negative relationship between the internal auditor experience and earning management**
   38, 24% strongly agree, 44, 12% agree, 14, 71%neutral, and 2, 94% disagree
5. **There is a negative relationship between internal auditing certificate and earning management**
   11.76% strongly agree, 47, 06%agree, 29, 41%neutral, and 11, 76 disagree

6. **There is a negative relationship between the internal auditing training and earning management**
   26, 47%strongly agree, 47, 06% agree, 20, 59% neutral and 2.94% disagree
7. **There is a negative relationship between the external auditors size and earning management**
   23, 53% strongly agree, 50% agree, 14, 71%neutral, 8.82%dissagree and 2.94%strongly disagree
8. **There is a negative relationship between the presence of audit committee and earning management**
   38, 24%strongly agree, 52, 82%agree and8.82%neutral
9. **There is a negative association between ownership construction and earning management in Egypt**
   26, 47% strongly agree, 50%agree, 17, 65% neutral and 5.88% disagree

Suggest research

This research paper is only a survey posted online and that has limited response so I suggest taking other sample without taken the industry different in consideration, and this research could retake by take measure of earning management and another research methodology and analysis

For audit committee I ask about the presence of audit committee, researcher could take the impact of audit committee characteristics on earning management

Or the influence of board of directors on earning management such as board composition, CEO compensation, --- extra

In other way researcher can take the relationship between internal audits qualities on earning management finally this survey can take in another country

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