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Proposing Conceptual Framework for Reducing Earning Management Using Ownership Structure Mechanism: Jordanian Companies Perspective

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Abstract

This paper evaluates as well as synthesizes the empirical studies results of the relationship between one mechanism of corporate governance and financial reporting quality (FRQ). The authors study one oversight mechanism that is ownership structure. For the mechanism, the authors recapitulate the links between variable monitoring effectiveness contribution and monitoring outcomes of FRQ namely earnings management (EM). The system arrangement affords synthesizing the empirical findings allegation, highlighting the mechanism of corporate governance role in improving FRQ. This probable synthesis inform regulators, board of directors and accountants who are apprehensive with enhancing the public and private corporations oversight in addition to decreasing managers and others the opportunities to engage in EM. The ownership structure components are insider managers, institutional investors, and block-holders that can improve the FRQ.

Keywords: Ownership structure, corporate governance, earnings management, financial reporting quality.

Introduction

While FRQ is not observable directly, famous observers stated that they know it as they see it; they also energetically emphasize the importance of FRQ as the same as a modern capital market foundation. Former chairman of the United States Securities and Exchange Commission (SEC), Arthur Levitt said: “high quality accounting standards …improve liquidity and reduce capital costs” and claims that “quality information is the life blood of strong, vibrant markets. Without it, liquidity dries up. Fair and efficient markets cease to exist.” Easley and O’Hara (2004) stated that capital market decrease premium financial reporting to enable investors reduce investment risks, lending sustain of conceptual to Levitt’s declare. Furthermore, the Senate of Canada (2003, p. 2) said: “analysts generally agree that the financial scandals appearing almost daily for months in the media were the result of some combination of at least three factors: failed corporate governance; lax auditing and accounting standards and oversight; and the incentives, at times perverse, provided by executive compensation systems”.

There is a shortage in consensus as to what FRQ constitutes. For example, Blue Ribbon Commission (BRC) (1999) and Sarbanes-Oxley act (SOX) (2002) required auditors to discuss the FRQ methods and acceptability. Jonas and Blanchet (2000, p. 353) stated that: “in light of these new requirements, auditors, audit committee members, and management are now struggling to define FRQ”. Rather than defining FRQ, prior literature review has focused on factors such as EM, financial restatements, and fraud that obviously curb the high FRQ

achievement and have used the presence of these factors as proof of a breakdown in the process of financial reporting (Nichols & Wahlen, 2004; Barth et al., 2008). Thus far, the FRQ measurement has evaded the researchers and those interested to improve it.

The main significant function of corporate governance is to increase the integrity of the FRQ process (Cohen et al., 2004). Watts and Zimmerman (1978, p.113) stated that: “one function of financial reporting is to constrain management to act in the shareholders’ interest”. Investors needed additional accurate and comprehensive information for their decisions of investment due to rising the complication rising of today’s business.

In the early 21st century, there were many corporate accounting scandals series in the United States of America (USA) and Europe. Examples included Enron, HealthSouth, Parmalat, Tyco, WorldCom and Xerox. The central issue of those scandals center was EM (Goncharov, 2005). EM has been concern of practitioners and controllers and has established substantial concentration in the literature of accounting (Loomis, 1999). EM has masked the accurate results of financial and businesses situation and has created ambiguous information that stakeholders be supposed to know (Loomis, 1999).

The crisis of global market (2008) has enthused enormous research body on both corporate control and FRQ. Usually finance and management are separated inside corporations. Though, the action of separation pretenses two conflicts. First, suppliers of fund facade communal action problems stopping them to monitor and discipline the company managers they are investors of (Macey, 1998). Second, managers need to persuade market applicants of the performance of firm, to be capable of apportion sufficient funds for the investments of firm. As the investments value is tied to the firm, this value relies on the future predictions of the business relationship between the firm and its suppliers. As a result, the stakeholders’ perception about the firm’s future forecast influences their inducement to take on such investments. Therefore, researchers recommended that in order to persuade stakeholders; managers may engage in EM (Graham et al., 2005).

The financial reporting scandals in USA and Europe corporations, which has previously been measured as the perfect model of financial reporting and regulation of capital market, has added to the defeat of investors’ confidence in the direction of the accounting numbers truthfulness. This resulted in an important investment extraction from the securities market in 2001 and 2002 (Saudagaran, 2003). Mutually these scandals with the Asian financial crisis 1997/1998 and the global market crisis of 2008 have strained deliberation to corporate governance improvements around the world and require improving the FRQ as long as the capital market requirements accurate and impartial financial reporting to securities value and encourage investors’ confidence.

The objective of this study is to analyze and synthesize the corporate oversight literature and its relationship with governance measures that are supposed to be linked with EM. The researchers inspect one mechanism of oversight – ownership structure component – that can add to the effective monitoring of companies’ financial reporting. The researchers recapitulate and construe

the results of USA and international empirical research examining the relationship among variables that can influence monitoring effectiveness.

The financial reporting theme is of enormous value to all financial statements users in making their investment decisions. So, this distinctive categorization method offers a way of synthesizing the empirical findings implications in a coherent framework, stress the corporate governance role in improving EM. EM may have a negative effect on the earnings quality, which in sequence might misled shareholders, investors, creditors, regulators, tax authorities and all other users they may rely on manipulated accounting numbers. For example, tax authorities determine the taxable income based on accounting income, after some adjustments according to the tax law. If accounting income is manipulated, so are taxable income, and thus the tax amount. Additionally, financial institutions base their decisions to give credit partly on the performance of the borrower; if managed, earnings will misallocate funds among competing firms. This study will be vital to Amman Stock Exchange (ASE) that is concerned about EM and improving the FRQ.

The structure of the paper is as follows. The text section overviews of the background of the study. Literature Review section summarizes the literature review. Corporate Governance Effectiveness section reports the corporate governance effectiveness. The Conceptual Model and Propositions Development section shows the conceptual model and propositions development. The finally Section summarizes and concludes this paper.

Background of the Study

Jordan is a stable nation, a moderate economy, as well as has comparatively sophisticated stock market. Yet, its economy is private segment slanting; the ownership state is quite small. Lately, a privatization series scheme has been put into practice to decrease government shares in the economy (Al-khabash & Al-Thuneibat, 2009).

In Jordan all registered firms are subject to the certification responsibility and publishing their financial reporting. From 1987, Jordanian Association of Certified Public Accountants (JACPA) is responsible for conducting the professional examination and monitoring the quality of financial report. It adopts International Accounting Standards (IAS) as a basis for preparing financial report.

In 1978 the Amman Financial Market (AFM) was established. Thereafter, the Securities Law 23/1997 was introduced as a process to transform Jordanian capital market. Three institutions emerged: the Jordan Securities Commission (JSC), the ASE, and the Securities Depository Center (SDC). The ASE is the largest stock markets in the region that authorizes foreign investment. In 2008, market capitalization to GDP was about 226.3% and listed securities are trade in electronically.

In accordance with the JSC Law (23/1997) and Directives of Disclosures, Auditing, and Accounting standards (1/1998), all listed companies are required to apply International Financial

Reporting Standards (IFRS). These directives specify the information to be disclosed and filed with the Commission for enhancing transparency. Listing companies are also required to apply the International Auditing and Accounting Standards under the supervision of the JSC. A new Securities Law number 76/2002 has been issued, which authorizes setting up other stock exchanges and allowed forming an independent investor protection fund, stricter ethical and professional codes, and a more stringent observance of the rule of law (ASE, 2009). Additionally, the Accountancy Profession Law (APL) 73/2003 was issued. Important features of the APL include the establishment of a High Council for Accounting and Auditing, headed by the Minister of Industries and Trade and the creation of an improved JACPA.

The above law evolvement shows that Jordan is a country in which investors rely on accounting information before making investment decisions. Thus, it is critical to consider the theme of EM in order to protect those investors from being misled (Al-Fayoumi, Abuzayed, & Alexander, 2010). This study proposes a conceptual model to assess the merit of calling different types of investors to play an active role in corporate governance practices.

Literature Review

Earnings Management

There are no compromises on the EM definition (Beneish, 2001). For example, Schipper (1989, p. 92), defined EM as: “the process of taking deliberate steps within the constraints of Generally Accepted Accounting Principles to bring about a desired level of reported income”. Healy and Wahlen (1999, P. 365) stated that: "earnings management occurs when managers use judgment in financial reporting in structuring transactions to alter financial reports, to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting". EM is also defined as: “an intentional structuring of reporting or production/investment decisions around the bottom line impact” (Hui & Fatt, 2007, p. 196).

A number of preceding studies investigated as to whether EM exist in firms reports (Healy, 1985; DeAngelo et al., 1994; Burgstahler & Dichev, 1997), attempt to find out the EM types (Beneish, 2001; Sirgar & Utama, 2008), or the EM motives (Healy & Wahen, 1999). Factors similar to compensation of management incentives of contract (Dechow & Solan, 1991; Guidry et al., 1999), motivations of regulatory (Key, 1997), motivations of capital market (Teoh et al., 1998), and incentives of external contract (Watts & Zimmerman, 1986) have been observed to understand behavior of managers to EM.

EM takes place in three ways namely, by the use of the certain revenue structuring and/or transactions of expense; the use of accounting procedures changes; and/or the use of accruals management (McNichols & Wilson, 1988; Schipper, 1989). Among these techniques of EM, accruals management is the most harmful to the accounting reports value because the investors are unconscious of the amount of accruals (Mitra & Rodrigue, 2002). Accrual can be defined like the difference between the earnings and cash flow from operating activities. Further, accruals can be classified into discretionary accruals and non-discretionary accruals. Discretionary accruals are adjustments to cash flows selected by the managers whereas non-discretionary accruals are

accounting adjustments to the firm's cash flows mandated by the accounting standard-setting bodies (Rao & Dandale, 2008).

The difference between theoretical definitions and categorizations has shaped a lot of opportunities for the researchers to investigate the practices, motivations and consequences of EM. Several international studies (Xie et al., 2003; Nelson et al., 2002, 2003; Kanagaretnam et al., 2003; Amat et al., 2003; Baralexis, 2004; Graham et al., 2005; Davidson et al., 2005; Othman & Zeghal, 2006; Roychowdhury, 2006) and national (Jordanian) studies (Qarran, 2005; Al-Momani, 2006; Hamad, 2007; Al-khabash, & Al-Thuneibat, 2009; Al-Fayoumi et al., 2010) have concentrated on the EM problem.

Xie et al. (2003) conducted a sample study of 282 USA firms via a model containing discretionary and non-discretionary total accruals components. Using both descriptive statistics and regression analysis, they originated that EM is less take place in companies as boards of directors comprise independent outside directors with experience of corporate. Correspondingly, banking audit committees members, investment, or corporate backgrounds negatively linked with the EM level. Moreover, a relationship among lower EM level and the boards of directors' frequency meeting as well as audit committees was found.

Based on collected data by using questionnaires regarding 515 EM efforts from 253 auditors of experienced working in the USA of a big firms accounting offices, Nelson et al. (2002, 2003) reported that EM contain areas like revenue recognition, business combinations, intangibles, fixed assets, investments, and leases. On the other hand, the majority regularly recognized attempts EM were reserves. Various respondents' motivations were afforded, which include meeting analysts' estimates, stock market influencing, management-compensation contracts meeting goals, shareholders communicating economic information, and income smoothing or improving future income for different reasons.

Based on audit reports examination of 35 listed companies in Spanish Stock Exchange, Amat et al. (2003) detailed several practices that might be competent like EM. Using descriptive statistics, extraordinary results analysis and financial statements notes, such performs incorporated the next: reserves expenses charged rather than counting them in the income statement, capitalization expense, inventory valuation system changing, depreciation methods accelerated, pension plans extraordinary fees, not reflecting stock options expenses, insufficient provisions, and earnings reduction as future losses.

Based on modeling a exact accrual associated with loan loss provisions as well as use correlation and multivariate analysis, Kanagaretnam et al. (2003) scrutinized the bank mangers' objects in via loan loss provisions discretion in order to manage earnings, using a sample of 4,166 observations of bank-quarter that include bank holding USA companies. Their finding offered evidence that banks managers with good existing performance and anticipated poor future performance will save future income by decreasing existing income during loan loss provisions. Likewise, banks with poor present performance and probable good future performance will borrow income from the future by rising present income during loan loss provisions.

Additionally, job security is a significant EM motivation; the decisions of managers in order to manage earnings are prejudiced by the cost of borrowing incentive reducing.

Based on collected data through distributing questionnaires for 100 independent accountants as well as 100 senior auditors in Greece, Baralexis (2004), used correlation analysis and x^2, found that, EM is accomplished to a great level (25% of earnings pre-managed). Both it is practiced through GAAP deficiency advantage and also violating it. Also, the big companies exaggerate profit for the increasing outside financing purpose. In contrast, small companies minimize earnings for paying low taxes; as a result, the firm size persuades the manipulation direction and reasons. Finally, it was found that legitimate EM is further accepted than illegitimate.

Based on a cross-sectional Australian companies sample of 434 for the ended year 2000, Davidson et al. (2005), studied the internal governance structures characteristics by using regressing discretionary accruals models on a set of internal governance factors (the board of directors, the audit committee, the internal audit function (IAF), and the external auditor choice) on EM effect. The results found that both boards and audit committees are significantly linked with a lower of EM. Additionally, there was a negative relationship among the presence of an audit committee and EM. Also, IAF was significantly associated with EM decreased. Likewise, there was no relationship between Big4 and EM lower level.

Based on surveying of more than 400 and interviewing with executives working in firms of USA in addition to using both descriptive statistics as well as correlation analysis, Graham et al. (2005), given confirmation that managers are interested in benchmarks earnings meeting and earnings manage in order to continue or add to stock price, to improve the management team of external reputation, and to converse future expansion predictions. Furthermore, they detailed that EM is accomplished during real actions economic for instance, delay of expenditures advertising, like manipulation throughout utilizing discretion within-GAAP similar to use the accrual management.

Roychowdhury (2006) investigated EM during actual (operational) manipulation activities, as opposite to EM throughout accruals. Founded on a USA sample of 4,252 firms, it was revealed that managers develop earnings reported through via discounts of price to provisionally sales increasing, with overproduction engaging in order to report lesser costs of goods sold, and by decreasing discretionary expenditures to progress margins.

Othman and Zeghal (2006) examined motivations of EM in both environments of Canadian and French. The sample was 1,674 Canadian and 1,470 French observations. Using correlation and regression analysis, they given proof that practices of EM in France are mainly associated to contractual debt and effective tax rates motivations. In contrast, incentives of market-related for instance initial public and subsequent equity offerings are tough in Canada, which reflect a dynamic capital market.

Qarran (2005) studied the income smoothing phenomenon and the factors that affect the inclination of management toward income smoothing (company size, taxes disbursements to sales ratio, return on sales, capital intensity, company profitability, ratio of operating expenses to

total expenses, ratio of general and administrative expenses to total assets, profitability of the individual share). She applied Eckel's model on a sample of 53 listed companies on ASE over the period 1996-2003. She found that income smoothing is widespread in manufacturing companies sector. The percentage of smoothing net income before tax was the highest (60.4%) after that smoothing net operating income (54.7%) and afterward by smoothing net income (43.4%).

Al-Momani (2006) studied the exploiting the flexibility level available in accounting standards by Jordanian companies during applying the modified Jones model (1991) on 70 listed companies in ASE over the period 1997-2003. Using regression analysis, t-test, and ANOVA, he found that the majority managers engage in EM by exploiting that flexibility, the banking sector was the highest in EM engaging while, the lowest was insurance sector. Furthermore, the following significant relationships were found: a positive relationship among the company profitability and EM on all sectors excepting banking sector, a negative relationship amid cash flow from operation (CFO) and EM on all sectors, as well as a negative relationship between the audit report liquidity and type and EM on the industrial sector.

Hamad (2007) studied the income smoothing effect on market return of both service and manufacturing companies sector listed in ASE. Based on a sample of 44 manufacturing and 24 service companies, in addition to using regression, t-test, and x^2 analysis methods, she found that these companies are practicing income smoothing. Also, there was no effect by the sector type on income smoothing implementation except for using gross profit as income measure. Furthermore, the company size found no impact on income smoothing except for when an average sale is used as a size proxy and testing mutually the sectors. Additionally, an important income smoothing statistical effect has been found on market returns.

Al-khabash, & Al-Thuneibat (2009) provided evidence regarding the EM existence from the external and internal auditors' perspective in Jordan. A particularly designed questionnaire was dispersed to a sample of both external and internal auditors. Using t-tests and ANOVA, they showed that external auditors supposed that significantly management engages only in legitimate EM that either increases or decreases income. On the other hand, internal auditors supposed that management engages in legitimate EM practices that only increase income. In both cases, there was important dissimilarity amid their opinions. There is no significant differentiation among large and small companies concerning EM practices. Nevertheless, the internal governance structure characteristics have a major consequence on illegitimate EM, while no major effect was found on legitimate EM.

Al-Fayoumi et al. (2010) studied the association amid ownership structure and EM for Jordanian industrial sample firms throughout 2001-2005 periods. EM is measured through discretionary accruals, while ownership structure by insiders, institutions and block-holders. Using the Generalized Method of Moment (GMM), the results showed that insiders' ownership is significant and positively affect EM. Additionally, found insignificant institutions and block-holders in monitoring EM managerial behavior. Their conclusion have significant policy insinuations in view of the fact that they supported encouraging applying principles of corporate governance to stimulate institutions and block-holders to afford effective monitoring of

managers in Jordanian firms. Accordingly, the reported earnings reliability and transparency may be improved**.**

Corporate Governance Effectiveness

Adrian Cadbury defined the aims of corporate governance as: "The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society" (Cadbury, 2002, p.13).

Additionally, the Organization of Economic Cooperation and Development (OECD) defined corporate governance as "The system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance" (OECD, April 1999).

The separation of ownership and control in modern corporations can give rise to the potential for conflicts of interest between owners and their agents who manage the day-to-day operation of the company. Jensen and Meckling (1976) argue that managers (the agent) act on behalf of the shareholders (the principal), who are the actual owners of the firm. This relationship empowers the managers' position and leaves the firm's shareholders with no control over the decision-making processes.

Jiraporn et al. (2008) argued that firms that are more informationally opaque may engage in more EM because a higher degree of asymmetric information makes it more difficult for shareholders to monitor managers. Thus, in the absence of effective control procedures within the firm, managers are more likely to take decisions that deviate from the interests of shareholders. As a result, managers may be better able to abuse their discretion over earnings, such as engaging in EM, thereby increasing agency costs. Hence it is argued by Fama and Jensen (1983) that firms need a system that can separate decision management from decision control in order to limit agency costs. Corporate governance can provide this desirable system or at least part of it. Such a system limits the power of management to disregard the interests of shareholders, thereby decreasing agency costs. This claim is also documented by Fama, (1980), Fama and Jensen, (1983) and Williamson (1988). These studies argued that corporate governance mechanisms constrain managerial opportunism. According to Hart (1995), a major part of corporate governance is designing checks and balances on opportunistic behavior by managers.

Over the last two decades, large and growing consideration has been given to the importance of different corporate governance mechanisms for monitoring managers' discretion, including their discretionary financial reporting. Investors and regulators believe strongly that corporate governance mechanisms such as independent directors on the board and audit committees help to

protect the shareholders' interests and alleviate any conflict of interest between shareholders and managers. For example, the former United States Securities and Exchange Commission (SEC) chairman recommended that the SEC needs to pay more attention to the effect of corporate governance mechanisms on financial reporting (Levitt, 1998).

The Sarbanes-Oxley Act (2002) suggested that corporate governance should impact on shareholders' perception of the information content of accounting earnings. Accordingly, in order to constrain any divergence in interests and to ensure appropriate accountability of resources, an organization needs a comprehensive structure of controls that encourages efficient performance and responsible behavior. Corporate governance is used to deter any conflict of interests between shareholders and managers that may result in EM behavior causing a reduction in shareholder wealth.

Cohen, et al (2002, p.587) recognized that: "…one of the most important functions that corporate governance can play is in ensuring the quality of the financial reporting process". Thus, effective oversight of the financial reporting process by the aforementioned monitoring mechanisms is thought to improve the accuracy of reports to shareholders and act as a deterrent against possible opportunistic behavior by managers.

EM is likely to reduce the FRQ and its usefulness for investment decisions, therefore, reducing investor confidence in the financial reports. On the other hand, accounting earnings are more reliable and of higher quality as opportunistic behavior of managers is reduced through using monitoring systems (Wild, 1996; Dechow et al., 1996). Thus, stock market regulators and other investor protection agencies are concerned about EM, especially after the collapse of several large firms in recent decades and they have responded through enhancing corporate governance.

One vital monitoring system is corporate governance. Its primary objective is directly improve corporate performance and resolve agency problems through aligning the interest of management with the interests of shareholders (Demsetz & Lehn, 1985). Gul and Tsui (2001) supported the corporate governance effectiveness as a monitoring system. Among others, Xie et al. (2003) and Klein (2002) showed that corporate governance reduces the ability of management to manage earnings.

With globalization of business and financial markets, there has been strong demand for FRQ from firms across countries so that investors can conduct comparative evaluation of risk and return of firms in different countries (Jaggi & Leung, 2007). Consequently, regulators in several countries outside the USA also started paying attention to corporate governance, in particular ownership structure components (insider managers, institutional investors, and block-holders) to improve the FRQ (Al-Fayoumi et al., 2010). In short, corporate governance therefore assists investors by aligning the objectives of management with the objectives of shareholders, thereby enhancing the financial information reliability and the financial reporting process integrity (Watts & Zimmerman, 1986).

The Conceptual Model and Propositions Development

The following conceptual model is developed to investigate the association between ownership structure and EM. The diagram for the conceptual model is illustrated in Figure 1. In this conceptual model, ownership structure and EM are independent and dependent variables respectively. The present study thus attempts to bridge the gap through providing a basis for a comprehensive and perceptive discernment of the impact of ownership structure on EM. Although the causal relationships among the constructs shown in Figure 1 seem to be straightforward, to our knowledge, the present study is the only one that investigates the relationship between ownership structure and FRQ. In order to make practical statements about ownership structure and its associations with EM, the model requires further analysis.

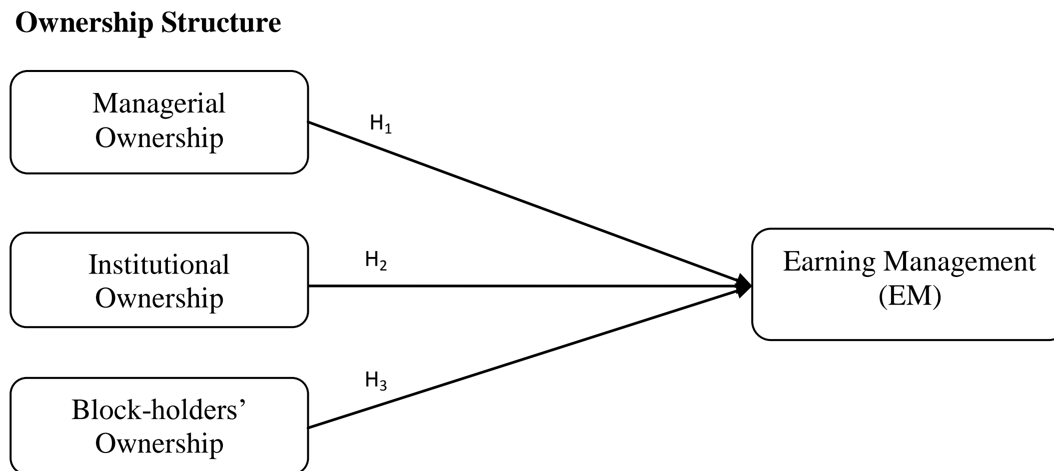

Figure 1: Ownership Structure and Earning Management

Propositions between ownership structure and earning management

Ownership structure as proposed by the agency theory is one of the most important corporate governance mechanisms to solve agency problems and suggests that concentrated ownership will result in more effective monitoring (Jensen & Meckling, 1976). Whilst researchers in developed countries focus on the conflict of interest among outside shareholders and managers in a diffused ownership, in Asia where ownership concentration structures are more common the agency problem shifts to conflicts amongst the controlling owners and the minority shareholders (Claessens & Fan, 2002). The concentrated ownership creates agency conflicts between controlling owners and minority shareholders, which are hard to mitigate during the traditional functions of a board of directors.

The ownership tightness allows self-interested behavior of managers to go unchallenged, internally through the board of directors and externally through takeover markets, as the controlling owners, who are often also the managers, gain effective control of a corporation and have the power to determine how the company is run and may expropriate the minority shareholders' wealth. Thus, the ownership structure of a company could be of critical importance to the effectiveness of oversight mechanisms employed to reduce the likelihood of EM practice.

It is argued that an effective mechanism to constrain EM is the development of an appropriate ownership structure.

There are two streams of thought regarding an effective structure of ownership. First, insiders or managers of the firm act also as shareholders if they acquire a considerable portion of the entity's shares, and this is deemed to be useful in reducing agency conflicts and aligning the interests of management and shareholders. Secondly, outsiders who own a significant number of the firm's shares, have more power and more incentive to monitor management activity, mainly the process of financial reporting, thus reducing the EM probability.

Jordan ownership appears to be less highly concentrated than in many emerging markets; average free float is about 40 percent. This figure includes blocks of about 5 percent that may be part of the majority group and are held separately or indirectly. Family-owned business groups, centered on the bank, and including insurance, industrial, and tourism firms, are typical. The main listed companies are controlled by about 30 percent of the shares, which is usually reinforced by cross-shareholdings and inter-locking directorships. In addition, around 70 firms are controlled by a super-majority, indicating that consent of minority shareholders is not required for fundamental decisions. So far, institutional investors play no significant role and foreign ownership, mostly from Arab countries, accounted for around 40 percent of market capitalization (Financial Standards Report, 2009).

This section illustrates three types of ownership, internal ownership by managers, external ownership by institutional investors and ownership by block-holders to reduce EM. The discussion includes pertinent previous studies on the effectiveness of these ownership structures on reducing EM.

Managerial Ownership

Koh (2003) investigated Australian firms in relation to the relationship between managerial ownership and aggressive EM practice and found a positive association between them. This result is consistent with the view that high managerial ownership encourages managerial accruals discretion.

Hsu and Koh (2005) extended Koh's (2003) research by investigating the effect of both short-term and long-term managerial ownership on the extent of EM in Australia. They found that managerial ownership is statistically significant for all linear specifications but insignificant for the non-linear models. However, managerial ownership is positively associated with income-decreasing discretionary accruals and negatively associated with income-increasing accruals. Bergstresser and Philippon (2006) supported this by saying that the more closely a CEO's compensation is tied to the value of stock and options, the more likely it is that discretionary accruals will be used to manipulate profits.

Teshima and Shuto (2008) examined the managerial ownership effect on EM and found that EM is significantly positive within intermediate regions of ownership, which suggested that the

entrenchment effect is dominant in these regions. Also, they found that the association between managerial ownership and EM is significantly negative within low and high regions of ownership, suggesting that the alignment effect is dominant in these regions.

The above studies suggested that monitoring seems to be weaker at higher managerial ownership levels and, therefore, a positive relationship is documented between the managerial ownership and EM. In the UK context, Peasnell et al. (2005) studied this relationship by hypothesizing that the constraining relationship between EM, on the one hand, and an independent board of directors and the audit committee existence, on the other hand, will be more pronounced when the level of managerial share ownership is low. They did not document a direct association between managerial ownership and EM. On the other hand, they found little support for these conjectures, suggesting that boards continue to have a constraining influence on EM, even when shareholders and managers interests are better aligned. Laux and Laux (2009) examined the board of directors' equilibrium strategies for setting CEO incentive compensation and overseeing financial reporting and the effects of these on EM by using UK data. The results showed that an increase in CEO equity incentives does not necessarily increase EM because of the directors adjusting their oversight effort in response to a change in CEO incentives.

However, there are few studies that argued the high managerial ownership is an effective governance device that results in reducing EM. Warfield et al. (1995) uncovered that the magnitude of accounting accrual adjustments is significantly higher when managerial ownership is low. Specifically, the absolute value of accrual adjustments is twice as high when managerial ownership is under 5 percent than when managerial ownership is above 45 percent. There are at least two plausible explanations for Warfield et al. (1995) contradictory result. First, they measured non-discretionary accruals as the five-year average of previous period accruals whereas other studies measured the discretionary accruals using models based on Jones (1991). The difference in the dependent variable measured is significant as they reported a mean of absolute discretionary accruals of 26%, which is much higher than that reported in the previously discussed studies, for example 7% in Koh (2003), 0.006% in Hsu and Koh (2005) and 3% in Teshima and Shuto (2008). The second plausible explanation is that Warfield et al. (1995) did not control for institutional ownership, which may be a correlated omitted variable in ownership and EM research.

In addition, Klein (2002) examined the effectiveness of the board and the composition of the audit committee on earnings manipulation. She found inconclusive results that showed positive in two out of five models at 0.10 p-values. Given the impact that managerial ownership is likely to have on EM, this study proposes the following hypothesis:
H_1: Managerial ownership is negatively related to earning management among Jordanian listed companies.

Institutional Ownership

The preceding literature illustrates that institutional investors can be considered as sophisticated investors who typically serve a monitoring role in reducing pressures for myopic behavior. For instance, Bushee (1998) investigated as to whether institutional investors create or reduce

incentives for corporate managers to reduce investment in research and development (R&D) to meet short-term earnings goals. The results indicated that managers were less likely to cut R&D to reverse earning decline when institutional ownership is high.

It is a global view that institutional investor involvement in corporate governance is a complementary to corporate governance mechanism. Ferreira and Matos (2008) investigated the institutional investors' role around the world using a comprehensive data set of equity holdings from 27 countries. The results showed that firms with higher ownership through foreign and independent institutions have higher firm value, higher operating performance and lower capital expenditures.

Institutional investors were classified into two main groups by recent studies. Firstly, long-term institutional investor who invest in firms with the intention of holding their ownership stake over a long period. Therefore, they have strong incentives to monitor those firms. Secondly, short-term oriented institutional shareholders or as some studies referred them as myopic or transient institutional investors. This group of investors is dominant and they focus mainly on current earnings rather than long-term earnings in determining stock prices (Bushee, 2001). They engage less in the management monitoring process and, if they are unhappy with the firm's results, prefer to sell their stakes rather than to monitor or remove inefficient managers (Coffee, 1991).

Bushee (2001) provided a method for classifying institutional ownership into short-term holdings and long-term holdings based on portfolio turnover and engagement in momentum trading. Latest studies use the level of institutional ownership and average percent of outstanding shares that are owned by institutional investors (Koh, 2003). Previous studies showed that short-term and long-term institutional holdings have opposite effects on EM. While long-term institutional holdings have a significant negative effect on the level of EM, short-term institutional holdings have a positive effect. Bushee (2001) stated that the characteristics of institutional investors should be considered when examining the relationship between institutional investors and EM.

Bushee (2001) examined different effects of institutional non-block-holders and active institutional block-holders on EM behavior. He proposed that institutional non-block-holders are more interested in short-run performance than are institutional block-holders and that this interest creates pressure on management to deliver high earnings. On the other hand, Cheng and Reitenga (2009) found that active institutional block-holders exercise their monitoring power only when there is a pressure to increase earnings. But when there is strong pressure to decrease earnings, the effect of active institutional block-holders is inconclusive. This suggests that active institutional block-holders are conservative since they appear to be more likely to limit income-increasing accruals than income-decreasing accruals.

Charitou et al. (2007) examined the earnings behavior of managers during the distressed period. The results showed that the management of distressed firms with lower (higher) institutional ownership have greater (lesser) tendency to manage earnings downwards. In Australia, Koh (2003) found that the relationship between institutional ownership and aggressive EM was positive at lower level of institutional ownership and negative at higher level of institutional

ownership. This is consistent with the view that monitoring by long-term institutional investors limits managerial accruals discretion.

Hsu and Koh (2005) extended Koh's (2003) research by investigating the effect of both short-term and long-term institutional ownerships on the extent of income-increasing and income-decreasing EM. It is found that managerial ownership is statistically significant for all linear specifications but insignificant for the non-linear models. Their results suggested that transient and long-term institutional investors co-exist and have differential effects on EM. Transient institutions are associated with upward accruals management while long-term institutions constrain this activity.

Osma and Noguer (2007) tested whether corporate governance mechanisms are effective in constraining EM. They found that key constraint of EM is institutional directors, unlike the UK and USA where independent directors play a significant role. Cheng and Reitenga (2009) examined the differential effects of institutional non-block-holders and active institutional block-holders on EM and found that active institutional block-holders need to exercise their monitoring power only when there is pressure to increase earnings. But when there is strong pressure to decrease earnings, the evidence regarding the effect of active institutional block-holders is inconclusive. This may suggested that active institutional block-holders are conservative since they appear to be more likely to limit income-increasing accruals than they are to limit income-decreasing EM. Cheng and Reitenga (2009) also asserted that the institutional investors' characteristics should be considered when examining the relationship between institutional investors and EM.

Chung et al. (2002) investigated the relationship between institutional ownership and EM practice and found significant relationship between institutional investors and EM. Peasnell et al. (2005) supported this by saying that there is no relationship exists between institutional investors and EM.

From the previous studies, it can be seen that institutional shareholders with a high ownership stake can play a significant role in monitoring and mitigating management opportunistic behavior such as EM. This seems not to happen when the institutional ownership stake is low. In Jordan, most institutional owners are social security institution (government pension funds) and financial firms. There is no existence of developed mutual funds or investment companies. As a result, institutional investors in Jordan are not effective in constraining managerial behavior of EM. Consistent with the argument that institutional investors in Jordan are short-term oriented and create incentives for managers of their portfolio firms to manage earnings aggressively, these institutional investors focus excessively on current earnings performance (Koh, 2003). Based on this phenomenon the following hypothesis proposes:
H_2: High institutional ownership is negatively related to earning management among Jordanian listed companies.

Block-holders' Ownership

Block-holders' ownership takes various forms including individual investors, pension funds, mutual funds, corporations, private equity firms, fund managers, banks and trusts. All these, except individual investors, are also known as 'institutional investors' (Cronqvist & Fahlenbrach, 2009).

Zhong et al. (2007) considered two competing views when studying the relationship between block-holders and EM. First, consistent with the agency theory perspective, small block-holders can sell their stocks quickly if they are not pleased with the performance of managers, whereas large block-holders found it hard to sell a large block of stock without it having considerable impact on the firm, including lowering its stock price. Thus, large block-holders normally adopt a long-term strategy and thus they need to monitor managers to produce more benefits for their equity ownership. Block-holders have the ability to monitor and 'voice' their concerns and objections as a result of their large voting rights. This, in turn, provides some monitoring over managers, which enables the block-holder to also affect the board of directors' composition (Person, 2006).

Secondly, unlike small shareholders, large block-holders can put pressure on managers to report a favorable financial performance and create another threat of intervention to perceived underperforming management (Barclay & Holderness, 1991; Shleifer & Vishny, 1997). Consequently, the existence of large block-holders may press firms' managers to engage in income-increasing EM to report a favorable financial performance.

Bethel et al. (1998) found that block trades have a positive association with more management turnovers and found that block-holders press the managers to take specific actions or face risk of being dismissed whenever the company performs badly. These two competing views of the effect of block-holder ownership are not necessarily mutually exclusive. The dominating factor in both views is the cost and benefit of the EM to the block-holders.

Zhong et al. (2007) examined the above two views on the effect of block-holders on EM. The sample was 5,475 firms that were observed between 1994 and 2003. EM was measured using pooled cross-sectional data and they used the modified Jones (1991) model. The results were consistent with the second view, which indicate that block-holder ownership is positively associated with discretionary accruals.

Additionally, Klein (2002) examined the effectiveness of characteristics of the board and the composition of the audit committee, while controlling the effects of block-holders' ownership. To measure the effect of block-holders on EM, she looked at firms whose audit committees included representatives of block-holders with more than 5% of the equity. She found a negative relationship between 5% block-holders sitting on audit committees and EM. The limitation regarding this test is that the block-holder measurement in her study included only block-holders who sit on the audit committee and discriminated the effect of external block-holders. Her result might have been driven through the independence of the directors on the audit committees, regardless of their block ownership.

Dempsey et al. (1993) divided their sample of owner-controlled firms into two types: owner-managed firms in which managers own a substantial block of equity, and externally-controlled-firms where outside block-holders own a substantial block of equity. They found that owner-managed firms have less income-increasing EM compared to externally-controlled firms, which suggested that insider block-holders have more effective governance, attributed to reduce EM, than outside or external block-holders. One limitation of Dempsey et al. (1993) is the measurement of dependent variable (EM). They used one particular type of accounting choice, namely, extraordinary item reporting, and this may not capture the extent of EM as managers usually use a variety of methods to manage earnings and these can be more elusive than extraordinary items.

Dechow et al. (1996) examined firms that were charged by the SEC with earnings overstatements that violate GAAP. They found a negative relationship between outside block-holders and earnings overstatements that violate GAAP. In the UK, Peasnell et al. (2005) found that no relationship exists between block-holders and EM.

Wang (2006) examined the relationship between the incidence of fraud and the presence of block-holders. The results showed that larger block ownership is associated with a higher probability of fraud detection and a propensity to commit fraud. In particular, she found that a 10% increase in block-holder ownership tended to decrease the probability of fraud by 3.8%. This result suggests that block-holders play an important role in protecting FRQ.

On the other hand, large shareholders may expropriate other investors and stakeholders by colluding with management, as documented by Shleifer and Vishny (1997). Claessens et al. (2000) argued that concentrated ownership enables block-holders to use accounting information to their own advantage, for instance through income–decreasing devices to diminish the other shareholders' residual claims.

Even if large shareholders monitor managers' behavior to some extent, there is a possibility that they expropriated minority shareholders by hiding the firm's real performance. This ownership concentration may also badly affect minority shareholders and in turn negatively affects the future value of the firm (Bebchuk, 1994). Moreover, there is empirical evidence that concentrated ownership (one ultimate owner) is one of the main causes of Asian companies' poor governance practice and poor accounting disclosure (Claenssens et al., 2000).

Yu (2008) used large shareholders and the percentage of size of the largest block of stock and tested their association with EM. It is found that the EM level of a firm with large shareholders is higher than that of a firm without large shareholders by 17% of the sample mean and by 30% of the sample median. Thus, the following hypothesis is proposed:
H_3: A block-holding of 5% or more in a firm is negatively related to earning management among Jordanian listed companies.

Summary and Conclusion

In general, the governance and EM literature suggested that ownership structures affect the financial reporting credibility. In relation to managerial ownership, most of previous studies suggested that low managerial ownership is a good governance attribute, and this is opposite to the proposition of agency theory. However, the review of the results indicated that high institutional ownership is associated with less EM and thus in accordance with agency theory. The review of the previous studies of the association between block-holders' ownership and EM show inconclusive results. Some results suggest that block-holders may behave in aggressive manner and collude with managers against the shareholders' interests. Several researchers are not agree with this statement but this may be based on their market and their ownership stake.
This study is pursued as an attempt to investigate the role of ownership structure on EM from the perspective of Jordanian listed companies. The study serves as a wake-up call for a motion to establish accountable management board. It does raise concerns as to whether the best practice of corporate governance mechanisms, as stipulated by the Western world, is applicable to the Jordan business environment or not. As emerging economies exhibit different governance structures as a result of different institutional environments, there is a need to revise UK and USA styles of corporate governance structures.

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