THE IMPACT OF FOREIGN OWNERSHIP ON BOTH TYPES OF EARNINGS MANAGEMENT

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Abstract

In the context of emerging markets, foreign ownership is considered as an effective mechanism that could complement current governance structure because foreign investors prefer to invest in good-governed firms. Using the population of all manufacturing firms listed on Amman Stock Exchange over the period 2017 – 2021, this notion is tested in constraining manipulations in accruals, sales, production costs, and discretionary expenses. However, the results reveal that foreign investors do not reduce the practice of earnings management which is inconsistent with reducing agency problems in Jordan. Accordingly, a caution must be exercised by Jordanian regulators in the process of promoting the scrutiny over listed firms.

Keywords: Foreign Ownership, Abnormal Accruals, Abnormal Operating Cash Flows, Abnormal Production Costs, Abnormal Discretionary Expenses.

1. INTRODUCTION

Up to date, surprisingly little research on foreign investor and earnings management has surfaced in the literature. This highlights the importance of further examination of the role that foreign investor plays in either constraining or motivating the practice of earnings management. In Jordan, foreign investors are provided with an attractive climate and incentive package. The country adopts an open economic policy where both Arab and Non-Arab foreign investors are openly permitted to invest in most companies listed on Amman Stock Exchange (ASE) (Naser et al., 2007). Both Foreign Direct Investment (FDI) and Portfolio Investment (PI) constitute a dynamic source of capital in the Jordanian market. For example, total foreign investment amounted to 20 percent of total trading volume of shares in March 2002, divided almost equally between Arab and Non-Arab investors. This makes Jordan a suitable case for further investigation of the subject matter, especially by examining the effect of foreign investors on accruals-based and real activities-based earnings management.

Theoretically, on the one hand, a number of researchers argue in favour of being ownership by foreign investors an effective corporate structure mechanism that complements other structure mechanism in deterring earnings management (e.g. Dahlquist and Robertson, 2001; Aggarwal et al., 2005; Li, 2005). On the other hand, other researchers propose that managers are tempted to manage earnings in order to raise capital or meet regulatory benchmark (e.g. Chen and Yuan,

2004; Haw et al., 2005). Due to the lack of empirical evidence concerning the subject matter, none of these views are conclusively supported.

Accordingly, from an agency theory perspective, ownership structure mechanisms should have a constraining effect on both types of earnings management. The relationship between foreign ownership and each of, abnormal accruals, abnormal cash flow from operating activities, abnormal production costs and abnormal discretionary expenses are examined.

2. LITERATURE REVIEW

Foreign investment involves the transfer of financial capital and a set of skills including managerial and accounting. Foreign investment beneficially influences economies in which there is high unemployment and capital shortage – as is typically the case in developing countries (Moosa, 2002). Yet, there are firm-specific motivations for foreign investors. Several researchers assert that foreign investors seek to invest in firms with good corporate governance (e.g. Aggarwal et al., 2005; Li, 2005). Foreign investors are well equipped for choosing a firm with good corporate governance as they are often more sophisticated than domestic investors in terms of their investment criteria and its finances (Lieberman and Kirkness, 1998). Given these characteristics, Dahlquist and Robertson (2001) consider foreign ownership as an effective mechanism that could complement current governance structure because its role resembles that of institutional investors. Further, Leuz et al. (2009) find that foreign investors prefer to invest in good governed firms, which indicate that firms seeking additional financing will enhance their corporate governance to attract the desired investment for foreigners.

Consistent with this view, Ali et al. (2008) examine the association between foreign ownership and earnings management in Malaysian listed firms. They estimate current discretionary accruals through the modified Jones model as a measure for earnings management. Ownership by foreign investor is measured as the proportion of shares owned by foreign investors to all outstanding shares. However, foreign investors are found ineffective in mitigating the practice of earnings management.

Similar evidence is found by Sarkar et al. (2006) who investigates the effect of foreign ownership on earnings management employing Indian data. They measure foreign ownership as the percentage of common shares held by foreign institutional investors. Further, they use absolute value of discretionary accruals, estimated via the modified Jones model, as a proxy for earnings management. The results also show no significant relationship between foreign investors' ownership and discretionary accruals.

The investigation of the association between foreign ownership and earnings management seems less straightforward in China than it in countries such as the aforementioned. While foreign ownership is considered as a monitoring mechanism in the above research, foreign investment could be seen as a motivation for earnings management practices in China. An elaboration is proposed by Haw et al. (2005). They note that earnings management behaviour might be different in China that it in western countries. In China, where the state owns significant portions of listed firms, managers rarely receive compensation based on firm

performance and they are frequently appointed by the state. Further, Chinese firms are usually unable to raise capital by issuing corporate bonds or offer seasoned shares due to regulatory constraints. Hence, rights issue and initial public offerings (IPO) constitute the primary source of capital to Chinese firms. Accordingly, Haw et al. (2005) argue that managers might be motivated by these events to engage in earnings management practices.

Within this context, Aharony et al. (2000) examines whether ownership by foreign investors would provide firms with strong incentive to manage their earnings around IPOs of Chinese state-owned enterprises (SOEs). In particular, they investigate whether Chinese SOEs manage their earnings prior to the issuance of B-Shares and H-Shares that are restricted to foreign investors on Chinese domestic stock exchange and Hong Kong exchange, respectively. They use earnings performance, measured as Return on Assets (ROA), surrounding the IPO year as a proxy for earnings management. The results show a significant post-issue earnings decline which is consistent with Chinese SOEs practicing earnings management to report high profits in the IPO year. This evidence is supportive of being foreign ownership a motivation for earnings management in China.

The fact that Jordan is considered one of the favourable investment destinations in the Middle East (Burghleh and Al-Okdeh, 2020), provides strong incentive to investigate the role played by foreign investors in the governance of their corporate shareholdings. Bearing in mind that there is little research on the effect of foreign ownership on accruals earnings management, it is important to mention that the effect of foreign ownership on real activities earnings management has never been investigated before.

Because the findings of abovementioned studies provide limited indications, both views are still sound and there should be a significant association between foreign ownership and earnings management. Even if foreign investors were not able to see through the earnings figure and price the shares fairly, the results do not show whether foreign investors were active in constraining earnings management after acquiring the voting rights or not. However, no prediction for the coefficient sign of foreign investors can be made. Accordingly, the following sub-hypotheses propose,

H1: There is a significant relationship between foreign ownership and abnormal accruals in Jordan.

H2: There is a significant relationship between foreign ownership and abnormal cash flow from operations in Jordan.

H3: There is a significant relationship between foreign ownership and abnormal production costs in Jordan.

H4: There is a significant relationship between foreign ownership and abnormal discretionary expenses in Jordan.

3. METHODOLOGY

3.1. Population and Sample

The data set of the current study comprises all manufacturing firms, the second largest sector (Junidi and Warrad, 2022), listed on Amman Stock exchange (ASE) for four consecutive years of reporting periods from 2017 to 2021. The study period is restricted to those four years in particular due to the date of good corporate governance act enforcement.

3.2. Measurement of Dependent Variables:

In this research, four measures in total are developed as proxies for earnings management. Typically, managed earnings are measured as the residuals from an expectation model. Afterwards, each measure of earnings management becomes a dependent variable when research hypotheses are formulated and tested. In detail, the first measure is abnormal accruals. This measure is the estimated residual from the Kothari et al. (2005) model that solely proxies for accruals earnings management. The second, third and fourth measures are estimated using the Roychowdhury (2006) model to proxy for real activities earnings management. These measures are: abnormal cash flow from operating activities, abnormal production costs and abnormal discretionary expenses, respectively.

3.2.1. Estimation of Accruals Earnings Management:

The Kothari et al. (2005) model is adopted in this research as the appropriate measure of discretionary accruals. This model is regarded as an extension to the widely used Modified Jones model as it maintains all of the three original explanatory variables as follows,

$$TA_{it}/A_{it-1} = \alpha_0 + \alpha_i [1/A_{it-1}] + \beta_{1i} [(\Delta REV_{it} - \Delta REC_{it})/A_{it-1}] + \beta_{2i} [PPE_{it}/A_{it-1}] + \beta_{3i} ROA_{it(or\ it-1)} + \varepsilon_{it}$$

Where,

TA_{it}	: total accruals in year t for firm i
A_{it-1}	: total assets in year t – 1 for firm i
α_0	: Intercept
ΔREV	: revenues in year t less revenues in year t-1 for firm i
ΔREC	: revenues in year t less revenues in year t-1 for firm i
PPE	: net property, plant, and equipment in year t for firm i
ROA	: Rate of return on assets
ε_{it}	: error term in year t for firm i

Therefore, absolute value of discretionary accruals is used in this research as the first dependent variable for two main reasons. First, following prior research mentioned above. Second, because absolute value of discretionary accruals is the best measure of the extent to which firms

use accruals to manage earnings in the absence of a particular direction (Issa and Abu Siam, 2020).

3.2.2. Estimation of Real Activities Earnings Management:

The Roychowdhury (2006) model is used in this research to estimate the second, third and fourth measures of real activities earnings management. These measures are: abnormal cash flow from operating activities, abnormal production costs and abnormal discretionary expenses. Each measure is obtained by employing a separate cross-sectional regression as follows,

$$CFO_t / A_{t-1} = \alpha_0 + \alpha_1 (1/A_{t-1}) + \beta_1 (S_t / A_{t-1}) + \beta_2 (\Delta S_t / A_{t-1}) + \varepsilon_t$$

$$PROD_t / A_{t-1} = \alpha_0 + \alpha_1 (1/A_{t-1}) + \beta_1 (S_t / A_{t-1}) + \beta_2 (\Delta S_t / A_{t-1}) + \beta_3 (\Delta S_{t-1} / A_{t-1}) + \varepsilon_t$$

$$DISEXP_t / A_{t-1} = \alpha_0 + \alpha_1 (1/A_{t-1}) + \beta_1 (S_{t-1} / A_{t-1}) + \varepsilon_t$$

Where,

CFO_t	: current cash flow from operation
$PROD_t$	: production costs
$DISEXP_t$	: discretionary expenses
S_t	: current sales
ΔS_t	: change in current sales
S_{t-1}	: lagged sales
ΔS_{t-1}	: change in lagged sales
A_{t-1}	: lagged total assets

Accordingly, each amount of managed earnings is measured as the residuals from the expectation model. It is important here to highlight that the data set of Roychowdhury (2006) is based on firms that report earnings greater or equal to zero. In other words, his data includes firms that are suspect of practicing real activities manipulations to avoid losses. Hence, his hypotheses are constructed to solely investigate income-increasing real activities earnings management which in turn has led to the use of signed residuals.

3.3. Measurement of Independent Variable:

The purpose of this subsection is to utilise the findings of previous studies in the development of the research hypotheses. The independent variable of foreign ownership equals the proportion of common shares held by the foreign investors.

3.4. Research Empirical Models:

Two models are applied in the current research to test the research hypotheses. The first model measures the effect of foreign ownership mechanism on mitigating accruals-based earnings management. The second model examines the mitigating effect of foreign ownership

mechanisms on real activities-based earnings management. Yet unlike the first mode, the second model entails the use of separate three regressions. That is, the effect of foreign ownership mechanism is measured on each of, abnormal levels of cash flow from operating activities, production costs and discretionary expenses. Therefore, the empirical models of research can be symbolically presented as follows,

The first model:

$$ABAC_i = \alpha + \beta_1\ FRGN + \beta_2\ BRDS + \beta_3\ SIZE + \beta_4\ GRWTH + \beta_5\ LEV$$

The second model:

$$ABCFO = \alpha + \beta_1\ FRGN + \beta_2\ BRDS + \beta_3\ SIZE + \beta_4\ GRWTH + \beta_5\ LEV$$

$$ABPRD = \alpha + \beta_1\ FRGN + \beta_2\ BRDS + \beta_3\ SIZE + \beta_4\ GRWTH + \beta_5\ LEV$$

$$ABDISX = \alpha + \beta_1\ FRGN + \beta_2\ BRDS + \beta_3\ SIZE + \beta_4\ GRWTH + \beta_5\ LEV$$

Where,

ABAC : absolute value of discretionary accruals estimated using the Kothari et al. (2005) model.

ABCFO : absolute value of abnormal cash flow from operating activities estimated using the Roychowdhury (2006) model.

ABPRD : absolute value of abnormal production costs estimated using the Roychowdhury (2006) model.

ABDISX : absolute value of abnormal discretionary expenses estimated using the Roychowdhury (2006) model.

FO : foreign ownership equals the proportion of common shares held by the foreign investors.

BRDS : board size equals total number of directors on the board.

SIZE : natural logarithm of total assets.

GRWTH : growth rate equals the change in total assets scaled by lagged total assets.

LEV : leverage equals total liabilities scaled by total assets.

4. RESULTS

4.1. Descriptive Statistics:

Table (1) presents descriptive statistics for all variables included in the empirical model. That is, this section explores means, medians, and standard deviation, minimum and maximum for abnormal accruals, foreign ownership, and a set of control variables.

Table (1) Descriptive Statistics

Variable	Mean	Median	Std. Deviation	Minimum	Maximum
ABAC	0.000	-0.008	0.110	-0.408	0.495
ACFO	0.000	0.002	0.117	-0.417	0.328
APROD	0.000	-0.005	0.105	-0.408	0.502
ADISX	0.000	-0.007	0.100	-0.098	0.203
FO	0.202	0.073	0.331	0.000	0.896
BRDS	9.433	8.000	1.896	6.000	13.000
LEV	0.832	0.810	0.372	0.133	3.554
GRWTH	0.386	0.074	0.556	-0.321	7.927
SIZE	7.591	7.386	0.679	6.227	8.936

ABAC = abnormal accruals; ACFO = abnormal cash flow from operating activities; APROD = abnormal production costs; ADISX = abnormal discretionary expenses; MO = the proportion of common shares held by the foreign investors; BRDS = number of directors on the board; LEV = total liabilities scaled by total assets; GRWTH = the change in total assets scaled by lagged total assets; SIZE = natural logarithm of total assets.

The means of managed earnings are equal to zero indicating a good fit for a linear model because "The best fitting regression line is the one that makes the mean residual equal to 0" (Hayes, 2005, p.282). Zero mean earnings management is consistent with prior research. For instance, Kothari et al. (2005) report mean abnormal accruals close to zero. Foreign ownership is measured by the proportion of common shares held by foreign investors. Therefore, the mean of 20.2% indicates that one fifth of shareholders oversee firms' affairs.

4.2. Regression Statistics:

4.2.1. Abnormal Accruals Model:

Table (2) reports results of multiple regression analysis for abnormal accruals model where the dependent variable is the transformed absolute values of abnormal accruals measured by Kothari et al.'s model (2005). The model's F-statistic is 3.608, and is statistically significant at 0.01 levels. The adjusted R^2 is 22.5% suggesting that the combination of independent variables explains 22.5% of the variation in accruals earnings management.

Although foreign investors, at least in theory, are considered as deterrence corporate governance mechanism, the limited prior research fails to document such inverse relationship between levels of foreign ownership and levels of abnormal accruals (e.g. Sarkar et al., 2006; Ali et al., 2008). Similar to those findings, table (2) shows that the coefficient of foreign ownership (FO) in this study is negative but statistically insignificant. Hence, H1 is rejected as foreign investors are found ineffective in mitigating the accruals earnings management in Jordan.

Table (2): regression analysis results of foreign ownership and abnormal accruals

Variable	Coefficient	t-Statistic
Constant	0.612	4.711[***]
FO	-0.058	-1.257
BRDS	-0.014	-1.487
LEV	0.007	1.885[*]
GRWTH	0.070	1.834[*]
SIZE	-0.068	-2.056[**]
Adjusted R^2	22.5%	
F-statistic	3.608[***]	
[***] Correlation is significant at the 0.01 level. [**] Correlation is significant at the 0.05 level. [*] Correlation is significant at the 0.10 level. FO = the proportion of common shares held by the foreign investors; BRDS = number of directors on the board; LEV = total liabilities scaled by total assets; GRWTH = the change in total assets scaled by lagged total assets; SIZE = natural logarithm of total assets.		

The insignificant coefficient of board size (BRDS) indicates that there is no relationship between number of directors and levels of abnormal accruals in Jordan. This is consistent with evidence found in Singapore and Malaysia by Bradbury et al. (2006). Rates of both leverage (LEV) and growth (GRWTH) are positively related to levels of abnormal accruals which is consistent with firms that are in financial distress or experiencing poor performance (e.g. Bartov, 1993; Wild, 1996; Nagar, 2002). Although significant differences are marginal, these findings suggest that managers of financially distressed firms in Jordan engage in accruals earnings management to either avoid violating debt covenants or renegotiate lending contracts (DeAngelo et al., 1994). Moreover, managers may use abnormal accruals to avoid reporting negative growth rates that might affect their bonuses. The coefficient of firm size (SIZE) is negative and statistically significant at 0.01 levels. This is consistent with Bushmen et al. (2003) and Xie et al. (2003) who find that the demand for systematic corporate governance is higher in large-sized firms relative to small-sized firms due to high information asymmetry between managers and shareholders in the larger firms with complex and dispersed ownership structure. Therefore, this result implies that large firms in Jordan operate under high scrutiny and hence, are less likely to report abnormal accruals.

4.2.2. Abnormal Cash Flow from Operating Activities Model:

Table (3) reports results of multiple regression analysis for abnormal cash flow from operating activities model. The dependent variable is the transformed absolute values of abnormal cash flow from operating activities measured by Roychowdhury's model (2006). The model's F-statistic is 3.851 and is statistically significant at 0.01 levels. The adjusted R^2 is 18.2% suggesting that the combination of independent and control variables explains 18.2% of the variation in sales earnings management.

The coefficient of foreign ownership (FO) is statistically insignificant indicating that H2 also fails to hold. This result might be attributable to the fractional interest owned by foreign investors. Hence, foreign investors are found ineffective in mitigating the practice of sale manipulation in Jordan.

As for the directors-specific control variable, the coefficient of board size (BRDS) is insignificant. Therefore, the number of directors is not a limiting factor of abnormal cash flow from operating activities in Jordan. Similar evidence is found by Visvanathan (2008). The positive and statistically significant coefficient of leverage (LEV) is consistent with the findings of Cohen and Zarowin (2010). In general, financially distressed firms have been associated with high leverage (e.g. Beneish and Press, 1995). Therefore, it could be concluded that firms in Jordan engage in income-decreasing sales manipulation in order to depict healthier financial position. Finally, the coefficients of the remaining control variables are not statistically significant, which indicates that firms in Jordan engage in sales earnings management regardless of their growth rates (GRWTH) or sizes (SIZE).

Table (3): regression analysis results of foreign ownership and abnormal operating cash flows

Variable	Coefficient	t-Statistic
Constant	0.742	3.290***
FO	0.056	1.385
BRDS	0.002	-0.091
LEV	0.016	1.772**
GRWTH	0.075	1.212
SIZE	-0.055	-1.411
Adjusted R^2	18.2%	
F-statistic	3.851***	
*** Correlation is significant at the 0.01 level. ** Correlation is significant at the 0.05 level. * Correlation is significant at the 0.10 level. FO = the proportion of common shares held by the foreign investors; BRDS = number of directors on the board; LEV = total liabilities scaled by total assets; GRWTH = the change in total assets scaled by lagged total assets; SIZE = natural logarithm of total assets.		

4.2.3. Abnormal Production Costs Model:

Table (4) reports results of multiple regression analysis for abnormal production costs model. The dependent variable is the transformed absolute values of abnormal production costs measured by Roychowdhury's model (2006). The model's F-statistic is 3.009, and is statistically significant at 0.01 levels. The adjusted R^2 is 20.4% suggesting that the combination of independent and control variables explain 20.4% of the variation in manipulated production costs.

H3 is rejected as the coefficient of foreign ownership (FO) is statistically significant. The result shows that levels of abnormal production costs do not differ among firms with different levels of foreign ownership. Therefore, foreign investors do not seem to have mitigating or motivating effects on levels of abnormal production costs.

The coefficient of board size (BRDS) is negative and statistically significant indicating that larger boards are more effective than smaller boards in mitigating abnormal production costs in Jordan. As for firm characteristic variables, only the coefficient of growth (GRWTH) is statistically significant at 0.01 levels. However, the positive sign of the coefficient does not indicate that only firms with higher growth rates are likely to manipulate production costs. This is based on the findings of Li (2010) that show growth rates positively associated with inventory levels regardless of whether the firm were suspect of practicing production costs manipulation or not. Both of the remaining control variables, leverage (LEV) and firm size (SIZE) are statistically insignificant, which is consistent with prior research such as Visvanathan (2008) and Cheng et al. (2010).

Table (4): regression analysis results of foreign ownership and abnormal production costs

Variable	Coefficient	t-Statistic
Constant	0.681	3.012***
FO	-0.057	-1.519
BRDS	-0.009	-2.514**
LEV	0.010	-0.613
GRWTH	0.121	2.978***
SIZE	0.008	0.289
Adjusted R^2	20.4%	
F-statistic	3.009***	
*** Correlation is significant at the 0.01 level.		
** Correlation is significant at the 0.05 level.		
* Correlation is significant at the 0.10 level.		
FO = the proportion of common shares held by the foreign investors; BRDS = number of directors on the board; LEV = total liabilities scaled by total assets; GRWTH = the change in total assets scaled by lagged total assets; SIZE = natural logarithm of total assets.		

4.2.4. Abnormal Discretionary Expenses Model:

Table (5) reports results of pooled multiple regression analysis for the abnormal discretionary expenses model. The dependent variable is the transformed absolute values of abnormal discretionary expenses measured by Roychowdhury's model (2006). The model's F-statistic is 3.417, and is statistically significant at 0.01 levels. The adjusted R^2 is 23.2% suggesting that the combination of independent and control variables explains 23.2% of the variation in discretionary expenses manipulations.

Similar to other real activities models, the coefficient of foreign ownership (FO) is not statistically significant. Hence, H4 is rejected. The insignificant coefficient implies that the enhanced scrutiny of foreign investors in Jordan does not motivate managers to manipulate discretionary expenses.

The marginal significant coefficient of board size (BRDS) might be interpreted as larger boards bring greater number of experienced directors who seem to play a role in mitigating abnormal discretionary expenses. The insignificant coefficients of firms' leverage (LEV) and growth (GRWTH) indicates that LEV and GRWTH are not associated with abnormal discretionary expenses in Jordan as they are not in the US (e.g. Garven, 2009) and China (e.g. Cheng et al., 2010). Finally, the coefficient of firms' size (SIZE) is highly significant and positive consistent with Gunny (2010). This indicates the larger the firm, the higher levels of abnormal discretionary expenses.

Table (5): regression analysis results of foreign ownership and discretionary expenses

Variable	Coefficient	t-Statistic
Constant	-0.187	-1.267
FO	0.017	1.113
BRDS	-0.004	-1.811[*]
LEV	0.007	-1.273
GRWTH	0.006	0.171
SIZE	0.101	3.753[***]
Adjusted R^2	23.2%	
F-statistic	3.417[***]	
[***] Correlation is significant at the 0.01 level. [**] Correlation is significant at the 0.05 level. [*] Correlation is significant at the 0.10 level. FO = the proportion of common shares held by the foreign investors; BRDS = number of directors on the board; LEV = total liabilities scaled by total assets; GRWTH = the change in total assets scaled by lagged total assets; SIZE = natural logarithm of total assets.		

5. CONCLUSION

In theory, foreign investors are expected to improve the governance of their shareholdings (Leuz et al., 2009). However, a review of the literature shows that no research has ever examined the effect of foreign ownership on real activities earnings management, and little research on accruals earnings management. Therefore, this research advances new theoretical perceptions in the fields of corporate governance and earnings management by empirically investigating the effect of foreign ownership on both types of earnings management.

With too little evidence on accruals, and no evidence on real activities, the findings of this research contribute for the first time to accounting research on earnings management and to agency theory. That is, the results do not validate agency predictions in general, and in contexts where levels of foreign ownership are relatively high.

Accordingly, a caution must be considered in the process of promoting the scrutiny over listed firms. That is, ASE could benefit from US's experience in Sarbanes-Oxley act that has led managers to reduce accruals earnings management and engage more in the costly real activities earnings management. Therefore, for any recommended reforms and additional monitoring to be successfully implemented, both types of earnings management should be considered to restrain their harmful consequences.

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