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The Relationship between Audit Quality and Earning Management in the Banking Sector in Palestine Exchange

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Abstract : *This study aims to explore the relationship between audit quality,corporate governance and earning management in the Banks in Palestine in one side, and analyses the materiality of each factor of the audit quality factors in the other side, moreover this study shows the influence of the role factors in audit quality to reveal the earning management practices in the sector of banks in the Palestinian environment.Analytical descriptive method has been used to collect data from the primary and secondary sources, there have been two tools in the study:*

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Firstly, Jones Modified Equation (1995) to calculate earning management in the banks working in Palestine (6) banks. Secondly,the study reaches the following conclusion, that the Banks working in Palestine practicing earning management during the different period of (2006-2010), although there was differentiation in that period, appeared obviously in (2009-2010), this study finds significant relationship between every each variable: (experience of audit team, size of audit firms, auditors independence, audit planning procedures, audit fees, auditors industry specialization, and audit firms linked to global audit firms), and earning management practice, and it finds non-significant relationship between every each variable: (auditor qualification, competition, and audit tenure), and earning management practices.

In the spotlight of findings, the study concludes numbers of recommendations, one of the most important is to focus in providing high environmental audit quality which limit the undesirable practices, and working for awareness of financial report users in general, and investors particularly, with side effects to this practice in making investment decision. Moreover, this study demands in the Banking in Palestine of more attention about full disclosure, transparency and clear financial statements, and the necessity of audit firms awareness of the importance to control audit quality and the benefits of commitment to control quality standards.

Earnings Management,audit quality, corporate governance, Palestine Exchange (PEX)

I. Introduction

In the last years, the auditing profession has faced a crisis of loss of confidence and credibility as a result of the increasing financial and economic crises at the and international levels, which led many of the users of the financial statements to question the public opinion of those who suffered damage as a result of the bankruptcy of many companies and banks. From the discovery of accounting imbalances and financial scandals from other companies, which led to the interest of international research and studies to study various aspects of the earning management that the importance of financial statements presented in the financial statements of the units. However, earnings management are one of the most powerful financial statements items and as such have an impact on business activities, management decisions firms and investment decisions.Furthermore, the managers may be tempted to adjust earnings to achieve desirable incentives (Fields, Gupta, Wilkins, & Zhang, 2018). The weakness of existing corporate governance mechanisms could facilitate this process. Furthermore, beneficial earnings management. Managing earnings to achieve private incentives (the managers' desired goals) constitutes opportunistic earnings management, and managing earnings to achieve stockholders' incentives constitutes beneficial earnings management (Rezaei, 2012; Jiraporn,Miller, Yoon, & Kim, 2008; Lara, Juan, Garcia Osma, & Penalva, 2018).

The existence of strong corporate governance mechanisms in a firm can lead to improvements in professional conduct in business transactions and limit the opportunities for earnings management. In contrast, the existence of weak corporate governance may encourage manipulation, corruption and mismanagement in the business (Leventis & Dimitropoulos, 2012; Anik, & Bauer, 2017; Vafeas, 2005).

Palestine is a growing country that needs to attract new investors, suppliers, lenders and other participants in business. The publication of earnings by Palestinian firms for external consumption is a relatively new phenomenon, and this new accountability brings with it requirements for corporate governance mechanisms, and the possibility of earnings management.

The aim of this thesis is to investigate the relationship between corporate governance mechanisms and earnings management in Palestinian industrial firms. We reach this aim by exploring the nature of corporate governance mechanisms and earnings management in Palestine exchange, whether internal or external, and determining how they affect accounting choices and operating decisions. We identify the particular accounting policies and tools that managers use to manage earnings. Estimates of earnings management are made using accruals-based models and we evaluate which model is the most effective in detecting earnings management in this context.

The analysis begins by discussing the context in which the firms operate in order to understand the differences between the economic environment of Palestine exchange as a developing country, other developing countries, and developed countries, based on prior literature to facilitate the comparison between the results of this research and those of prior literature.

After that, we critically analyse and compare earnings management models employed in the literature, such as the work of Fields, et al,. (2018); Lara, et al,. (2018); Anik, & Bauer (2017); Waweru, & Prot, (2018); Suryanto, & Grima, (2018); Nazir, & Afza, (2018); Elyasiani, Wen, & Zhang, (2017), in order to understand the differences and similarities in these models' approaches to detecting earnings management, to understand the definitions of accruals used in the different models and to facilitate the process of interpretation of our empirical findings.

Understanding the characteristics of earnings management in Palestine exchange could potentially be useful to regulators in setting standards; to investors in making investment decisions; to auditors in auditing Palestine exchange companies and to the government in drafting legislation.

Eventually, such understanding could lead, via these mechanisms, to more reliability and transparency in published financial statements (Fields, et al,. (2018); Lara, et al,. (2018).

In order to understand more specifically about how earnings management is defined, we first consider a few definitions from previous literatures. Anik, & Bauer (2017) define earnings management as "an intervention to prepare and control the external financial reporting process, and obtain some special benefit (facilitating the operation process)".

Healy and Wahlen (1999, page 368) argue that earnings management "occurs when managers use judgment in financial reporting and 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 numbers". Earnings management is considered to be one of the most important issues that affects the structure of financial statements, which may be changed to mislead the stockholders and other users of financial statements. Ronen and Yaari(2008) organise the definitions of earnings management into three clusters according to existing literatures; these are as follows:

1.2.1 Earnings management

• "…. is taking advantage of the flexibility in the choice of accounting treatment to signal the manager's private information on future cash flow". (Dubbed "beneficial and white earnings management".)

"…. is choosing an accounting treatment that is either opportunistic (maximizing the utility of management only) or economically efficient". (Dubbed "neutral and grey earnings management".)

"…. is the practice of using tricks to misrepresent or reduce transparency of the financial reports". (Dubbed "pernicious and black earnings management".) Managers may manipulate their earnings via two types of accounting approach, and theseare: (1) the accounting choices approach and this approach has two aspects, legal and illegal transactions. (2) Operations decisions (Dianita and Rahmawati, 2011).

Earnings management achieved via operating decisions is notoriously difficult to detect and therefore published research has tended to focus on the former category, the accounting choices approach. Distinguishing between legal and illegal accounting choices is deemed one of the most common difficulties that auditors and accountants face; the reason being that there are many gaps in the accounting standards, GAAP, and international auditing standards. This increases the opportunities for managers to manipulate the financial statements to achieve their desired goals, and also it is adaunting task to determine whether transactions are legal or illegal because there is no clear guidance on where this boundary lines.

1.2.1 Earnings Management Motivations

Numerous incentives motivate managers to engage in earnings management. Existing literature on earnings management has discussed these incentives under two headings: opportunistic earnings management and beneficial earnings management. Managing earnings to achieve private incentives (managers' desirable goals) constitutes opportunistic earnings management, and managing earnings to achieve stockholders' incentives constitutes beneficial earnings management (Anik, & Bauer 2017); Waweru, & Prot, 2018; Nazir, & Afza, 2018.

Studies have claimed that managers engaged in earnings management opportunistically in order to change revenues and expenses in different reporting periods, in order to achieve strategic reporting incentives (Suryanto, & Grima, 2018). In other words, they exercise their discretion in financial reporting decisions in order to exploit an opportunity that results ingains for their own benefit (Nazir, & Afza, 2018). Prior studies of earnings management found numerous opportunistic and beneficial incentives. Figure (2.1) presents earnings management motivations in prior literature.

Financial reporting manipulation (earnings management) is an important issue to researchers, industry practitioners, legislative boards, auditors and individual firms. Consequently, corporate governance mechanisms are some of the most important channels to prohibit the publication of financial statements which could be misleading or erroneous (Waweru, & Prot, 2018; Suryanto, & Grima, 2018).

II. Palestinee Xchangean Overview

Palestine Exchange (PEX) was established in 1995 to promote investment in Palestine. The PEX was fully automated upon establishment-a first amongst the Arab Stock Exchanges. The PEX operates under the supervision of the Palestinian Capital Market Authority. There are 48 listed companies on the PEX as of 31/03/2014 with market capitalization of about $ 3 billion across five main economic sectors; banking and financial services, insurance, investments, industry, and services1. Most of the companies are profitable and trade in Jordanian Dinar, while others trade in US Dollars. Only stocks are currently traded on the PEX. In 2009, the PEX ranked thirty third amongst the worldwide security markets, and regionally comes in second in terms of investor protection.

The most commonly used model in detecting earnings management is the Modified Jones (1995) model. Prior research documented that the model is effective in detecting earnings management in mostly developed countries (Dechow, Sloan, & Sweeney, 1995). Recently an empirical research revealed that the Modified Jones (1995) model does not fit for Asian and Bangladeshifirms (Yoon, Miller, & Jiraporn, 2006). It is therefore possible that the Modified Jones (1995) model is not effective also to other countries as Palestine in today's context. Yoon et al., (2006) proposed a model to be employed in detecting earnings management in Bangladesh capital market. Yoon et al., (2006) showed that the model was effective in detecting earnings management with less error rates.

Therefore, in this paper, we investigate the effectiveness of the Modified Jones (1995) and Yoon et al., (2006) model in PEX. We want to find out if the two models detect earnings management effectively. We also compare the Modified Jones (1995) model with the Yoon et al., (2006) model. That is to determine the best model in detecting earnings management practiced by Palestinian listed companies in the PEX from the period of 2006 - 2011.

III. Data And Methodology

The population of this study includes all listed companies in the PEX. It includes listed companies in all sectors such asbanking, industry, insurance, investments and services. The study sample was selected on the basis of the following mainconditions: (1) The company must be classified as an industrial or services company; (2) its annual financial reports areavailable for six years (balance sheets and income statements); (3) its shares must have been publicly traded; (4) its fiscal year ends on 31 December. This selection approach resulted in a sample of 26 listed industrial and services companies from the period 2006-2011. The data was derived from companies' financial reports. We collected six financial reports for each company. Therefore, 156 financial reports were obtained for the study purposes.

As we mentioned above, we are looking for an appropriate model to the Palestinian environment; we want to use it todetect earnings management practiced by listed companies in the PEX. Based on that, we first applied the Modified Jones(1995) model for the study sample. We second employed the Yoon et al., (2006) model that is to analyze the effectiveness of these two models in detecting earnings management in the bank Palestine.

Besides, we used the multiple regression analysis to compare the explanatory power and models fitness between the twomodels to determine the best model in detecting earnings management in the PEX.

Through applying the two models, we utilized the discretionary accruals as a proxy to state the extent of earningsmanagement. In addition, we found discretionary accruals by subtracting non-discretionary accruals from total accruals. Nondiscretionary accruals were valued by using a regression model.

THE MODIFIED JONES (1995)
MODEL IS DESCRIBED IN THE FOLLOWING EQUATION:

$$\frac{TA_t}{A_{t-1}} = \beta 1\left(\frac{1}{A_{t-1}}\right) + \beta 2\left(\frac{\Delta REV_t - \Delta REC_t}{A_{t-1}}\right) + \beta 3\left(\frac{\Delta PPE_t}{A_{t-1}}\right) + \varepsilon$$

TAt (Total accruals) = accounting earnings – CFO
Ai,t-1 = total asset in year t - 1
ΔREV i,t = the difference of operating revenue
ΔREC i,t = the difference of account receivable.
ΔPPEi,t = the difference of gross property plant and equipment.
The Yoonet al., (2006)
MODEL IS DESCRIBED AS THE FOLLOWING EQUATION:

$$\frac{TA_t}{REV_t} = \beta 1\left(\frac{\Delta REV_t - \Delta REC_t}{REV_t}\right) + \beta 2\left(\frac{\Delta EXP_t - \Delta PAY_t}{REV_t}\right) + \beta 3\left(\frac{\Delta DEP_t - \Delta RET_t}{A_{t-1}}\right) + \varepsilon$$

TA (Total accruals) = accounting earnings – CFO
REV = net sales revenue
REC = receivables
EXP = sum of cost of goods sold and selling and general administrative expenses excluding non-cash expenses.
PAY = payables
DEP = depreciation expenses
RET = retirement benefits expenses
Δ = change operator.

The Yoon et al., (2006) model posits that total accruals will normally depend on changes in cash sales revenue, changes incash expenses and some non-cash expenses including depreciation expenses and retirement benefits expenses. Therefore, to get the discretionary accruals, non-discretionary accruals will be subtracted from the total accruals for each observation.

IV. Results

Firstly, we applied the two models to the study sample. We found that the Modified Jones (1995) model could detect 56 of listed companies practice earnings management (e.g., %36 of the study sample). And Yoon et al., (2006)

model detected that 80 of listed companies practice earnings management (e.g., 52% of the study sample). Thus, this result proves that Yoon et al., (2006) model has the ability to classify companies practicing earnings companies much more than the Modified Jones (1995) model.

Correspondingly, we used the multiple regression analysis to compare the explanatory power and models fitness between the two models. It can be observed that Modified Jones (1995) model's goodness of fit is very poor compared to the Yoon et al, (2006) model for industrial and service companies as presented in Table1. R_2 is only 17% as compared to 34% in the Yoon et al., (2006) model for industrial companies. In addition, all the three explanatory variables of the Modified Jones (1995) model are not significant explanatory variables. On the other hand, two variables of Yoon et al., (2006) model are consistent and significant (e.g, Y_1 and Y_2). As for services companies, $R^2$is only 10% as compared to 41% in the Yoon et al., (2006) model, but the two models have two significant variables (e.g., $X_1 X_2$,Y_1, Y_2).

Table 1. Comparison between the Modified Jones (1995) Model and Yoon et al, (2006) for industrial and service companies.

		Modified Jones (1995) Model				Yoon et al., (2006) Model			
		X_1	X_2	X_3	R^2	Y_1	Y_2	Y_3	R^2
Industry	B	-10644.95	-0.060	-0.056	0.17	0.076	-0.099	0.264	0.34
	Sig.	0.972	0.665	0.089		0.012	0.037	0.562	
Services	B	79717.19	0.184	0.005	0.10	-1.00	-0.942	-0.147	0.41
	Sig.	0.013	0.038	0.838		0.000	0.000	0.940	

Then, these results are consistent with application results in our study presented in the appendices 1 and 2. Both prove that the Yoon et al., (2006) model is better than the Modified Jones (1995) model in detecting earnings management practiced by targeted companies. In general, these results are consistent with Yoon et al., 2006.

Furthermore, Table 1 shows R2 of both models are weak compared to other studies (Yoon and Miller, 2002; Yoon et al., 2006; Islam et al., 2011). R_2 must be greater than what was resulted in the application of both models to the study sample (e.g. 34% for industrial and 41% for service companies in Yoon et al., (2006) model). Therefore, we suggest in a future research developing a new model by incorporating new variables to be used in detecting earnings management in Palestine.

V. Conclusion

Most previous studies using the Modified Jones (1995) and Yoon et al., (2006) models have been done in USA, UK and a few of developed countries. Only a very limited number have been carried out in emerging markets. It is therefore possible that these models do not work effectively in other countries as Palestine.

In this paper, we have focused on Palestine as an example of emerging markets to test the effectiveness of the Modified Jones (1995) and Yoon et al., (2006) models. Our application results of the two models showed that Yoon et al., (2006) model can detect companies practicing earnings companies more effectively than the Modified Jones (1995) model. Furthermore, the multiple regression analysis proves as well that the Yoon et al., (2006) model is better than the Modified Jones (1995) model in detecting earnings management in the Palestinian's context.

Additionally, the results proves that the effectiveness of the Yoon et al., (2006) model is also weak compared to other studies done in other countries (Yoon et al., 2006;). Consequently, developing new models is imperative to be used in detecting earnings management in Palestinian's context. The inclusion of other variables will significantly increase the explanatory power in detecting earnings management practiced by industrial and services Palestinian firms.

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