EUROMID ACADEMY OF BUSINESS AND TECHNOLOGY

EuroMid Journal of Business and Tech-innovation (EJBTI)
https://ejbti.com

Online ISSN: 3062-2131

Conceptualizing the Effect of Political Instability towards Audit Committee Effectiveness and Earnings Management

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Received: July 12, 2021; **Accepted**: January 1, 2022

Abstract: This paper aims to conceptualize the relationship between audit committee (AC) characteristics and earnings management (EM), hypothesizing that political instability moderates the relationship between the two variables. It seeks to bridge the knowledge gap by proposing a conceptual framework that links AC characteristics, EM, and political instability. The paper reviews recent literature on corporate governance (CG) and EM to understand how AC characteristics may mitigate EM practices. Additionally, it explores the effect of political instability on managers' engagement in EM. Evidence from prior studies indicates that the AC is a critical component of a firm's structure, tasked with monitoring the quality of financial information presented in financial reports. An effective AC is argued to play a significant role in reducing EM levels. During periods of intense political instability, managers may be motivated to engage in higher levels of EM to present an enhanced financial performance for their companies. This paper argues that a more effective AC can deter such opportunistic behaviors by managers, thereby limiting their engagement in EM.
Keywords: Corporate Governance, Earnings Management, Political Instability, Political Theory, Agency Theory, Palestine.

Type: Research paper

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DOI: 10.51325/ejbti.v1i1.84

1. Introduction

The quality of corporate governance (CG) has become a critical issue because of the global financial scandals caused by the failure of CG mechanisms at a number of large companies in the USA, Canada, and the EU, for example Enron, WorldCom, Adelphia, Tyco, HealthSouth, Fannie Mae, AIG Nortel, Crocus Parmalat, and Royal Ahold (Aljadba et al., 2021). These scandals brought about calls for more transparency and credibility to protect the interests of stockholders and stakeholders alike (Abbadi et al., 2016; Aziz et al., 2017; Aljadba et al., 2019). Indeed, CG characteristics, such as audit committee (AC), and earnings management (EM) have received significant attention from the auditing and accounting profession, practitioners, policy makers, academic bodies and the public, especially following those high-profile corporate scandals. With respect to political

instability, Roe (2003), Gourevitch (2003), and Pagano and Volpin (2005) argue that the social and political circumstances in any country affect the company in various important ways. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) have argued that a strong legal system can minimize agency problems because it protects the investors' rights. Berglöf and Claessens (2006) argue that political instability may lead to poor enforcement and implementation of CG. Effective governance would constrain managers' ability to abuse the wealth of stockholders. In other words, agency costs depend on the political stability in any country (Mangena et al., 2012). Therefore, the purpose of this paper is to conceptualize the effect of political instability on the relationship between AC characteristics and EM practices. The remainder of the paper is structured as follows. Section 2 provides an overview of the governance, economic, and political situation in Palestine. Section 3 reviews the relevant literature on CG, AC, and EM under an unstable political environment. In Section 4, we develop our hypotheses and research framework. Section 5 concludes.

2. CG, Political, and Economic Environment in Occupied Palestine

The Israeli-occupied state of Palestine is an emerging economy in the Middle East and North Africa (MENA). Palestine has unique political and economic characteristics that distinguish it from other emerging economies. One of the most important characteristics of the Palestinian business environment is the high degree of political and economic instability. Indeed, the Palestinian economy has seen constant fluctuations for many years. Following the Oslo Accords and the establishment of the Palestinian Authority (PA), the Palestinian economy experienced strong annual growth of 9% on average between 1994 and 1999 due to large inflows of private and public capital and increased private investment. However, after the second Intifada in 2000, Israel imposed physical, institutional, and administrative restrictions that divide occupied Palestinian territories into small cantons that lack economic resources, pushing the annual growth rate to -9%. Between 2008 and 2012, growth picked up to an annual average of 8% due to large amounts of donor funding, which in 2018 was equivalent to 32% of the GDP. The 2014 war in Gaza and a drop in donor aid have led to severe economic decline in recent years. The latest war in Gaza has severe social consequences and left a devastating impact on private sector activities, causing the Palestinian economy to slip into a recession in 2014. Growth has been slowing since before the war due to a significant drop in donor aid. As a result, real GDP growth slowed down to an annual average of 2% between 2013 and 2016 and dropped to a mere 0.7% in the first quarter of 2017 (0.8 percent in the West Bank and 0.4 percent in Gaza). This decline is a clear sign of the absence of the growth drivers of the Palestinian economy in 2007-2012 (World Bank, 2013).

Palestine, as a developing country, needs to attract investments and enhance its business sector. Therefore, Palestinian corporations must prioritize the quality and credibility of their financial disclosure, governance, and financial information to attract new funds and enhance the Palestinian economy amidst the unstable political situation. The Palestine Capital Market Authority (PCMA), as a supervisory body, seeks to ensure the availability of high-quality financial information to the stakeholders. Since its establishment in 2004, PCMA has implemented appropriate CG mechanisms and

transparency rules to enhance the quality of the financial reporting systems of Palestinian corporations (Asmar et al., 2018).

CG mechanisms can play a fundamental role in improving firm value and stock market efficiency (Hamdan, 2017; Alareeni, 2018a; Alareeni, 2018b). Thus, the PCMA issued a CG code in November 2009, which became effective in the same year. The Palestinian Monetary Authority (PMA) has also issued a stricter code of CG for financial companies (banking and insurance companies). The 2009 code is applicable to all public shareholding companies, whether financial or non-financial. The code covers the following key aspects of CG: general committee meeting, shareholders' compatible rights, corporate management, auditing, disclosure, and transparency. It consists of three main types of rules. The first type is mandatory rules based on valid laws and regulations in Palestine. The second type includes good practice guidance that companies are encouraged to adopt. These are voluntary rules that comply with international corporate governance practices but should not conflict with any legislations in Palestine. The third type of rules is good governance practices that comply with international governance policies and not in conflict with any legislations. The National Committee for Corporate Governance in Palestine has requested the amendment any conflicting legislation to conform to the practices and rules (Hassan et al., 2016).

Based on the above, this study conceptualizes the effects of AC characteristics on EM in the politically unstable Palestine. To the best knowledge of the authors, there are limited studies on CG characteristics and EM in Palestine. This paper can assist policy makers and the PCMA by shedding light on CG under the unstable environment in Palestine. In addition, it expands the limited research on an environment characterized by severe political and economic instability and a lack of control over major economic and fiscal policy instruments (Hassan & Hijazi, 2015). Based on the previous arguments and the limitations of the literature, we find that Palestine is a suitable context to examine AC effectiveness and its relationship with EM practices.

3. Literature Review and Theoretical Background

The agency theory focuses on the conflict between stockholders and managers. The agency problem emerges when the interest of stockholders and managers are not compatible. For example, the primary goal of stockholders is to maximize profit and their wealth, but sometimes this goal will lead to a conflict between managers and stockholders. The separation between ownership and management creates a conflict of interest between managers and owners. To mitigate this conflict, both managers and stockholders must incur some agency costs (Jensen & Meckling, 1976). Jensen and Meckling (1976) state that the agency cost comprises monitoring cost, bonding cost, and residual loss. Monitoring costs relate to the hiring of a manager or external auditors to control the top management's behavior, such as the roles played by the AC. Bonding cost is related to the contracting process to guarantee that agents make rational decisions that support the stockholder's wealth. Residual loss is the agency. By mitigating the agency problem between owners and managers, firms will perform better and be more efficient (Reddy et al., 2010). AC characteristics will be investigated in this paper as CG mechanisms. This study focuses on the monitoring roles of AC in mitigating agency conflicts, which in turn

constrains EM practices. The agency theory suggests that CG mechanisms such as AC characteristics can enhance financial reporting quality and firm performance (Alghamdi, 2012). Indeed, the agency theory proposes that the key role of AC is to monitor the quality of financial reports and prevent fraudulent accounting statements (Klein, 2002).

The agency theory is the most common theory in CG literature. It posits that there is a conflict of interest between owners and managers of the firm. It also suggests that there is a conflict between minority and majority shareholders. Agency theory offers numerous solutions to mitigate the conflicts between principals and agents and between shareholders themselves. CG mechanisms are the main instruments to mitigate the conflicts. Thus, the agency theory is most relevant for this study as it explains the opportunistic behavior of management, which may cause them to perform EM. The agency theory also stresses the important role of ACs as internal mechanisms to mitigate agency problem and EM practices and enhance financial reporting quality.

Most CG literature on EM or firm performance has adopted the agency theory. In this study, employing political theory will be better beside the main theory applied which is agency theory. Besides the agency theory, this study also adopts the political theory to effectively capture the political context of Palestine (Gourevitch, 2003; Roe, 2003). The political theory argues that the social and political circumstances in any country affect the company in important and several ways (Roe, 2003; Gourevitch, 2003; Pagano & Volpin, 2005). It elaborates to which extent the government influences firms and how they react to the political and social environment to protect current and prospective investors. La Porta et al. (1998) have argued that a strong legal system can minimize agency problems because it protects the investors' rights. Berglöf and Claessens (2006) argue that political instability may lead to poor enforcement and implementation of CG. Effective governance would constrain managers' ability to abuse the wealth of stockholders. In other words, agency costs depend on the political stability in any country (Mangena et al., 2012).

4. Conceptual Framework and Development of Hypothesis

4.1.Research Framework

The research framework is constructed and developed based on prior studies and the agency theory, which is used to explain the effect of AC characteristics on EM practices. The study also adopts the political theory to discuss the moderating effect of political instability on the relationship between AC characteristics and EM in Palestine.

To achieve the research objectives, two relationships will be explored. The first relationship is illustrated in Figure 1. EM represents the dependent variable and is measured using Kothari et al.'s (2005) model, while AC characteristics are the independent variables. Furthermore, political instability is the moderating variable between AC characteristics and EM.

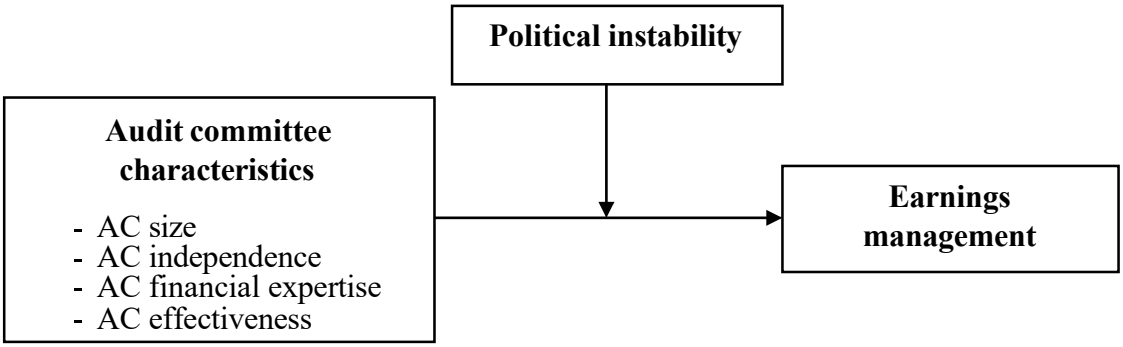


Figure 1: Research framework

4.2.Development of Hypotheses

Based on the agency theory, political theory, and prior literature, the following hypotheses have been formulated:

Audit Committee Size

Studies have reported mixed findings about AC size and its relation to EM and financial reporting quality (Ayemere & Elijah, 2015; Idris et al., 2018; Aljdaba, 2021). Al-najjar (2011) finds that larger ACs may be stronger monitors of top management and increase the quality of financial reports. Ayemere and Elijah (2015) report that EM practices are constrained by AC size, and that there is a significant negative relationship between AC size and EM. We thus formulate the following hypothesis:

H01: There is a negative relationship between AC size and EM.

Audit Committee Independence

The independence of the AC is typically associated with its effectiveness (Hamid et al., 2015). Independence may be an important determinant of financial reporting quality (Siagian & Tresnaningsih 2011). Hamdan et al. (2016) discover no relationship between earnings quality and AC independence, likely because the ACs in Jordanian industrial companies are not independent. On the other hand, Davidson et al. (2005) report that non-executive directors on the AC play a critical role in reducing the manipulation behaviors and EM practices. Crutchley et al. (2007) find that fewer independent members on the AC lead to more accounting fraud. Xie et al. (2003) report that independent members of the AC play an essential role in constraining any financial reporting irregularities. But other studies have reported no significant association between AC independence and EM (Lin et al, 2006). We thus hypothesize that:

H02: There is a negative relationship between AC independence and EM.

Audit Committee Financial Expertise

Accounting or financial expertise are among the important characteristics of AC due to its scope of work in the firm. Most studies have given much attention to the financial expertise and knowledge of AC as evidence of committee effectiveness. Zalata et al. (2018) argue that financial expertise and gender of AC members are some important

monitoring mechanisms. They also find that financial expertise mitigates EM. Ayemere and Elijah (2015) report a negative association between AC financial expertise and EM practices. Bilal et al. (2018) report a strong positive association between earnings quality and AC financial expertise. Idris et al. (2018) document a negative significant relationship between AC financial expertise and EM. Therefore, we formulate the following hypothesis:

H03: There is a negative association between AC financial expertise and EM.

Audit Committee Effectiveness

The duties, responsibilities, and monitoring function of the AC ensure financial reporting quality and enhance corporate accountability. There are several characteristics that enhance the effectiveness of AC, such as the existence of financial and accounting experts and independent directors (DeZoort et al., 2002; Shawtari et al., 2015). According to DeZoort et al. (2002), it is better to measure AC characteristics as a group to measure AC effectiveness. Ward et al. (2009) argues that investigating the mechanisms of CG collectively rather than individually would be better in the future studies. Zgarni et al. (2016) examine the influence of AC effectiveness and external audit quality on the quality of financial reporting system to reduce EM practices in Tunisian listed firms before and after the adoption of financial security law. They measure the effectiveness of AC based on five characteristics (existence, size, independence, meeting frequency, and financial expertise). They find that AC effectiveness and specialist external audit can mitigate EM practices. Based on the above evidence, we conceptualize that AC effectiveness can constrain EM:

H04: There is a negative relationship between AC effectiveness and EM.

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

Several studies have examined how financial and political crises affect EM and income smoothing (Attia et al., 2016; Hsiao et al., 2016; Obaidat, 2017; Harymawan & Nowland, 2016; Aljadba, 2021). Hsiao et al., (2016) find that USA oil and gas firms engaged in EM practices during the Arab Spring. Furthermore, Obaidat (2017) indicate that firms are more likely to practice income smoothing during periods of political crisis. Mangena et al. (2012) examine the association between board of director, ownership structure, and firm performance during severe political environment and economic crisis. They use the political theory developed by Roe (2003) to investigate the relationship. They find that during the period of post-presidential election, board size, executive directors' ownership, and ownership concentration increased, while the proportion of non-executive directors decreased. Firm performance is positively related to board size and ownership concentration in the post-presidential election period, but not in the pre-presidential election period. The relationship between performance and executive directors' ownership is positive in the pre-presidential election period, but negative in the post-presidential election period. Overall, they suggest that large boards and ownership concentration are more important during severe political and economic crises. Finally, they recommend more on disclosure and EM in an unstable political environment. Based on the political theory, we formulate the following hypothesis:

H05: Political instability moderates the relationship between AC effectiveness and EM.

5. Conclusion

This study extends the CG and EM scholarship with a number of contributions. Firstly, there is a lack of studies addressing the relationship between AC and EM in Palestine. To the authors' best knowledge, this study is the first to examine this relationship. Secondly, this study builds on prior studies by examining a new variable, AC effectiveness. Past studies have empirically linked EM to the individual characteristics of the AC. Thirdly, previous studies suggest that the effectiveness of CG mechanisms are affected by political instability. Therefore, we recommend further research on the relationship between CG mechanisms and EM during political instability. Furthermore, future research should include other CG characteristics, such as board characteristics, ownership structure, and internal and external audit attributes. To conclude, this paper will extend the existing literature of EM by employing political instability as a moderator between AC characteristics and EM.

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