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The Impact of Earnings Management on The Firm Value: An Applied Study In A Sample of Iraqi Private Banks

Assist. Teacher. Ameer Saheb Shaker
University of Kufa/ Administration and Economy Faculty
Department of Accounting
Ameer.saheb83@gmail.com

Abstract:

The research aims to examine the impact of earnings management practices on the firm value. The sample of study consists of 10 Iraqi private banks listed in Iraq Stock Exchange using data collected from the annual reports of the sample banks for the period between 2006 to 2015. the software package Spss is used to examine the data and to infer the conclusions. The results indicate that the earnings management practices have an influence on the firm value the sample banks by conveying a good image about the profitability power of the bank to the potential investors. The results also indicate that the earnings management practices stem from the flexibility that existed in the accounting standards, which permit to accountants to choose among a several alternatives of the measurement. In addition, the earnings management represents an intentional intervention in the accounting and reporting processes in order to change the perception of the stakeholders about the reality of bank's profitability, and in turn lead to increase market value of the bank. The findings of this study can be used as guideline to investors for detecting the cases in which the earnings numbers managed in order to provide a real evaluation of the bank listed in stock markets.

Key words: Earnings management**,** firm value, profitability, stakeholders.

1- Problem of the research:

Some companies apply practices of earnings management in order to enhancing earnings consequently gain a lot of shareholders or to reduce their earnings in order to flee from tax paying, whereas, earnings management means using the gaps exist in the accounting policies that work on showing the best view of the bank, it is worth to mention that the banks administrations tend to rapid short-term earnings in order to enhancing their own benefits which are mostly planned against benefits of shareholders represented by magnifying the value of the bank in long term, continuity of earnings and their permanence.

We can brief the problem of the research by the following queries :

a. What is the type of the earnings management (by decrease or increase) that has been practiced by the private Iraqi banks that are enlisted in the Iraqi stock exchange markets?

b. Are there differences with significant statistical evidences between the book amount for the principles of Iraqi banks and the market value?

c. How much does earnings management inpact upon the bank value?

2- Importance of the Research:

The importance of the research comes from the fact that it deals with an important side which is earnings management and how much it influences upon the value of the bank via the manipulating processes done by this practice in the fiscal lists published by the banks, consequently influence significantly upon the materialistic status and their value in the market.

3- Aims of the Research:

Aims of the research are represented in the following point:

a. Illustrating the concept of earnings management.

b. Briefing the practices of earnings management.

c. Testing how much the earnings management influence the value of the bank.

4- Hypotheses of the research:

Hypotheses of the research emanated from the problem and aims of the research and could be briefed as follows:

a. private Iraqi banks management commonly rely on earnings management by increment.

b. Decrease of book value of private Iraqi banks from the market value significantly.

c. There is a statistical evidence effect between the practicing of earnings management and bank value.

5- Literature Review :

In this section we will brief the previous studies pertained the research problem:

a. Study of (Al- Mashhadany and Al-Fatlawi, 2012) entitled with " Accredited Approaches In Measuring Earnings Management Of Companies And Effect Of Governance Techniques In Commuting Them" , this study tackled with how much using of the companies governance in reducing the process of earnings management due to fact of most companies resorted to the policy of earnings management via manipulating the gaps existed in banks rules to manipulate the numbers found in fiscal reports, using indexes of stock exchange association in China plus using Jones pattern that is used in measuring the earnings management, the study has come up with the existence of a significant effect of applying companies governance in reducing the practicing of management for earnings management.

b. Study of (Abdullah and Tawfeek, 2012) entitled with " The Concept Of Accounting Equity And Role In Reducing The Practices Of Earnings Management".

This study tackles illustrating the accounting equity in accounting career due to the huge role in reducing the styles of earnings management, the study has come up with reducing practicing of earnings management embodied in the proper application of the role of equity in the accounting, and abide employees of bank with this policy would avoid the future bankruptcy.

c. Study of (Ibrahim and Haroon, 2016), entitled with " Judicial Accounting And Its Role In Limiting The Practicing Of Earnings Management In Markets Of Al-Khartom" .

This study tackles a punch of procedures that are based on judicial accounting to discover the used styles of earnings management that have a significant influence upon the fiscal reports, the study also has come up with that there is a big and active role for the judicial accounting in reducing using the earnings management via providing the legal consultancy for companies after raising efficient data and through which we can discover any improper practice related with the fiscal corruption cases.

While, for the position of current study within the previous studies, each study has tackled with an independent subject from the other to deal with the relation with companies governance, other study dealt with it's role with accounting equity, other study dealt with earnings management with judicial accounting, hence, all previous studies didn’t tackle with the subject of practicing earnings management and its influence upon the bank value which we are going to study it in this chapter.

6-The Theoretical Side :

6-1: Concept of Earnings Management.

There are many definitions to the earnings management being defined by (Al-Dauor and Abid, 2009, 823) as it is :

Choosing to a group of methods and procedures that used by the bank to achieve specific goals via using the available flexibility in the accounting policies in order to influence the financial lists in purpose of misleading the shareholders from the work of the bank or influencing the data that show up in these reports, while it is defined by (Iesa, 2008: 13) as it is an practice done by managers purposely in order to get a personal earning via misleading the users of accounting information, while (Fadawy:121) tended to identify it as " An activity done by the management when doing financial reports in order to influence the profitability of the bank by decrease or increase" , also was defined by (Marai & Pavlovic, 2013:40) as it is the using of managers to the personal decision when they prepare the financial reports in order to misleading the projects owner from the real economic status of the company or to manipulating the accounting numbers that contractual results depend on" .

The research sees that earnings management means exploiting the gaps existed in the accounting rules and use them for the behalf of the bank to reflect a good picture about the economic and financial reality of the bank to attract more shareholders.

6-2: Aspects of Earnings Management.

It is easy to illustrate the aspects of earnings management via the following points (Mulford &Comiskey, 2002:3):

1- Hostile accounting : It is application of accounting methods and policies for main purpose of earning earnings regardless the safety and health of these policies and accounting procedures.

2- Deceiving financial reports: It is defined as offering reports from the financial head center of the organization via invalid financial database by omitting and not clarifying the real financial database in order to mislead the users of the reports and financial lists.

3- Innovative accounting: It is a process that employs the accountants for their experiences in the accounting policies and rules in order to manipulate in the obtained numbers and financial reports related to the organization.

4- Decorating the income: it is an accounting manipulating aimed to improving the shape of the income of the financial periods via transferring the high rates of income during past periods to another periods where the income is weak, to let the users be convince that the income is very well of that company, to show that the organization is able to preserve their incomes regardless the surrounding circumstances.

5- Practicing styles of innovative accounting : It is using procedures and practices rather than those which are used in proper and valid procedures and practices in order to obtain unreal earnings via manipulating the values of expenses and revenues.

6-3: Styles of earnings management

Styles of earnings management are represented by (Jasim and Mohammed, 2011: 452-455).

1- Accounting policies: means changing the applied method in the accounting practices like changing from the method of : Using the method of income is first outward is first to income instead of the method of outward is last income is first, and being careful that the modified accounting policy should not contradicted with the generally-accepted accounting principles, and the bank should continue in his new policy for a certain period.

2- Basis of merit : The basis of merit is represented by the accounting processes that happened during the year like increasing in the origins, commitments and incomes to apply the principles of comparing the incomes with the expenditures.

3- Personal estimation: Personal estimation is considered one of the reasons that lead the administration to the use of earnings management, it influences when using the financial reports and being the main reason of using it is to obtain agreements with another group of companies, or to give an improper picture for the concerned individuals about the economic reality of the bank.

4- The relative importance : the relative importance is considered very important due to it intervenes in all accounting practices due to it's significant influence upon the showing of data base that show up in the fiscal reports notably against the items of expenses and incomes.

6-4: Motivations of Earnings Management.

There are many reasons that push the companies to resort to earnings management to mention some of them: (Abo Ajila and Hamdan, 2001: 7), (Jabbar, 2016: 11) .

1- Motives of the financial market: Most of investors and market dealers need always the accounting information in order to knowing the share prices, so, in this respect, some managers try to manipulate some financial reports to magnifying the value of shares to attract more investors.

2- Contractual motives: According to the theory of agency that based on several contractual relations, they are emanated from many problems between the management and the shareholders so these contracts have been used in order to subsiding the tension between the management and shareholders.

3- Organizing motives: Some managers tend to use the earnings management to make use of the rules that company deals with, these rules either be special for banks like the requirements of achieving the capital, or a general like the legislations of fighting the monopoly that have main goal of reducing the intervening of the government in the work of these companies or acquiring the supports from the government.

6-5: Methods of Earnings Management :

The management used many methods that influenced upon the earnings, one of these methods are: (Shaheen , 2011:9)

1- The management works on magnifying the earnings via reducing debts that are suspected to be obtained by reducing the ratio of their obtaining when it comes to classify them.

2- Classify some expenses like maintenance as a capitalistic expenses and then being added to amount of earnings.

3- Not registering the processes related with selling the findings or stock exchanges in the same date of selling and then that would influence the amount of annual earnings.

4- Sometimes the managers intend to evaluate the store stocks with high market values when they apply the equation of cost or market which one is less in order to magnifying the earnings.

5- The management works on increasing the productivity age of the findings that works on reducing the annual extinction installment.

6-6 : Risks of Earnings Management:

When the management works on using practices of earnings management so there will be some risks may influence upon the bank we mention some of them :(Al-Ashkar 2010: 34-35)

1- External risks of the bank: These risks may be political, economic or public risks, showing the earnings in the financial report in improper way will lead to an increase in the taxes consequently influence the distribution of earnings, in return when the administration used this kind of earnings management may lose some of the clients confidence and then that will extend to another banks.

2- Internal risks of the bank: These risks are represented by the risks that influence the bank internally, the practicing of the bank to the earnings management may result in losing some shareholders and then rising of expenses related with capital and losing the competition privilege, increasing of requests of the shareholders to pay their funds which leads the bank to lend from other to pay them.

6-7: Measurement of Earnings Management.

There are many ways to measure the earnings management can be listed as follow: (Humaidy, 2011: 76-86)

1- Optional Payments Method: Based on comparing the annual expenses against the annual revenues of each bank to know the result between them of profit or loss, using this method , due to the flexibility in work of it , so it gives a wide space to the bank to use the personal opinion and estimations which lead to easy application of earnings management by the administration, samples of this method (1985 Healy, 1991 Jones, Industry model, 1986 De Angelo).

2-Method of contrast factor: This method of measuring earnings management depends upon a hypothesis of that the profit is a linear function of another variable, as the measurement done by opposing the profit against the contrast of the another variable to find out if there is earnings management or not, some of these samples are (Eckel 1981, 2001 Chaney and Lewis).

3-Miller method 2007: This method is used in measurement of earnings management, by which we can discover the banks that intentionally rely by its management on intervening the process of determining the periodic profit, this method is represented by measuring the relation between the change of the active capital against the change of the monetary supply from the working activity, and comparing the result of the current year with the same relation for the previous year, if the result be zero means the bank doesn't practice earnings management, while if the result was not zero means the bank practice the earnings management.

4- Method of voluntary items: This method based on testing a punch of styles that are used in earnings management to reduce the unexpected deviations in the profit like (Abnormal items, sample of measuring, 1976 Baranea and Sadan and Ronen, 1975 Sada and Ronen , change in the used styles in the accounting processes, samples are, 1987 Moses, 1996 Inoue and Herrmann) .

6-8: Effect of Earnings Management upon the Bank Value.

earnings management is considered one of the method that company resort to in order to manipulating the data shown in the financial reports that face vast concern by shareholders and clients, to give a shining face of these report and show numbers that reflect high earnings scored by these banks in order to attract the shareholders to deal with such banks, consequently the bank value will be higher when they show such reports, therefore the bank value get influenced by cheating and manipulating that are used by the bank management that exploit the gaps exist in the accounting applications and policies.

7-Practical Side:

Measurement of the research variables

First: - Independent variable (earnings management).

Second:- Dependent variable (Bank value).

Third: - Controlling variables.

1- Capacity of the bank.

2- Financial carrier.

3- Age of the bank.

Table (1) Statistical description of research variables.

	N	Minimum	Maximum	Mean	Std. Deviation
Earnings management	99	-29.7960-	24.2410	.087677	5.2114608
Value of the company	99	-.5310-	4.6680	.314152	.8305569
Capacity of the company	99	10.432	12.262	11.44922	.400528
Financial Carrier	99	.245	826.730	8.98643	83.025150
Age of the company	99	52	275	158.89	54.259
Valid N (listwise)	99				

8- Results of testing the hypotheses :

First hypothesis :

In order to test this hypothesis, we divided the banks of the samples into two groups based on Miler index for earnings management as follows:

- First group included the views of earnings management by decrease , were (48) view and has been given (0) number.
- Second group included the views of earnings management for increasing and were (51) views given the number (1).

Using the statistical analyzing (Binomial), the results of the tests was as follow :-

Table (2) Binomial Test

		Category	N	Observed Prop.	Test Prop.	Asymp. Sig. (2-tailed)
Earnings Management	Group 1	0	48	.48	.50	.841[a]
	Group 2	1	51	.52		
	Total		99	1.00		

a. Based on Z Approximation.

From above mentioned results, we noticed the level of incorporeal of test was (0.841) and it is much higher than the acceptable mistake in the social sciences which is (0.05), so the hypothesis will be refused.

Second hypothesis :

In order to test this hypothesis , sample banks been divided into two groups based on the value of the indication (Q) to measure the value of the bank as follows:

- First group includes the views where Q value was <1, 90 views and given the number (0).
- Second group includes views where Q value was >1 , 9 vies , given the number (1)

By using Binomial statistical analysis , results were as follow:

Table (3) Binomial Test

		Category	N	Observed Prop.	Test Prop.	Asymp. Sig. (2-tailed)
Company value	Group 1	1	9	.09	.50	.000[a]
	Group 2	0	90	.91		
	Total		99	1.00		

a. Based on Z Approximation.

We can noticed that the corporeal level of the test was (0.00) and it is much less than the acceptable mistake level in social sciences which is already determined as (0.05), hence this theory is acceptable.

Third hypothesis :

In order to test this hypothesis , we created the following statistical sample :

$$Q_{it} = B_0 + B_1 \text{ Earning } M_{it} + B_2 \text{ Size}_{it} + B_3 Lev_{it} + B_4 Age_{it} + \varepsilon_{it}$$

As :

Q_{it} = Bank value.

Earning M_{it} = Earnings management of the bank.

$Size_{it}$ = Bank size.

Lev_{it}= Financial leverage of the bank.

Age_{it} = Age of the bank.

E_{it} = Estimation mistake.

By using the statistical analyzing program SPSS, results were as follow:

Table (4) Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.387[a]	.15	.113	.7821116

a. Predictors: (Constant), Company capacity, Financial leverage, Earnings management, Age of the company

Table (5) Contrast

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	10.103	4	2.526	4.129	.004[a]
	Residual	57.500	94	.612		
	Total	67.603	98			

a. Predictors: (Constant), Company capacity, Financial leverage, Earnings management, Age of the company
b. Dependent Variable: Value of the company

Table (6) Treatments

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	6.371	3.096		2.058	.042
	Earnings management	-.003-	.015	-.018-	-.184-	.854
	Capacity of the company.	-.489-	.291	-.236-	-1.680-	.096
	Financial leverage.	.001	.001	.054	.558	.578
	Age of the company	-.003-	.002	-.188-	-1.334-	.185

a.Dependent Variable: Value of the company .

The model summary shows the dual correlation factor (R) between the two variables is (0.387), while specifying factor is (R square) is (0.15), i.e. , 15% of the change in the dependent variable (bank value) attributed to the change in the independent variable (earnings management), also we noticed that the Std. Error of the estimate was (0.782) and it is a tiny value, the decreasing in such kind of mistake, the less mistake of estimation.

The ANOVA table showed Mean Square of Residuals is (0.612) and it is the average of mistake of estimation, F value is (4.129) and it is higher than tabular value of (1.93), evidence level is (0.004) and representing the sample reliability or what is called (P-Value), this evidence is much less than the acceptable mistake in the social sciences which is defined already as (0.05), hence this hypothesis is accepted.

The table of coefficient of the declination function above mentioned, that the equation of slope was as follow:

Bank value = 6.371 –(0.003x Earnings management) – (0.489 x Bank size) + (0.001x Financial leverage) – (0.003 x Bank age)

This equation showed the relation between the research variables by the coefficient (B).

Negative value of B2 refers to the reversal relation between the independent variable (Earnings management) and the dependent variable (Bank value).

9- Conclusion

This study aims to examine the impact of earnings management practices of the firm value of Iraqi private banks. The sample banks of 10 private banks listed in Iraq stock Exchange using a data extracted from the annual reports of the sample banks during the period from 2006 to 2015. The results indicate that earnings management practices seek to gain the confidence the stakeholders through the earnings numbers reported in the financial reports. The results shows that the earnings management have an influence on the firm value of the banks by the supporting the market values of their shares. In addition, earnings management behavior is a personnel decision of the bank's management to convey a good image about the performance of the bank to the stakeholders. The findings of the study also states the earnings management is an outcome of the flexibility of accounting standards permits to the companies to manipulate the earnings between the periods. Finally, this study provides a guideline for stakeholder in general and the investors in particular to discover the states in which a potential bias or intentional intervention to improve the bank value by the improving the earing figures.

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