Do Companies in Gulf Cooperation Council (GCC) Countries Manage their Earnings?

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Abstract

This study considers data for listed companies in GCC countries with an objective to determine if companies practice Earnings Management (EM). The study sample consists of 332 listed companies during the period from 2010 to 2015. The EM level was measured using discretionary accruals (DA) calculated using the Modified Jones (1995) Model. The results reveal that companies in GCC countries are engaged in EM practices except for Oman. Further, the companies in most GCC countries practice EM through income-decreasing discretionary accruals.Therefore, the results of this study provide empirical support for the development of new regulations and amendments and necessary corrective decisions regarding the effectiveness of applying corporate governance codes in GCC countries. More specifically, this study reveals an urgent need for new amendments to restrict EM practices in GCC countries. In addition, the study enriches the EM literature by covering GCC countries, which has not been sufficiently examined in relation to this topic.

Keywords: Earnings Management, Discretionary Accruals, the Modified Jones (1995) Model, GCC Countries.

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1. Introduction

Managers of the firmalways try to secure the funds required in all possible ways to maintain firms' going concern.Thismaydrive to manipulate firms' earningsto create more positive picture of firms' performance (Türegün, 2016).This also enables managers to realizetheir benefits,maximize their utility, and maintain their power or job security (Jiraporn et al. 2008). Thus, the EM isused to influence the accounting profits by using some of the flexibility allowed by accounting policies and practices (Parfet, 2000).

However, managers significantly practiceEM in different methods, hence producing misrepresentations in financial reports.EM practicingmethods can be classified (Gul et al. 2009) into positive discretionary accruals (income-increasing) and negative discretionary accruals (income-decreasing). This is based on the assumption thatfirms' earnings are used by financial statements users as a proxy in capital markets to evaluate companies'financial position (Türegün, 2016).

There are number of studies that evidence strong incentives for EM. For example, Kahneman and Tversky, (1979) support that largest incentives to manage earnings occur while moving from relative or absolute loss to gain. Carslaw (1988) and Thomas (1989) found that firms practice discretion to increase earnings when the level of earnings per share is slightly below a round number, though neither paper provides specific evidence for earnings near zero. In addition, Burgstahler and Dichev (1997) analyzed the impact of firm's losses on EM and concluded that large and small firms manage their profits in order to avoid small losses or decline in small profits. This view was also supported by other researchers as Hayan (1995),Degeorge et al. (1999), Gore et al. (2001), Beatty et al. (2002), Roychowdhury (2006),Myers et al., (2007), Hamdi and Zarai (2012), and Llukani (2013) indicate that firms manipulate earnings to avoid small losses or decrease in earnings. Coppens and Peek (2005) reported also that when the tax regulations strongly affect financial accounting, firms do not try to avoid reporting small losses. In addition, when the tax regulation is weak, the firms engage in EM to avoid reporting losses.

Based on these facts, the doubt increased on the truth and fairness of financial statements and whether they involve changes associated with EM practices and behavior to affect earnings and show it violation of reality.

In GCC countries[2], managers are likely to practice EM opportunistically to maximize their own benefits rather than the stakeholders' benefits. Thus, this study determines whether listed companies in GCC countries practice EM as a method to hidetheirlow performance and to mislead financial statements users. To the best of our knowledge, there has been very limited number of studies that dealt with this vital topic in GCC countries.In more detail, this study shows whether firms are practicingmanagement of positive discretionary accruals (income-increasing) or management of negative discretionary accruals (income - decreasing). In addition, the previousstudiesthat measured the EM practices were done only in one country of GCC but not in entire GCC countries (e.g., Habbash and Alghamdi, 2016).Thus, the study broadens the scope with awide coverage of the entire GCC countries based on recent data extracted from Bloomberg database for GCC countries, for six years (2010-2015).The statistical analysis was performed for each country separately to get more robust and accurate results.GCC countries wereselectedas they started experiencing economic difficulties because of decrease in the oil prices. Thus, this could affect firms' financial performance and motivates firms to practice EM. Therefore, it is significant for many end users to detect the level of EM practices in these countries as any manipulation of the firms' performance in the GCC countries could affect the entire Arab region.Therefore, result of this study is useful for many parties as auditors, banks, credit institutions, and financial statement users in general. Further, it helps government in setting rules and procedures to protect the interest of shareholders.

The rest of the paper is organized as follows. Section 2 presents the research design. Section 3 analyses the study results. Section 4 presents the study's conclusion, limitations and the scope for further research.

[2]Gulf Cooperation Council (GCC), is a union consisting of six Arab Gulf States(Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates).

2. Research design

2.1 Methodology

Previous studies reported that the Modified Jones(1995) Model is the best measurement of discretionary accruals and the most common model as a proxy of earnings management(Dechow et al.,1995; Francis et al., 1999; Saleh and Ahmed, 2005; Gore et al., 2007; Uwuigbe et al., 2012; Atieh and Hussain, 2012; Walker, 2013; Alareeni and Aljuaidi, 2014; Uwuigbe et al., 2014; Ipino and Parbonetti, 2016). Therefore, this study uses the Modified Jones (1995) Model to calculate the discretionary accruals as a proxy of earnings management and to decide whether companies practice Earnings Management (EM). Thus, the research methodology involves estimating values of DA for each firm based on the Modified Jones (1995) Model. This analysis is applied to all the GCC countries.

The Modified Jones (1995) Model is based on the following equation:

$$\frac{TA_t}{A_{t-1}} = \beta 1\left(\frac{1}{A_{t-1}}\right) + \beta 2\left(\frac{\Delta REV_t - REC_t}{A_{t-1}}\right) + \beta 3\left(\frac{\Delta PPE_t}{A_{t-1}}\right) + \mathcal{E}j, t \tag{1}$$

Where:

TA_t (Total accruals) = Accounting Earnings – CFO
$Ai,_{t-1}$ = Total asset in year t - 1
$\Delta REV_{i,t}$ = Change in the revenues of company j from year t-1 to year t
$\Delta REC_{i,t}$ = Change in the receivables of company j from year t-1 to year t
$\Delta PPE_{i,t}$ = Fixed asset of company j at the end of year t
$\mathcal{E}_{j,t}$ = Errors of company j in year t

To estimate the parameters (β1, β2, β3) of the Modified Jones (1995) Model in equation (1), multiple regression analysis was used. DA was then identified as the difference between estimated accruals and actual accruals. The value of DA was used as a proxy of the degree of EM.

2.2 Sample size and data collection

The study sample consists of all listed companiesin the GCC countries. The GCC countries include Saudi Arabia, Kuwait, Oman, United Arab Emirates, Bahrain and Qatar. The study sample was collected from the Bloomberg database for the period from 2010 to 2015.It was selected based on the following criteria: (1) Company must be classified as industrial or service company; (2)Company’s datais available for six years. The other sectorslike banks, insurance and financial servicesare excluded as they have different operating characteristics (Carcello and Nagy, 2004)and they possess complex properties that are unique in nature and different from those of other sectors (Al-Thuneibat, et al., 2011). Accordingly, initial sample consists of 332companies out of 7968 observations. 296companies’ observations are dropped due to missing data on some variables. Therefore, the final sample includes 332 companies with a total of 7672 observations. Table 1 describes the study sample distribution by country:

Table 1: Sample distribution by country

Country	#of Companies	# of Observations
Saudi Arabia	120	2712
United Arab Emirates	51	1180
Kuwait	113	2664
Qatar	13	308
Oman	14	304
Bahrain	21	504
Total	**332**	**7672**

3. The results

Table 2 shows the descriptive analysis of discretionary accrual for the GCC countries included in the study sample. It presents the mean, minimum and maximum values and the standard deviation of discretionary accrual.

The exhibit from the Table 2, Referring to Saudi Arabian companies, the mean value of discretionary accrual valueis equal to (-0.721) with minimum (-0.6858), maximum (0.47607) and standard deviation of (0.0809). This indicates that the Saudi firms practiced EM through the negative discretionary accruals (income-decreasing).

Table 2: Descriptive Statistics of discretionary accrual for each country

Variables	Min	Max	Mean	Std.
Saudi Arabia	-0.6858	0.47607	*-0.721*	0.0809
Kuwait	-0.3832	0.46022	*-0.911*	0.07974
United Arab Emirates	-0.77637	0.29145	*-0.232*	0.0840
Oman	-0.13	0.16	0.0000	0.05992
Qatar	-0.19336	0.18140	*-0.927*	0.0600
Bahrain	-0.5210	0.29297	*-0.3986*	0.09107

For Kuwait, the companies mean value of discretionary accrual is equal to (-0.911) with a minimum (-0.3832), maximum (0.46022) and standard deviation of (0.07974). This implies that even Kuwaiti companiesare involvedin EMthrough the negative discretionary accruals.

Inthe United Arab Emirates, the companies mean value of discretionary reached to (-0.232) with a minimum (-0.77637),maximum (0.29145) and standard deviation of (0.0840). This indicatesthat the UAE companiesare engaged in EMactivities through the reducing income (negative discretionary accruals).

The analysis presents on the average that Qatari and Bahraini companies are also engaged in EMpractices through the negative discretionary accruals.The mean value of Qatari companies touched (-0.927) with a minimum (-0.19336), maximum (0.18140) and standard deviation of (0.0600). In Bahrain, the companies mean value of the discretionary accruals reached (-0.3986) with a minimum (-0.5210), maximum (0.29297) and standard deviation of (0.09107).

Finally, the results are different for companies in Oman, their mean value of discretionary accruals of zero with a minimum (-0.13), maximum (0.16) and standard deviation of (0.05992). This confirms on the average that Omani companies did not practice EMby their management.

In the nutshell, based on the results of descriptive analysis, on an averageindicates that the companies in GCC countries (Saudi Arabia, Kuwait, UAE, Bahrain, and Qatar) except for Oman are engaged in downward EMactivities. Namely, the companies practice income-decreasing. This could beto reduce stock prices prior to granting stock options and prior to re-purchasing sharesfrom the stock markets. In addition, may avoid some political and social costs that may be incurred by GCC companies as a result of the announcement of a high profit. Furthermore, to avoid any proposed increases by the employees to raise wages and salaries.However, this is not due to reducing the value of tax payments, as most of the companies in GCC countries are not taxable.

4. Conclusion

The objective of thestudy is to determine if the listed companies in GCC countries practice EM.The study usedDAto measure the EM practices. It examined a sample of 332 listed companies with a total of 7672 observations during the period 2010-2015.

The findings indicatethat firms in GCC countries (Saudi Arabia, Kuwait, United Arab Emirates, Bahrain, and Qatar) except for Oman are engaged in EM practices and they are practicing downward EM activities. This may be to avoid some political and social costs or to avoid any proposed increase by the employees to raise wages and salaries.Regarding Oman, the result showed that Omani companies did not practice EM.

The limitation of this study is missing of some financial data. Some observations were deleted, as their data was not provided by Bloomberg database. Furthermore, as reported by Turegun (2016) the capability of the Modified Jones (1995) Model is still open to discuss on whether itisaccuratein classifying discretionary and non-discretionary accruals. Thus, the validity of this study results relyon the accuracy and correctness of DA as a suitable proxy for EM.

Further research could be conducted using financial firms and banks and insurance companies since thenature of their financial data is different. Further research also could include other firms' characteristic as firm age, governance indicators etc. Thus, future research is suggested to further examine this research problem using the reported suggestions.

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