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Unveiling Earnings Management Strategies Through Financial Ratios: A Comprehensive Investigation of Audit Quality's Mediating Role in Jordan's Financial Landscape

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Abstract

Purpose – This study aims to investigate the mediating impact of audit quality on the relationship between financial indicators and earnings management.

Design/methodology/approach – The research uses panel date method to test the relationship between financial factors and earnings management. The sample consists of 930 firm-year observations for 93 listed companies in the Amman Stock Exchange for the years from 2009 to 2018. STATA software is used for regression analysis, Baron, and Kenny's model used to test the significance of the mediating effect.

Findings- The empirical findings of the study showed that earnings management is positively associated with earnings per share. Moreover, the findings showed that debt to equity is negatively associated with earnings management. Regarding the mediation role of audit quality, the results revealed that audit fees fully mediate the association between financial structure ability and earnings management and partially mediate the association between earnings ability and earnings management.

Research limitations– The current study has some limitations. First, the study sample was limited to Jordon market. Therefore, the study results may not be generalized outside Jordon market. Another limitation is that audit fees are used as a mediator variable. Future studies may use different audit quality factors such as auditor size or audit opinion. Finally, financial factors are limited to earnings per share, debt to equity and current ratio and future studies may apply to other financial indicators such as cash ratio, leverage ratios and turn in equity ratio.

Practical implications: The findings of the current study have implications for policymakers and investors. Policymakers to ensure high financial reporting quality they may demand for high audit quality regardless the audit cost. In addition, investors may benefit from the findings of this study. They can format their decisions based on the level of financial factors.

Originality/value – This study contributes to the knowledge by investigating the role of audit quality on mediating the association between financial factors and earnings management on

Jordon market. Moreover, the current study is the initial study that investigates the relationship between financial factors and earnings management by using Jordon settings.
Keywords: Financial Ratios, Earnings Management, Audit Fees

Introduction

The issues of earnings management is considered one of the most challenge topics in accounting researches (Kliestik et al., 2021). According to Alzoubi (2016), corporate stakeholders and regulators pay more attention to earnings management issues. It gained this importance due to its association with financial reporting, especially after financial scandal of Worldcom and Enron. Hamza (2012) reported that earnings management practices are the main reason behind the collapse of these companies. Whereas Schipper (1989) claimed that earnings management as the management's interference in financial reporting process to gain a personal benefit, (Healy & Wahlen, 1999) defined earnings management when managers uses their judgments to distort financial reports to mislead the shareholders about economic performance or to influence outcomes that depends on accounting figures.

An entity's profit is considered one of the most important items in financial statements that provide a significant indicator about corporate activities, investment and management decisions. According to (Almasarwah, 2015) managers may are motivated to manipulate profit figures to achieve the desired goals. Many factors motivate managers to manipulate reported earnings such as contract agreements between external stakeholders and managers, the need to meet market expectations or to achieve targeted profits, job security, and self-interest in compensation plans (Healy & Wahlen, 1999; Nia et al., 2015). It has been argued that earnings management increase the information asymmetry between managers and owners and then lead to non-stability of financial position of companies Fang et al (2018) wherefore Financial reporting is the tool that reflects the financial position of the company and has the financial information that can be used by the investors to format their investment decisions. Wherefore Financial indicators such as earning ability, financial structure ability, debt repaying ability and non- financial factors ability are the most important information in financial statements that may reflect the corporate activities in financial markets, (Ado et al., 2020).

Several previous studies address the association between financial indicators and earnings management. For example, Shiri et al (2013) stated that earnings ability (EB) has an influence on the activities of earnings management and its disclosure. Moreover, earnings ability may be manipulated by managers to increase the loyalty of employees of the company (Rashid, 2017). Financial structure ability (FSAB) was also found to have correlation with earnings management. It has been found that managers have the ability to increase the level of debt compared to shareholders' equity level ((Wang & Zhu, 2013).

Audit quality (AQ) is a common concept in audit literature. There is no consensus on a single definition of audit quality, and there are many definitions by many scholars. However, the most widely used definition is that provided by (DeAngelo, 1981). Audit quality according to this definition is the ability of auditor to discover the material misstatements and report them to the management. As well as there is a dispute that occurred regarding measuring the quality of the audit between outers and academics. This is attributed to the difficulty of evaluating the audit process in advance and what is observable is only the audit report, which is usually standard and clean (Francis, 2004; Guizani & Abdalkrim, 2021) Audit fees is one of the most used measure of audit quality (Alhababsah, 2019; AlQadasi & Abidin, 2018) High audit fees are associated with audit quality as the external auditor spend more effort in audit process (Schauble, 2018). Several studies found that audit fees have a negative impact on earnings management. For instance, Martinez and Moraes (2017) stated that companies that pay high audit fees to external audit have less earnings management practices. They argued that companies pay more audit fees for good auditors, which could discover the fraud activities and pay more monitoring when reviewing financial statements.

The study seeks and aims for the following

- This study investigates the mediating effect of audit quality on the association between financial indicators and earnings management.
- It provides greater insight into the effect of financial indicators on audit quality.
- In addition, it analyses the role of audit quality in monitoring management misbehaviors.
- How do Jordanian companies practice earnings management?
- Which model is better for detecting earnings management?
- Coverage of a lack of studies in Medial East countries that address the effectiveness of financial indicators. Interestingly, this study is the initial study that investigates the association between financial indicators and earning management by using audit quality as a mediator, so this study contains many contributions in the relevant literature by achieving the objectives of the study

The current study is organized as follows: section two reviews the literature related to study variables and builds the study's hypotheses. Study data and research methodology are highlighted in section three. Section four discusses study results. Finally, implication and conclusion are drawn in section five.

Literature Review & Hypothesis Development

Effect of Financial Indicators on Earnings Management

According to Tan and Jamal (2006), the earnings ability is the ability of a company to generate a profit in business transactions. Shubita (2013) argues that earnings ability is the cabilibabilty of companies to diliver a benefits to the shareholders. His study found that earnings ability has an influence on earnings management practices and their disclosure.

(Rashid, 2017) stated that earnings ability in a situation of imbalance of the company financial position is considered a financial index. The study referred that earnings ability is a vital indicator which can guide investors and shareholders in their investment decisions. Similarly, (Miloud, 2014) suggests that investors and shareholders are attracted by disclosure of earnings ability information. Dilla et al (2014), stated that the confidence of earnings ability information is increased by shareholders and investors specially when managers disclose information concerning earnings management. This is in line with agency theory that protects the rights of all parties. However, this point of view is in contrary with the reality since the managers cannot provide information about their misbehaviors that may affect their reputation negatively.

Based on the above discussed literature, the following hypotheses is developed

H1: There is an association between earnings ability and earnings management.

Financial Structure Ability and Earnings Management

(Jackson et al., 2013) defined financial structure ability (FSAB) as the ability of company to meet its obligations. Malinic et al (2013) reported that information of financial structure ability is beneficial for shareholders as it helps them to evaluate corporate earnings management activities. The study suggests that both managers and shareholders can benefit from defined financial structure ability. Managers can use it to increase the profit to satisfy the shareholders and increase the confidence on their investments and the shareholders can exploited financial structure ability to detect the misconduct of management of manipulating corporate financial reporting.

(Arasteh et al., 2013) claimed it is possible to test the effect of financial structure ability on earnings management activities by analyzing long-term debt and short-term debt. It has been argued that manipulating the financial structure ability can bring a benefit to the company by addressing aggressive debt. Therefore, according to (Rashid, 2017), financial structure ability can be used as a strategy by management to increase profitability of the company. His study also suggests that financial structure ability should be used in absolute terms and all agency's parties should benefit without affecting the benefit of the other party. Based on the above discussed literature, the following hypotheses is developed

H2: The Financial Structure Ability (FSAB) have relationship with Earnings Management (EM).

The Mediation Effect of The Audit Quality on Relationship Between Financial Indicators and Earnings Management

According to agency theory, audit quality plays an important role in monitoring the association between agency' parties. It is an effective tool in reducing managers' misbehaviors (Alzoubi, 2016, 2018). He stated that the auditor has the role to add the creditability of financial reporting which helps him to detect earnings management practices. Thi et al (2018) argued that because of the controversial results of previous studies, the effect of audit quality on earnings management is still questionable. Yasser & Soliman (2018) argued that audit quality is related to the quality of financial statements. This is because high quality financial statements are usually audited by high quality auditors who are more likely to detect fraud and errors. Salehi et al (2017) refers that audit financial statements are an essential source of fair, impartial and transparent information and this increases the importance of audit quality in capital markets. Moreover, it is argued that audit quality reduces the information asymmetric between owners and managers. Therefore, audit quality is considered and essential monitoring mechanism that prevents managers from practicing earnings management activities (Abu Afifa et al., 2023).

Based on the above discussed literature, the following hypotheses is developed:

H3: Audit quality significantly influences the association between earnings ability and earnings management.

H4: Audit quality significantly influences the association between financial structure ability and earnings management.

Research Design

Sample

The sample of this study consists of a balance data set of 930 year-firm's observations for 93 listed companies in Amman Stock Exchange. Study sample covers the years from 2009 to 2018. This period is selected because it reflects the problem of the study. Moreover, the code of corporate governance in Jordon started to be implemented since 2009. The study uses secondary data collected from financial reports of companies listed on the Amman Stock Exchange. Amman Financial Market and (UNIZSA) DataStream used to obtain the study's data. The balance panel data method used in this study represents the number of crosssectional and time series data sets. that balance panel data helps to produce better results than unbalanced panel data (AbRahman et al., 2016; Rashid, 2017). Thus, using balance panel data can help the study to provide better practical evidence regarding the effect of financial factors on earnings management in companies listed on Amman Stock Exchange.

3.2 Measurements of Study's Variables

The dependent variable in the current study is earnings management. There are two types of earnings management activities, real earnings management and accrual-based earnings management. Accrual based earnings management is the type used in this study. There are several models used to detect accrual-based earnings management activities such as Jones's (1991) model, modified jones model Dechow et al (1995); Kothari et al (2005) model. This study uses Kothari et al (2005) model. It is that this model is more efficient in detecting accrual earnings management activities than other models (Almasarwah, 2015). Financial ratios are the independent variables used in this study. These variables are earnings ability, financial structure ability. Following Chen (2011); Rashid (2017), earnings ability is measured by earnings per share, financial structure ability is measured by dept to equity ratio. Regarding mediator variables, the current study utilized audit quality as mediator variable measured by audit fees. The summary of measurements of all variables are presented in Table 1

Table 1

Summary of Variables Included in Empirical Model

Financial indicators	**Abbreviations**	**Measurements**	**Proxies**
Earnings Management	EM	Discretionary Accrual (Kothari Et Al. (2005) Model)	DA
Earnings Ability	EAB	Earnings Per Share (Net Income – Preferred Div) / Number Of Outstanding Shares = Earnings Per Share	EPS
Financial Structure Ability	FSAB	Total Liability / Total Equity = Debt To Equity	DTE
Audit Quality	AQ	Log Audit Fees	LAF
Firm Size	FS	Log Total Assets	LTA
Firm Performance	FP	Return On Assets	ROA

Number of control variables are included in this model. Most of prior literature found that these variables effect earnings management (Mnif & Cherif, 2020). These variables are firm size and firm performance. According to Baatwah et al (2015), control variables increase analysis's confidence and reduce the bias in estimation earnings management models.

Research Models

This study applies (Baron & Kenny, 1986) method to evaluate the mediator influence of audit quality on the association between financial ratios and earnings management. There are three steps in Baron and Kenny (1986) model. Firstly, to identify the effect of independent variables (financial indicators) on dependent variables (earnings management). The following equation represents first step:

$DA= +\beta_0 +\beta_1\ EPS+ \beta_2\ DTE + \beta_3\ TA+ \beta_4\ ROA +\varepsilon$ …………………… model (1)

The second step is to evaluate the impact of financial ratios (independent variables) on audit fees (mediator variable). The following equation represents second step

AF= +β0 +β1DA+β2 TA+ β3 ROA +ε ………………………………. model (2)

Th third step is to investigate the effect of mediator variable and independent variables on dependent variables. The following equation represents the third step

DA= $+\beta_0 + \beta_1$ AF+β_2 EPS+ β_3 DTE + β_4 TA+ β_5 ROA +ε ……….. model (3)

Where

DA= Discretionary Accrual, AF= Log Audit Fees, EPS= Earnings Per Share, DTE= Dept to Equity, LTA= Log Total Assets ROA= Return on Assets

According to (Baron & Kenny, 1986), to ensure the existence of mediation, three conditions should be fulfilled. First, in the first regression, the independent variables must significantly affect the dependent variable. Second, the independent variables must significantly affect mediator variable in the second regression. Finally, the mediator variable must significantly influence dependent variable in the third regression.

According to Baron and Kenny (1986), full mediation is existed if the result of regression in third showed that mediator variable has no affect in dependent variable. Also, partial mediation exists when the effect of independent variable on dependent variable in third regression is less than it is in first regression.

Results and Discussion

Descriptive Statistics

Table 2 presents the basic descriptive statistics of variables included in the current study.

Table 2

Descriptive Statistics of variables of the study

Variable	N	Mean	Std. Dev	Minimum	Maximum
DA	930	0.098	0.103	0.000	1.031
AF	930	18,198	24,844	800	109,000
EPS	930	0.311	0.795	0.000	3.380
DTE	930	2.172	5.378	0.000	22.370
TA	930	95,005,175	226,235,282	320,140	1,798,635,967
ROA	930	2.184	12.348	-195.300	40.380

The descriptive results show that the average discretionary accrual (DA) is 0.098 with a range between 0.000 and 1.031. This result suggests that earnings management practices in Jourdan is more than those found in other countries. For instance, (Al-muzaiqer, 2022) in UAE and Bouaziz et al (2020) in France found that the average of DA is 0.03 and 0.07, respectively. Audit fees (AF) is presented to have a mean of 18,198 JOD with a minimum of 800 JOD and a maximum of 109,000 JOD. Regarding Earnings per share (EPS), it is presented to range between 0 and 3.380 with a mean of 0.311. Debt to equity (DTE) appears to have a mean of 2.172 with a minimum of 0 and maximum of 22.370. For total assets (TA), the table showed that its average is 95,005,175 JOD with a range between 320,140 JOD and 1,798,635,967 JOD.

Finally, return on assets (ROA) has a mean of 2.184 with a minimum of -195.300 and maximum of 40.380.

Correlation Analysis

Correlation analysis determines that relationship between study variables. Correlation analysis is conducted to ensure that explanatory variables are free from multi-collinearity issues. According to Pallant (2020); Pallant (2001), multi-collinearity problem arises when the association among explanatory variables is more than 0.90 percent. Table 3 shows that correlation coefficients are relatively less than 0.90 percent. Therefore, multi-collinearity does not existence among study samples.

Table 3
Pearson Correlations for 930 Company Observations

	DA	AF	EPS	DTE	TA	ROA
DA	1	-0.481	-0.194	-0.223	-0.078	-0.051
AF		1	0.616	0.572	0.468	0.034
EPS			1	0.871	0.189	0.056
DTE				1	0.170	-0.059
TA					1	0.310
ROA						1

Multivariate Analysis

Table 4 presents the findings regarding model 1 which investigate the impact of financial indicators on earnings management.

Table 4
Regression results of model 1

Variable	Coe	T-test	P- Value
EPS	0.035	3.03	0.003
DTE	-0.002	-1.69	0.092
TA	-0.66	-3.06	0.002
ROA	-0.001	-4.86	0.000
N	930		
F value	18.80		
R^2	0.22		

EPS= Earnings Per Share, DTE= Debt to Equity, TA= Total Assets, ROA= Return on Assets.

* Significant at 0.10 level ** Significant at 0.05 level *** Significant at 0.01 level

The table showed that ESP has a positive association with discretionary accrual at 1 percent significant level. This result refers to the fact that the increase in earnings per share led to more earnings management practices by the managers. The higher earnings per share indicates that the company makes more profit. Accordingly, (Kumar et al., 2021) stated that companies that achieve more profit are more likely to engage in earnings management practices.

Regarding financial structure ability, the table showed that DTE (Debt to Equity) is significantly negatively associated with DA (discretionary accrual) at 10 percent level. This result suggests that the decreased level of dept of equity contributes to the increase in earnings management practices in the business transactions. This means that the company would not be able to provide the shareholders with returns in the capital market when DTE is increased. Therefore, managers reduce their ability in practicing earnings management activities. This finding is in line with (Rashid, 2017), who found negative assocition between DTE and discratory accruals.

About control variables, the results showed that total assets (TA) are negatively associated with DA at l percent level significant. This indicates that management practices less earnings management activities when company have more total assets. This result is supported by Meek et al (2007); Purnama & Nurdiniah (2019) who argued that big firms with high assets have good corporate governance system and subjected to strict monitoring role which subsequently reduces the misbehaviors of managers. For return on assets (ROA), the study also found that found that ROA is negatively associated with DA. The result refers that misconduct of managers is reduced when the company practice more profit. This result is in line with Kapoor & Goel (2017) in India who found that profitable companies have a little motivation to manipulate their earnings.

Regarding the second model which tests the direct effect of financial factors (independent variables) on audit quality (mediator variable), the related results are shown in table 5.

Table 5
Regression results of model 2

Variable	Coe	T-test	P- Value
EPS	0.147	4.300	0.000
DTE	0.012	2.700	0.007
TA	0.271	4.210	0.000
ROA	-0.000	-0.980	0.329
N	930		
F value	127.59		
R^2	0.51		

EPS= Earnings Per Share, DTE= Debt to Equity, TA= Total Assets, ROA= Return on Assets.
* Significant at 0.10 level ** Significant at 0.05 level *** Significant at 0.01 level

The result reported that EPS, DTE is significant positively associated with audit fees (AF) at 1 percent level. These findings indicate that the companies hire high audit fees to the external auditors when the companies have strong earnings ability, strong financial structure ability. These findings are in line with Prasad et al (2021) who found that hiring higher audit fees will extend the scope of external auditor work which resulting in strong monitoring in internal auding function which subsequently leads to quality prepared financial statements.

Table 6 presents the findings regarding the third model which tests the impact of financial factors and audit fees on earnings management.

Table 6
Regression results of model 3

Variable	Coe	T-test	P- Value
AF	-0.180	-18.050	0.000
EPS	0.616	6.190	0.000
DTE	-0.000	-0.300	0.766
TA	-0.180	-0.970	0.333
ROA	-0.002	-6.340	0.000
N	930		
F value	63.63		
R^2	0.38		

EPS= Earnings Per Share, DTE= Debt to Equity, TA= Total Assets, ROA= Return on Assets.
* Significant at 0.10 level ** Significant at 0.05 level *** Significant at 0.01 level

As it can be seen from Table 6 that AF is significantly associated with DA. Regarding financial factors, the table presented that EPS is significantly associated with DA whereas DTE is insignificantly associated with DA. Applying the model of (Baron & Kenny, 1986), it was presented that DTE is significant in model 1 and 2 and non-significant in model 3. This indicates that audit fees fully mediate the association between financial structure ability and earnings management. Moreover, regarding EPS, it has been presented to have significant effect on all of three models. Therefore, according to (Baron & Kenny, 1986)' model, the audit fees are partially mediate the association between earnings ability and debt repaying ability and earnings management.

An additional test was conducted to assess the robustness of the results. The current study used (Kothari et al., 2005) model as a proxy of discretionary accruals (DA). Modified Jones' (Dechow et al., 1995) model is another proxy that can be applied to measure DA and to test the robustness of the main results. The results shown in Table 7 reveal that most independent variables are insignificantly associated with DA measured by Modified Jones' Dechow et al. (1995) model. This result is in line with Ayedh (2013); Kothari et al (2005) who claimed that modified Jones model is less powerful in detecting earnings management than Kothari et al (2005) model.

Table 7
Results by Using Modified Jones' (Dechow et al.1995) Model as a proxy of DA.

Variable	Coe	T-test	P- Value
EPS	0.002	0.340	0. 735
DTE	-0.000	-0.140	0.869
TA	-0.000	-0.200	0.840
ROA	-0.001	-4.86	0.000
N	930		
F value	18.80		
R^2	0.08		

EPS= Earnings Per Share, DTE= Debt to Equity, CR= Current Ratio, DIV= Dividend percentage, TA= Total Assets, ROA= Return on Assets.
* Significant at 0.10 level ** Significant at 0.05 level *** Significant at 0.01 level

Summary and Conclusion

The main objective of the current study is to investigate the mediating effect of audit fees on the association between financial ratios and earning management. The empirical findings highlight mixed results. Whereas the earnings ability is found to have positive association with earnings management, financial structure ability has negative association with earnings management. A large set of data explored in this study covers 93 non-financial companies and 930 year-firm's observations for the period from 2009 to 2018 extracted from Amman Stock Exchange. Balance panel data analysis was used in the current study and a fixed affect method was applied. STATA software was also used to analyses the relationship among variables.

The main hypothesis in this study is that financial ratios not only directly affect earnings management but also affect earnings management via their effect on audit quality. The findings showed that audit fees fully mediate the association between financial structure ability and earnings management and partially mediate the relationship between association between earnings ability and earnings management.

The study has important implications for policymakers. The study found that audit fees mediate the negative relationship between financial ratios and earnings management. Therefore, policymakers may demand high quality audits, even with high fees to ensure quality financial reporting. The study findings also may be of benefit financially, the investors may look to the companies their financial factors are very strong since it indicates that financial position of these companies are strong. Therefore, they are motivated to invest in these companies.

This study is not without limitations. Firstly, this study is limited to investigate the mediating effect of audit fees on the association between financial ratios and earnings management using a sample from Jordon market. Further studies may investigate the same variable by using samples from another country. Second, this study limits its mediating role testing to audit quality. Future studies may use other mediating variables such board characteristics, audit committee characteristics or another audit quality factors such as auditor size or audit opinion. Finally, the study applied earnings per share and debt to equity ratio as indicators of the company's financial ratios. Future research may consider another financial indicator such as cash ratio, leverage ratios and turn in equity ratio.

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