An empirical investigation of the performance consequence of real earnings management during the unstable political environment

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Abstract:

The Egyptian economy had suffered from political changes over the period from 25th January 2011 to 30th June Revolution in 2013, resulting in a decline in economic performance, which in turn may discourage managers to engage in real earnings management practices. The managers could engage in income-increasing earnings management to influence the stock prices and maintain the firm’s market capitalization, or engage in income-decreasing earnings management to avoid taxes or any political costs that may arise from obligations imposed by the state in such circumstances. On the other hand, the political changes and the uncertainty risks may discourage managers to engage in earnings management practices due to the fearing of the increase of strict control rules which could be issued by regulators, Egyptian Stock Exchange, or other stakeholders such as banks and creditors, as an attempt to improve the conditions of the Egyptian economy. This study examines whether a firm’s financial performance is influence by the extent of firm’s real earnings management around the unstable political environment period. Using a sample of 130 firms operating in Egypt during the period 2008-2013, two hypotheses are tested. This sample was spilt up to the period before unstable political environment 2008-2010, and during the unstable political environment period 2011-2013. The empirical findings indicate a significant difference between real earnings management practices measured by abnormal cash flow from operation, production cost and discretionary expenditures before and during the unstable political period. After controlling for the effect of financial crisis and real earnings management, the empirical findings also indicate a significant relation between real earnings management and firm’s financial performance during unstable political period.

Keywords: real earnings management; accrual-earnings management; unstable political environment; financial crisis.

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1. Introduction

The Egypt economy has suffered from the spillover effect of unstable political environment. The Egyptian Ministry of Planning states that the most important changes in the Egyptian economy after the 25th political changes are the decline in the economic growth rate, the decrease in Egyptian's investments, the decline in net flows of foreign direct investment, the decline in the stock and bond issues, and huge losses in the Egyptian Stock Exchange (Ministry of Planning, 2011/2012).

In the light of these changes, it is clear that unstable political environment affected the Egyptian economy and capital markets, and these consequences have led to the absence of national and foreign investors’ feeling of security and stability, which may be reflected on the behavior of the directors, shareholders and investors. These may have direct or indirect impact on the firms’ performance.

The motivation for this study is investigating the effects of unstable political environment period and the uncertainty risks on the behavior of managers and directors, and if the increasing of the shareholders and investors’ expectations in these circumstances could courage managers to engage in income-increasing earnings management to influence the stock prices and maintain the firm’s market capitalization, or to engage in income-decreasing earnings management to avoid taxes or any political costs that may arise from obligations imposed by the state in such circumstances. On the other hand, the unstable political environment period and the uncertainty risks may discourage managers to engage in earnings management practices due to the fearing of the increase of strict control rules which could be issued by regulators, Egyptian Stock Exchange, or other stakeholders such as banks and creditors, as an attempt to improve the conditions of the Egyptian economy.

The research problem is summarized in a set of research questions: to what extent the Egyptian firms have real activities earnings management practices? Is there a significant difference in the earnings management practices pre and during the unstable political environment periods? Is real earnings management practices - if any- will significantly influence the firms performance measured by book to market ratio during unstable political environment period?
The main objective of this research is analyzing the trend of real activities earnings management practices, and its effect on firm’s performance before and during the unstable political environment periods.

This research contributions are twofold. First, it provides a statistically evidence on the significant inverse relation between real earnings management practices and political changes period. Second, this research is the first to provide an evidence on the significant difference between the impact of real earnings management practices on firms performance measured by market to book ratio before and during the unstable political environment period.

The reminder of the paper is organized as follows: Section 2 covers the literature review. Section 3 presents the hypotheses. Section 4 explains the research design and method. Section 5 contains data analysis and finding. Section 6 includes discussion and conclusion.

2. Background and literature review

There is a growing interest in earnings management practices since 2008 because of the global financial crisis and the collapse of a large number of major companies. The earnings management practices arise due to the managers’ motives in achieving the private benefits of income-increasing or decreasing earnings management practices, which could harm the benefits of other stakeholders. The most important motives of these practices are to maximize managers extrinsic rewards, manipulate of market stock prices, comply with the terms of the debt covenants, meet the financial analysts forecasts, avoid tax, or to avoid the political costs (Jha, 2013; Bar-Yosef & Prencipe, 2013; Johnson et al., 2012; Chen et al., 2011; Cheng et al., 2011; Chen & Tsai, 2010).

Accordingly, three different earnings management practices are developed. First, accrual-based earnings management practices due to the flexible accounting standards, which allows subject choice between the alternatives of accounting policies such as depreciation methods, inventory valuation, and estimating the future events provisions, such as provision for doubtful debts (Dechow & Dichev, 2002; Francis et al., 2005). Second, the real earnings management practices through decisions making associated with real activities manipulation using the abnormal cash flow, production cost or discretionary expenses such as advertising and research and development.
(Gunny, 2010; Goh et al., 2013; Taylor & Xu, 2010). Third, financial restatement based on the classification shifting (Donelson et al., 2013; Fan et al., 2010)

several prior studies explored the earnings management practices behavior by testing the impact of macroeconomic factor, legal and political changes and managers’ incentives to engage in real earnings management practices, in addition to their effect on the adequate transparency in the financial markets (Agarwal et al., 2007; Ahmad-Zaluki et al., 2011; Kousenidis et al., 2013; Trombetta & Imperatore, 2013; Iatridis & Dimitras, 2013; Cohen et al., 2008; Abdelmotaal, 2013; Cormier et al., 2013).

The effect of financial crisis on the earnings management practices behavior was investigated by Agarwal et al.(2007), Ahmad-Zaluki et al. (2011), Kousenidis et al. (2013), Trombetta & Imperatore (2013), Iatridis & Dimitras (2013). Agarwal et al. (2007) found significant differences in the incidence of earnings management behavior during three periods; the first period of rapid growth from 1985 to 1990, the second period of economic recession from 1991 to 1996, and finally, the third period of a severe recession due to the credit crisis from 1999 to 1997. He pointed out that 78 Japanese banks had accruals earnings management practices using the loan loss provision during the first and second periods. This is due to the fact that this banks had non-performing loans, and it reached its highest level during the third period.

The results of Ahmad-Zaluki et al. (2011) study provided statistically evidence on income-increasing earnings management during periods of economic stress resulting from the East Asia crisis. That study also indicated that the earnings management practices was less pronounced in the periods after the crisis. Kousenidis et al. (2013) study found that the quality of earnings increased on average during periods of crisis. On the other hand, companies that had a high level of accruals earnings management during one year had lower earnings quality. Trombetta & Imperatore (2013) provided statistical evidence on the presence of significant effect of the financial crisis on the earnings management practices, however that effect is non-monotonic. Iatridis & Dimitras (2013) study showed that Portuguese, Italian and Greek companies tend to engage in more earnings management practices through its efforts to improve its profitability and low liquidity, and absorb their higher debt, while Ireland achieved less evidence of manipulation of earnings.
Cohen et al. (2008) tested the effect of the issuance Sarbanes-Oxley Act (SOX) law. The results proved the high level of accruals based earnings management practices during the period from 1987 until the issuance of Sarbanes-Oxley Act in 2002, followed by a significant drop after the application of the law. It also proved that the level of real earnings management practices activities decreased before the actual issuance of Sarbanes-Oxley and increased significantly after the issuance and application of the law, which refers to that companies shifted from accruals based earnings management practices to the real activities earnings management after the actual application of Sarbanes-Oxley.

Chen et al. (2011) studied the impact of the political costs on earnings management practices in China during the economic transformation phase, using a sample of Chinese real estate companies listed on the stock exchange during the period from 2002 to 2007. The study found that the political costs inversely associated with earnings management practices. In addition, the state-owned company achieved the highest rates of accruals based earnings management.

Abdelmotaal (2013) analyzed the behavior of the accruals based earnings management practices for 130 firms operating in Egypt before the political changes period 2009-2010, and during the period the political changes 2011-2012. The results provided evidence on the decrease of accruals earnings management practices during the period of the political changes compared to the former period.

Cormier et al. (2013) study investigated the relationship between the accruals earnings management and information asymmetries measured by stock prices volatility under the environmental uncertainty. The findings indicated that there was a weaker relationship between earnings management and information asymmetry under the complex and dynamics environment.

In sum, although those studies explored the effects of macroeconomic, political and legal factors on the earnings management practices, there is no large scale of research focusing on the real earnings management practices and its impact on the firm’s performance during unstable political environment.
3. Research hypotheses

The analysis of previous studies indicates that most of the studies focused on testing the effects of economic crises on earnings management practices. However, there is lack of a sufficient number of studies on measuring the effects of political changes on these practices. Therefore, it is expected that due to the spillover of the political changes on the economic condition, it may be lead to affect real activities earnings management practices. In addition, previous studies did not determine a clear trend for the relationship between the real earnings management practices behavior and firm market performance before and during the unstable political environment period. Thus, the following two hypotheses are formulated:

\[
H_1: \text{There is a significant difference between absolute values of real earnings management practices before and after the unstable political environment period.}
\]

\[
H_2: \text{There is a significant difference between the impact of absolute values of real earnings management practices on firm's performance before and during the unstable political environment period.}
\]

4. Research design and method

4.1. The sample and data collection

The initial sample is selected from 240 listed companies operating in Egypt and available in Osiris Database, these companies are classified into 9 sectors according to Global Industry Classification Standard. 4 sectors were excluded because they have less than 20 companies in each sector, also the banking and other financial institutions sectors are excluded due to their different financial models. Accordingly, the final sample is 130 firms for which panel data is available for the six-year period 2008–2013. Table 1 indicates the distribution of the sample of firm-years by industry.

Insert Table 1 here
4.2. Variables measurement

4.2.1. Real-earnings management variables

Following to the prior research, The real operating activities are measured by three variables: Abnormal cash flow from operation, abnormal production cost, and abnormal discretionary expenses variables.

4.2.1.1 Abnormal cash flow variable

The abnormal cash flow from operation variable is estimated based on the following model:

\[
\frac{\text{CFO}_{it}}{A_{it-1}} = \beta_1 \left[ \frac{1}{A_{it-1}} \right] + \beta_2 \left[ \frac{\text{Sales}_{it}}{A_{it-1}} \right] + \beta_3 \left[ \frac{\Delta \text{Sales}_{it}}{A_{it-1}} \right] + \epsilon_{it}
\]

Where:

- \( \text{CFO}_{it} \) is the net cash flows from operating activities (Osiris #16400).
- \( A_{it-1} \) is the total assets (Osiris #30050) for firm \( i \) at the beginning of the year \( t \).
- \( \text{Sales}_{it} \) is the revenues for firm \( i \) at year \( t \) (Osiris #30210).
- \( \Delta \text{Sales}_{it} \) is the change in revenues (Osiris #30210) for firm \( i \) between year \( t-1 \) and year \( t \).

The industry parameter estimates from this equation are used to estimate the firm-specific normal cash flow (NCFO\(_{it}\)) for the sample firms. The measure of abnormal cash flow (DCFO\(_{it}\)) is the difference between net cash flow from operation and normal cash flow. Following to prior studies the absolute values of abnormal cash flow (absDCFO\(_{it}\)) are used as a proxy for cash flow activities earnings management practices.

4.2.1.2 Abnormal production cost variable

The abnormal production cost variable is estimated based on the following model:

\[
\frac{\text{Prod}_{it}}{A_{it-1}} = \beta_1 \left[ \frac{1}{A_{it-1}} \right] + \beta_2 \left[ \frac{\text{Sales}_{it}}{A_{it-1}} \right] + \beta_3 \left[ \frac{\Delta \text{Sales}_{it}}{A_{it-1}} \right] + \beta_3 \left[ \frac{\Delta \text{Sales}_{t-1}}{A_{it-1}} \right] + \epsilon_{it}
\]
Where:

Prod\( _{it} \) is the cost of good sold (Osiris #30215) plus the change in inventory (Osiris #30010) for firm i between year \((t-1)\) and year \(t\). \(A_{it-1} \) is the total assets for firm i at the beginning of the year \(t\) (Osiris #30050); \(Sales_{it} \) is the revenues (Osiris #30210) for firm i at year \(t\). \(\Delta Sales_{it} \) is the change in revenues (Osiris #30210) for firm i between year \((t-1)\) and year \(t\). \(\Delta Sales_{it-1} \) is the change in revenues (Osiris #30210) for firm i between year \((t-2)\) and year \((t-1)\).

The industry parameter estimates from this equation are used to estimate the firm-specific normal production cost \((NPC_{it})\) for the sample firms. The measure of abnormal production cost \((DPC_{it})\) is the difference between total production cost and normal production cost. Following to prior studies the absolute values of abnormal production cost \((absDPC_{it})\) are used as a proxy for production cost activities earnings management practices.

4.2.1.3 Abnormal low discretionary expenses variable

The abnormal discretionary expenses variable is estimated based on the following model:

\[
\frac{DisE_{it}}{A_{it-1}} = \beta_1 \left[ \frac{1}{A_{it-1}} \right] + \beta_2 \left[ \frac{Sales_{it-1}}{A_{it-1}} \right] + \epsilon_{it}
\]

Where:

\(DisE_{it} \) is the discretionary expenses (Osiris #22035) for firm i at year \(t\). \(A_{it-1} \) is the total assets for firm i at the beginning of the year \(t\) (Osiris #30050). \(Sales_{it-1} \) is the revenues (Osiris #30210) for firm i at year \((t-1)\).

The industry parameter estimates from this equation are used to estimate the firm-specific normal discretionary expenses cost \((NDE_{it})\) for the sample firms. The
measure of abnormal discretionary expenses (DDE\textsubscript{it}) is the difference between total production cost and normal production cost. Following to prior studies the absolute values of abnormal production cost (absDDE\textsubscript{it}) are used as a proxy for discretionary expenses activities earnings management practices.

4.2.2. firms’ performance variable

The firm performance is measured by market to book value ratio; market price per share (Osiris #39202) over book value per share (Osiris #39217).

4.2.3 Unstable political environment

Political changes period is measured by a dummy variable takes the value of one for the period during unstable political environment from 2011 to 2013 and the value zero for the period before unstable political environment from 2008 to 2010.

4.2.4. Control variables

4.2.4.1. Financial crisis

Financial crisis periods, is measured by a dummy variable takes the value of one for the period during the financial crisis from 2008 to 2009 and the value zero otherwise.

4.2.4.2. Accrual earnings management practices

Accrual earnings management practices, is measured by the Dechow et al. model, which called modified Jones model. The model parameters are estimated using the following equation.

\[
\frac{TAC_{it}}{A_{it-1}} = \beta_1 \left[ 1 / A_{it-1} \right] + \beta_2 \left[ \Delta Sales_{it} / A_{it-1} \right] + \beta_3 \left[ PPE_{it} / A_{it-1} \right] + \varepsilon_{it} \quad (1)
\]

Where:

- \( TAC_{it} \) is total accruals measured as the difference among the change in net income before extraordinary items (Osiris #13034) and the change in net cash flows from operating activities (Osiris #16400). \( A_{it-1} \) is the total assets at the beginning of the year (t); \( \Delta Sales_{it} \) is the change in revenues between year (t-1) and year (t); \( PPE_{it} \) is the
gross value of property, plant and equipment (net property, plant & equipment (Osiris #13068), plus accumulated depreciation(Osiris #20255)) in year (t).

The industry parameter estimates from equation (1) are used to estimate the firm-specific non discretionary accruals (NA_it) for the sample firms:

\[
NTAC_{it} = \beta_1 [1/A_{it-1}] + \beta_2 [(\Delta Sales_{it} - \Delta REC_{it})/A_{it-1}] + \beta_3 [PPE_{it}/A_{it-1}] + \varepsilon_{it} \tag{2}
\]

Where: \(REC_{it}\) is the change in accounts receivable from the preceding year.

The measure of discretionary accruals is the difference between total accruals and non discretionary accruals, defined as

\[
DAC = TAC_{it} / A_{it-1} - NTAC_{it} \tag{3}
\]

Following to prior studies the absolute values of discretionary accruals (absDAC) are used as a proxy for earnings management practices.

4.2.4.3. firm size

The size of the company is measured by natural logarithm of total assets(Osiris #30050).

4.2.4.4. Leverage

Leverage is measured by total debts (Osiris #30115) divided by total assets (Osiris #30050).

4.2.4.5. Firm financial performance

The previous firm performance is measured by both the ratio of return on assets (Osiris#krrota) for the firm (i) at the year (t), and net cash flows from operating activities(Osiris #16400) scaled by total assets for the firm (i) at the year (t).

5. Data analysis and findings

Table 2 reports the descriptive statistics for scale variables; the absolute value of abnormal cash flow (absDCFO), the absolute value of abnormal production cost(absDPC), the absolute value of abnormal discretionary expenses (absDDE),
REM composite measure (absREM), the absolute value of abnormal accruals (absDAC), firm size, leverage, return on total Assets, and cash flow from operation ratio.

Insert Table 2 here

Regarding to the period before and during the unstable political environment, Table (2) represents that the mean and median of the absolute value of the real earnings management composite variable, and its three components variables are higher in the period before the unstable political environment than during the period of the unstable political environment.

The mean and median of the absolute value of abnormal accruals are also higher in the period before the unstable political environment than during the period of the unstable political environment.

With respect to the price to book ratio (PBratio), the mean and median are 0.7, 1.6, respectively, before unstable political environment, and reached the 1.59, 1.19, respectively, after the unstable political environment.

Table 3 demonstrates sample correlation matrix. It is shown that there is significant negative correlation between the political change and all of the absolute value of the real earnings management composite variable, its three components variables, and the absolute value of abnormal accruals variable.

Insert Table 3 here

5.1. Testing of the first hypothesis

In order to test the first hypothesis, five panel data regression models are used. Table 4 presents the regression results for earnings management as dependent variable: the absDCFO earnings management model results, absDPC earnings management model, absDDE earnings management model results, the REM composite measure model results, and absDAC earnings management model results respectively.

\[
\text{absDCFO}_{it} = \beta_1 \text{Political}_{it} + \beta_2 \text{Crisis}_{it} + \beta_3 \text{Sector}_{it} + \beta_4 \text{Size}_{it} + \beta_5 \text{Leverage}_{it} + \beta_6 \text{ROA}_{it} + \beta_7 \text{CFO}_{it} + \epsilon_{it} \tag{1}
\]

\[
\text{absDPC}_{it} = \beta_1 \text{Political}_{it} + \beta_2 \text{Crisis}_{it} + \beta_3 \text{Sector}_{it} + \beta_4 \text{Size}_{it} + \beta_5 \text{Leverage}_{it} + \beta_6 \text{ROA}_{it} + \beta_7 \text{CFO}_{it} + \epsilon_{it} \tag{2}
\]

\[
\text{absDDE}_{it} = \beta_1 \text{Political}_{it} + \beta_2 \text{Crisis}_{it} + \beta_3 \text{Sector}_{it} + \beta_4 \text{Size}_{it} + \beta_5 \text{Leverage}_{it} + \beta_6 \text{ROA}_{it} + \beta_7 \text{CFO}_{it} + \epsilon_{it} \tag{3}
\]

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REM_{it} = \beta_1 \text{Political}_{it} + \beta_2 \text{Crisis}_{it} + \beta_3 \text{Sector}_{it} + \beta_4 \text{Size}_{it} + \beta_5 \text{Leverage}_{it} + \beta_6 \text{ROA}_{it} + \beta_7 \text{CFO}_{it} + \epsilon_{it} \quad (4)

absDAC_{it} = \beta_1 \text{Political}_{it} + \beta_2 \text{Crisis}_{it} + \beta_3 \text{Sector}_{it} + \beta_4 \text{Size}_{it} + \beta_5 \text{Leverage}_{it} + \beta_6 \text{ROA}_{it} + \beta_7 \text{CFO}_{it} + \epsilon_{it} \quad (5)

Where:

absDCFO_{it} is the absolute values of abnormal cash flow for firm(i) at the year(t).

absDPC is the absolute values of abnormal production cost for firm(i) at the year(t).

absDDE_{it} is the absolute values of abnormal discretionary expenses for firm(i) at the year(t).

REM_{it} is the composite measure of the absolute values of abnormal cash flow, abnormal production cost, and abnormal discretionary expenses for firm(i) at the year(t).

absDAC_{it} is the absolute values of abnormal accruals for firm(i) at the year(t).

Political_{it} is a dummy takes the value of one for the period during unstable political environment from 2011 to 2013 and the value zero for the period before unstable political environment from 2008 to 2010.

Crisis_{it} is a dummy variable takes the value of one for the period during the financial crisis from 2008 to 2009 and the value zero otherwise.

Sector_{it} is a categorical variables takes the code 15 for material sector, 20 for industrial sector, 25 for consumer discretionary sector, and 30 for consumer staples sector.

Size_{it} is the natural logarithm of total assets for firm(i) at the year(t).

Leverage_{it} is the total debts divided by total assets for firm(i) at the year(t).

ROA_{it} is the ratio of return on assets for the firm(i) at the year(t).

CFO_{it} is the net cash flows from operating activities scaled by total assets for the firm (i) at the year (t).

Insert Table 4 here

The results of the statistical analysis in Table (4) provide evidence on the significant inverse relation between the political changes variable and earnings management practices at significance level 1% for absDCFO earnings management, the REM composite measure, and absDAC earnings management models. And at 10% level for absDPC earnings management model. The results also provides non significant inverse relation between political change variable and absDDE earnings management. This results support the first hypothesis.

5.2. Testing of the second hypothesis

Tables 5 reports the empirical results for the two models for firms market performance as dependent variable. The detailed real earnings management
components variables are included in the first model, and the real earnings management composite variable is included in the second model.

\[
P_{\text{Bratio}} = \beta_1 \text{absDCFO}_{it} + \beta_2 \text{absDPC}_{it} + \beta_3 \text{absDDE}_{it} + \beta_4 \text{absDAC}_{it} + \beta_5 \text{Crisis}_{it} + \beta_6 \text{Sector}_{it} + \beta_7 \text{Size}_{it} + \beta_8 \text{Leverage}_{it} + \beta_9 \text{ROA}_{it} + \beta_{10} \text{CFO}_{it} + \varepsilon_{it} \quad (1)
\]

\[
P_{\text{Bratio}} = \beta_1 \text{REM}_{it} + \beta_2 \text{absDAC}_{it} + \beta_3 \text{Crisis}_{it} + \beta_4 \text{Sector}_{it} + \beta_5 \text{Size}_{it} + \beta_6 \text{Leverage}_{it} + \beta_7 \text{ROA}_{it} + \beta_{8} \text{CFO}_{it} + \varepsilon_{it} \quad (2)
\]

Where:

- P\text{Bratio} is the market to book ratio for firm(i) at the year(t).
- absDCFO\text{it} is the absolute values of abnormal cash flow for firm(i) at the year(t).
- absDPC\text{it} is the absolute values of abnormal production cost for firm(i) at the year(t).
- absDDE\text{it} is the absolute values of abnormal discretionary expenses for firm(i) at the year(t).
- absDAC\text{i} is the absolute values of abnormal accruals for firm(i) at the year(t).
- Crisis\text{it} is a dummy variable takes the value of one for the period during the financial crisis from 2008 to 2009 and the value zero otherwise.
- Sector\text{it} is a categorical variables takes the code 15 for material sector, 20 for industrial sector, 25 for consumer discretionary sector, and 30 for consumer staples sector.
- Size\text{it} is the natural logarithm of total assets for firm(i) at the year(t).
- Leverage\text{it} is the total debts divided by total assets for firm(i) at the year(t).
- ROA\text{it} is the ratio of return on assets for the firm(i) at the year(t).
- CFO\text{it} is the net cash flows from operating activities scaled by total assets for the firm (i) at the year (t).

**Insert Table 5 here**

The results when including all the 6 years are reported in the first-two columns, in order to investigate the effect of unstable political variable the sample is split; The results for the period before the unstable political environment are reported in the second-two columns and the results for the period during the unstable political environment are reported in the third-two columns.

With respect to both the size and significant of the coefficients, there are inconsistent results. Table 5 shows different evidences. First, the abnormal cash flow variable does not significantly affect the firm market performance measured by the market to book ratio before the unstable political environment period. However, it has a negative and
significant impact on the market to book ratio during the unstable political environment period. Second, the abnormal production cost variable has positive and significant effect on the market to book ratio before the unstable political environment period. However, it has a negative and significant impact on the market to book ratio during the unstable political environment period. Third, the abnormal discretionary expenses variable has positive and no significant effect on the market to book ratio before the unstable political environment period. However, it has a positive and significant impact on the market to book ratio during the unstable political environment period. Fourth, the abnormal real earnings management composite variable has positive and no significant effect on the market to book ratio before the unstable political environment period. However, it has a positive and significant impact on the market to book ratio during the unstable political environment period. Finally, the abnormal accrual earnings management variable has negative and significant effect on the market to book ratio before the unstable political environment period, it also has a positive and significant impact on the market to book ratio during the unstable political environment period. Thus the second hypothesis is supported.

6. Discussion and Conclusion

This study aims to provide recent evidence on the effects of the unstable political environment on the managers’ engagement in the real earnings management practices, and its impact on the firm’s performance measured by market to book ratio.

Final sample size is 130 firms during the period from 2008 to 2013. In order to investigate the difference of real earnings management before and during the unstable political environment, the sample is split into two sub-samples.

Respect to the first hypothesis, which tests the effects of the unstable political environment on the extent of real earnings management practices, the results showed inverse and significant relation between the unstable political environment and the real earnings management practices. These results are consistent with both Chen et al. (2011) and Abedelmotaal(2013), which support the political cost hypothesis. Thus the managers have incentives to reduce the real activities earnings management in order to avoid the political cost and control.
Regarding to the second hypothesis, which tests the impact of real earnings management activities on the firm’s performance before and during the unstable political environment. The results provd mixed evidences on the size and significant of the real earnings management coefficients before and during the unstable political environment. These results are consistent with Cormier et al. (2013) and support the hypothesis of information asymmetries, thus the difference of the impact of real earnings management activities before and during unstable political environment indicate that stockholders do not have adequate transparency during that period.

The most important limitations of this study include: first, sample size is only 130 firms because the number of industry sectors were limited by the availability of more than 20 firms in each sector. Thus only four sectors are available. The industry parameter estimates depending on the Global industry Classification standard, thus more research on the median industry real earnings management, as an instrumental variable is needed. These all limitations provide directions for future research.

References


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## Table 2
### Descriptive Statistics

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Regression results for earnings management as dependent variable*  

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$t$ statistics in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

* Fixed effect regression models
### Table 5
Regression results for firms performance as dependent variable

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* $t$ statistics in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

* Random-effects GLS regression models