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CEO Duality Political Connection and Firms' Reporting Earnings Quality in Egyptian Firms

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Abstract

In this study, we investigate the impact of CEO duality on firms' reported earnings quality (FREQ). Further, the moderating role of CEO political connection is also explored. Our sample is based on 154 Egyptian firms for 2008-2018. We find negative and significant impacts of CEO duality on FREQ. Likewise, CEO political connection moderates the negative impact of CEO duality on FREQ. In additional analyses, we find CEO gender substitutes the negative impact of CEO duality on FREQ. We also explore the constraining role of corporate governance for negative impacts of CEO duality on FREQ. When the presence of female directors reaches three (critical mass), FREQ improves. However, we find insignificant impacts of boards independence on FREQ in Egypt.

Disciplinary: Management Science (Business Management, Finance, Accounting, Corporate Governance).

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1 Introduction

The firm financial reporting information quality (FREQ) is one of the main concerns for stockholders. The importance of earnings quality is so critical that authorities throughout the globe spared no effort to steady marketplaces augmenting stockholder promise (Arthur et al., 2015). Global financial crisis reasons transitory current year earnings, dropping firm capitalization and improbability about firms prospect (Bepari et al., 2013). However, the momentary and noisy earnings nature is expected to influence investors to study the prospects of firms; probable earnings as the prospect becomes undefined. The Egyptian financial crisis of 2011 adversely affected FREQ that ultimately impacted the Egyptian stock exchange performance. These results have shattered investors' confidence that caused many listed EGX firms' letdown. The literature has shown that crises resulted in investors' freaks during the crises (Talley and Johnsen, 2004). In the context of FREQ during crisis periods, apprehensions might be raised to the administration in respect of the use of accounting structure manipulating earnings intentionally (Iatridis and Dimitras, 2013; Persakis and Iatridis, 2015). Nevertheless, the management may prefer transparency in earnings quality to retain stockholder confidence and recuperate firm's liquidity (Arthur et al., 2015). Therefore, the role of the governance mechanism is quite important in determining FREQ in Egypt.

Being an emerging economy, Egypt offers the case of a diverse prediction about the accrual's superiority of accounting-based performance measures. Since there is no established financial analysis industry in the Egyptian capital market, public firms do not disclose forecasted financial information commonly (Ragab and Omran, 2006 and Ebaid, 2010). So, the firm financial reports are the only source of basic information for stockholders as guidance for their future investments. Accordingly, accrual accounting information lays the basis for almost all stock transactions in the Egyptian market; therefore, it is quite imperative to use accruals-based measures for earnings quality because stock prices are significantly associated with earnings quality in Egypt (Ragab and Omran, 2006; Hassan et al., 2009 and Ebaid, 2010).

2 Literature Review

2.1 CEO Duality and Earnings Quality

CEO duality refers to a position where the CEO also chairs the board of directors (Jaggi et al., 2009). The literature provides contradicting views on the role of CEO duality in earnings quality. Chen et al. (2007) acknowledged that we can divide corporate governance into two traits: the firm's ownership structure and leadership. In the context of leadership structure, the board structure and CEO duality are the main causes of concern. In some economies, like the US, most of the organizations prefer CEO duality; whereas in the UK, Canada, and Japan, only a few CEOs are also BOD chairman. Although CEO duality appears to be an apparent encounter, the evidence on either it really damages stockholders is quite diverse. Some authors have found that the duality raises the probability that CEO rewards need to be kept in check. (Petra and Dorata 2008) found that excruciating the roles upsurges the probability that CEO compensation may be reserved or kept in check. This is in line with the view that a CEO with a dual role may enhance the probability to look after his own interests at the cost of stockholders. In contrast, (Faleye 2007) highlighted that firms prefer to have CEO duality. The study explores the impacts of CEO duality on firms' reported earnings quality. CEO duality refers to the situation where CEO also chairs. Empirics show that a CEO acquires power largely through his tenure in his current position. A newly appointed CEO tends to confront substantial encounters and hindrances that he has never practiced. First, he needs acceptance from his board in order to retain his job and secure his authority (Tuwey and Tarus, 2016). Therefore, until he can satisfy the anticipations of his board, his power remains much weaker than that of an established CEO (Baker et al., 2019). Once he is accepted by the board, his managerial capability and discretion also rise. Hence this increased expertise and discretion may enable him to have certain choices like ‘‘compliant’’ directors. In this way, he can strengthen his influence over the corporate board. Therefore, the study hypothesizes as;

H1: CEO duality is negatively and significantly associated with a firm’s reported earnings quality in Egypt.

2.2 CEO’s Political Connection and Firm’s Reported Earnings Quality

In transitional economies, political connection carries costs that firms are exposed to. This cost is affiliated with government interventions on a firm’s operation (Li et al., 2015). The intervention often affects firms’ operations and results in the pursuance of political goals unsuited with firms’ objects (Fauzi and Locke, 2012). As a result, the firm is involved in hiring unqualified folks of government executives to fill high-ranking positions (Elbadry et al., 2015). At the same time, there are fewer prospects for shareholders to diversify their risk. The strong political connection results in poor governance mechanisms and professionalism (Mashayekhi and Bazaz, 2008). Further, the literature highlights information asymmetry problems, poor earnings quality, and less precise analyst forecasts in these firms (Chen et al., 2010). In addition, Al-dhamari & Ismail (2015) documented that politically connected firms are related to poor FREQ. In contrast, it is stated that firms offer to source for special treatment through tax waivers, government subsidies, and ease in access to finance (Darko et al., 2016). This view supports the maxim that politically connected firms may outperform their counterpart. So far, the impacts in transition economies are negative on firms' performance and earnings quality. A higher percentage of political connections leads to window dressing in the financial statement (Watts & Zimmerman, 1990; Huang et al., 2012). Moreover, agency conflicts are prominent in politically connected firms, which may result in poor earnings quality (Al-Dhamari& Ismail, 2015). Therefore, we argue that a politically connected CEO is more likely to involve in earning management since his political connection empowers him to influence the corporate board and obtain favor for his personal likings. His involvement reduces the reported earnings quality. Hence, the study hypothesizes as under:

H2: A CEO political connection moderates the negative relation between CEO duality and FREQ in Egypt.

2.3 Role of Board Diversity in FREQ

Earlier literature highlights contradictory evidence concerning the association between female directors and FREQ. However, there are pieces of evidence that show that female presence results in better board monitoring (Adams and Ferreira, 2009). Further, it is believed that female directors are comparatively more independent and active in motoring as they are not a part of “old boys’ networks”. At the same time, they are less tolerant of opportunistic behaviors. According to resource dependency theory, female directors are often different in skills, knowledge and their background and they help the board make better decisions by bringing about contrary and acute rational. Therefore, their presence may increase monitoring intensity and quality; thus, reducing CEO influence on corporate decisions (Cumming et al., 2015). In this vein, earnings management implies that actual firm performance is distorted, and is known as one of the most important salient features of CEO self-serving conducts. The presence of female directors is associated with fewer earnings management, fewer firm frauds, and tax avoidances (Owen and Temesvary, 2018). Thus, we propose that female directors can curtail the CEO power and reduce or eliminate the negative impacts of CEO powers on firms' reported earnings quality. The hypothesis is constructed,

H3: The presence of board gender diversity mitigates or substitutes the negative relation between CEO duality and FREQ in Egypt.

For further clarity, we constructed a sub-hypothesis based on gender critical mass as most of the prior studies have highlighted female directors do influence firms' policies once they obtain a critical mass on the corporate board. To explore the constraining role of gender-critical mass (three female directors), we construct the hypothesis

H3a:- The presence of gender-critical mass mitigates or substitutes the negative relation between CEO duality and FREQ in Egypt.

2.4 Board Independence and FREQ

As per the agency theory, conflicts of interest exist between minority and majority shareholders, with risks of exploitation of resources for private gains. Major shareholders could look to exploit their personal interests and expropriate the capital of other stakeholders (Chang, 2003). Major shareholders have direct access to inside information; they can utilize it for personal gains. Therefore, the outside investors mostly depend on the monitoring activity of the BOD. Board is authorized by shareholders to monitor management on their behalf. Likewise, the agency theory backs the concept that board independence is significantly related to board effectiveness (Halme&Huse, 1997). Therefore, board independence is one of the most important factors used to monitor the firm managerial activities (Jensen & Meckling, 1976). Arguably, an independent board is in a superior position to have checks-and-balances on management (Dunn & Clark, 1987). As recommended by Baker (1987), the presence of outside directors encourages management to be involved in long-term policies rather than making short-term decisions in order to have a quick payoff. In fact, the dominance of independent directors helps to ease agency conflicts by having checks-and-balances on management opportunistic behavior (Jensen &Mecking, 1976). As a result, board independence may play an imperative role in monitoring the CEO's Powers in the firm's decision-making. To conclude, it is confirmed that prior researchers have supported the hypothesis that board independence reduces earnings management and increases earnings quality. Therefore, we construct the hypothesis as

H4:- Board independence mitigates or substitutes the negative relation between CEO duality and FREQ in Egypt.

2.5 Measurement of Earnings Quality (Dependent Variable)

The literature highlights diverse measures of FREQ, which are significantly affected by the trends in earnings quality, their determinants over time and accounting changes, changes in corporate governance codes, and cost of capital. Since there is no direct mechanism to calculate or observe the FREQ of the firms, the study uses accruals quality as a proxy to measure earnings quality. Further, Dechow and Dichev (2002) encompass this impression into the applied degree of a firm's accrual and FREQ and provided a new method to evaluate the quality of a firm's accruals. The measures of a firm's accrual quality primarily focus on the mapping of the ratio of a firm's current accruals into earlier ratios, existing and future cash flows from the firm's operations (Raman et al., 2008). For this purpose, Kothari et al. (2005) demonstrated that a firm's accruals are correlated with performance. For analysis, they recommended that there is a need to include ROA as a supplementary variable in the modified-Jones model advocated by Dechow et al. (1995) for valuing a firm's discretionary accruals. In main regression, ROA is measured as net income before extraordinary items divided by firm total assets at lag year (year t-1):

$$\frac{TAC_{it}}{TAsset_{t-1}} = \alpha_0 + \alpha_1 \frac{1}{TAsset_{t-1}} + \alpha_2 \frac{\Delta REV_{it} - \Delta REC_{it}}{TAsset_{t-1}} + \alpha_3 \frac{PPE_{it}}{TAsset_{t-1}} + \alpha_4 ROA_{it} + \varepsilon_{it} \qquad (1).$$

In Equation (1)

$TAC_{j,t}$= TAC represents the firm's i total accruals for in year t.

$TAsset_{j,t-1}$= TAsset represents the firm's i total assets in year t-1;

$\Delta REC_{j,t}$= $\Delta REC_{j,t}$ represents the firm's I account receivable in year t

$\Delta REV_{j,t}$= REV represents revenue of firm i in year t; and

$PPE_{j,t}$= $PPE_{j,t}$ represents the value of the firm's property, plant, and equipment in year and

ROA= return on assets.

2.6 Descriptive Statistics

The mean value of the sample firm's age is 27.26% with a median value of 27.171 and the data is negatively skewed with an SD of 3.435 and kurtosis 2.423. Further, firm growth has mean and median values of 2.577 and 1.301, respectively. The maximum and minimum ranges for firm growth are 21.477 and -2.19 and the data on the variable is negatively skewed. Financial leverage represents the debt to equity ratio and its mean and median values are 1.480 and 1.452. The overall data of firms' size is positively skewed. Table 1 shows the Descriptive statistics of this study.

Table 1: Descriptive statistics

Variables	Mean	Median	Maximum	Minimum	SD	Skewness	Kurtosis
CEO Duality %	0.339	0.305	1.000	0.000	0.499	0.123	1.015
Gender dummy%	0.851	1.000	1.000	0.000	0.356	-1.972	4.890
BOD independence%	0.340	0.317	0.733	0.188	0.160	0.214	2.547
Political connection %	0.307	0.000	1.000	0.000	0.461	0.838	1.702
Firm Age %	27.260	27.171	57.000	16.000	3.435	-0.077	2.423
Firm Growth	2.577	1.301	21.477	-2.19	4.867	-0.408	5.473
Financial Leverage	1.480	1.452	7.189	0.003	0.355	6.905	7.955
Firm Size (log)	4.423	4.330	9.190	0.301	1.679	0.221	2.585
International Financial Reporting Standard (IFRS)	0.521	1.000	1.000	0.000	0.500	-0.083	1.007
Dividend per Share (DPS)	1.572	1.566	6.975	0.016	1.085	-4.897	8.833

For further clarity, the study also conducted the variance inflation (VIF) test. In this study, the VIFs are applied as an overall diagnostic measure of collinearity. In addition, it signifies an extensively improved method than reviewing the simple correlation matrix. It's important to note that it provides researchers an advantage because VIF values specify the coefficient for which the collinearity may be a problem. (Casella, Fienberg et al. 2015). As per literature support, the problem of multicollinearity persists if VIF values are above 5. VIFs estimates are presented in Table 2 and the findings show that the VIF estimate for each variable is below 5 indicating no problem if multicollinearity is in mode.

Table 2: Variance Inflation Factor (VIF)

Variables	1/VIF	VIF
Reported earnings quality	0.422	2.369
Board independence	0.522	1.914
CEO duality	0.612	1.632
DPS	0.613	1.630
Firm age	0.803	1.245
Firm growth	0.806	1.239
Financial leverage	0.841	1.188
Foreign ownership	0.873	1.144
Firm size	0.374	2.670
Gender diversity	0.508	1.966
IFRS	0.305	3.271
Political connection	0.493	2.027

3 Main Results

The main findings of the GMM estimator are reported in Table 3. As per findings reported in Table 3, the earnings quality (-1) has a significant and positive association with earnings quality (β= 0.7660 and p>.01; refer to Table 3). Further, the variables of concern include CEO-duality, board diversity, and BOD independence. The findings show that CEO-Duality negatively and significantly impacts earnings quality of the Egyptian firms (β= -0.1108 and p>.05; refer to Table 3). These findings are in line with earlier findings (Bruno, 2005; Egger and Merlo, 2007). The negative relation may be attributed to CEO power dynamics. CEO power dynamics view confers that CEO with dual role exercises more power and the role also empower him to implement his discretion (Lewellyn and Fainshmidt 2017, Wijethilake and Ekanayake 2019). Thus his dual role is negatively associated with earnings quality. However, the finding contradicts with earlier findings of (Bruno 2005, Egger and Merlo 2007). Therefore, H1 is strongly supported.

Meanwhile, the direct impacts of political connection, gender dummy, Female-Director, and board independence are tested and we found a negative association between CEO political connection and FREQ (β= -0.0711 and p>.10; Table 3). In contrast, gender dummy and board independence have an insignificant association with FREQ in Egypt. However, we find a positive and significant impact of Female-Director on FREQ in Egypt (β= 0.163 and p>.01; Table 3).

Our main concern is the interaction term between CEO duality and three measures of corporate governance (gender dummy, Female-Director, and board independence). The first interaction term between CEO duality X political connection is negative and significant implying that political connection moderates the negative relation between CEO duality and FREQ in Egypt. We find a higher level of significance and coefficient value for the interaction term. Therefore, it can be concluded that CEO political connection moderates the negative relation between CEO duality and FREQ both in terms of magnitude and level of significance. Hence our H2 is strongly supported.

Further, we find that the interaction term between CEO duality and gender dummy is negative and significant implying that gender dummy does not weaken the negative association between CEO duality and FREQ. This means that the presence of one female serves as tokenism as they are unable to constrain CEO power in manipulating firm's earnings. Resultantly our H3 is not supported. To test H3a, we introduced the interaction term between CEO duality and Female-Director and findings show that the interaction term is positive and significant (β= 0.0912 and p>.05; refer to Table 3). Therefore, we conclude that the presence of female directors positively impacts FREQ in Egypt only once it reaches the critical mass on the board. As a result, H3a is supported.

Table 3: Hypotheses Testing

Variables	Coefficient	p-value
Earnings quality (-1)	0.766***	0.000
CEO Duality (H1)	-0.110**	0.042
Political connection	-0.071*	0.072
Gender dummy	0.002	0.163
BOD independence	0.008	0.066
Female-Director	0.163***	0.000
Interaction terms		0.202
CEO Duality X political connection (H2)	-0.199***	
Gender dummy X political connection (H3)	-0.100	0.000
Female-Director X political connection (H3a)	0.091**	0.081
Board independence X political connection (H4)	-0.045**	0.445
Control factors		0.019
Firm Age	0.070***	0.052
Firm Growth	-0.001***	
Financial Leverage	-0.133	0.000
Firm Size	-1.255***	0.000
Audit Quality	0.834***	0.312
IFRS	0.082***	0.000
Year effect	Yes	0.000
Industry effect	Yes	0.000
ARELLANO-BOND TEST (AR(1)) p-value	-9.665***	
ARELLANO-BOND TEST (AR(2)) p-value	0.722	
Hansen p-value	0.650	0.001
Wald chi-square	118.061***	0.622
Wooldridge p-value	546.482***	0.512
Wu-Hausman P-value	9.181***	0.000

In contrast, the interaction term between CEO duality and board independence is negative and significant. This shows that board independence does not serve as constraining role in Egypt. Based on these findings, it is stated that board independence is an ineffective mechanism to mitigate the negative consequence of the CEO when he exercises duality in the context of FREQ in Egypt. Hence, our H4 is not supported.

To ensure the measured effect may not be influenced by other factors, the study includes additional factors that are held constant in the main regression as control factors (Bernerth et al., 2018; Li et al., 2020). Among the control factors, firm age has a positive and significant impact (β= 0.0703 and p>.01; refer to Table 3) on FREQ. In contrast, we find a negative association between firm growth and FREQ in Egypt (β= -0.0010 and p>.01; refer to Table 3). This supports the firms' growth prospects views as the firms in the growth stage are financial constraints, less likely to have profit, and lower retained earnings (Collins et al., 2017). Financial leverage is insignificantly related to FREQ. Surprisingly, the study finds firms' size as negative and significant determinants of FREQ in Egypt (β= -1.2558 and p>.01; refer to Table 3). Further, IFRS is also positively and significantly associated with FREQ in Egypt (β= 0.0821and p>.01; refer to Table 3). The findings support the maxim that IFRS Standards address the contest of accounting since it provides quality international accounting standards that take along limpidity, responsibility, and efficiency to financial markets in Egypt. Lastly, the study finds an insignificant association between DPS and FREQ. For further clarity, the study also includes year and industry effects to capture in variation is a specific year or industry following earlier researches (Vasilescu and Millo, 2016; Capalbo et al., 2018; Mason and Morton 2020).

4 Discussion

This study highlights the negative consequences of CEO duality in Egypt in the context of earning quality. Further, the shareholders are required to oversight CEO duality through the board so that earnings management should be constrained in Egyptian firms. Likewise, it is quite imperative to eliminate the CEO's dual role when he is politically connected since the political connection augments the negative relationship between CEO duality and FREQ. The shareholders can curtail the role of CEO duality by appointing a critical mass of female directors as gender diversity significantly substitutes the negative association between CEO duality and FREQ. Lastly, the policymakers are required to review the role of board independence as we find no evidence of board independence in the Egyptian context.

5 Conclusion

Based on agency theory and resource-based view, this study tests the role of CEO duality, and the findings fail to support resource-based view; whereas, agency theory prevails as the study finds negative impact of CEO duality on firms reported earnings quality. Further, gender diversity shows positive significant impacts on firms' reported earnings quality supporting the resource-based view and gender-critical mass maxim in Egypt. However, the study fails to find any evidence to support the resource-based view or agency conflicts in the context of board independence. The study also tested the role of political interferences and the findings show that politically connected firms are more likely to have poor FREQ. The findings are consistent with an agency-based view. In contrast, political affiliation does not have any significant impact on firms' reported earnings quality. The study used interaction terms to explore the moderating or weakening role of political connection for the association between CEO duality and FREQ. Findings show controversial support for agency theory. Political connection serves as a mechanism that increases agency conflicts as far as the interaction terms are concerned. This implies that politically connected firms have comparatively more agency conflicts than their counterpart. Meanwhile, gender diversity does serve as a mitigating mechanism only once female presence reaches the benchmark of critical mass (three female directors on the corporate board). However, there is presence below critical mass serve as a token as they do not influence or constrain the CEO power in Egypt. At the same time, we find that board independence does not serve as a constraining mechanism in Egypt, and CEOs with dual roles exercise dominance on board independence in the context of earnings management.

6 Availability of Data And Material

Data can be made available by contacting the corresponding author.

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