International Journal of Economics, Commerce and Management
United Kingdom ISSN 2348 0386 Vol. 12, Issue 9, Sep 2024

https://ijecm.co.uk/

THE RELATIONSHIP BETWEEN FINANCIAL INDICATORS AND PROFIT MANAGEMENT USING JONES AND MODIFIED JONES MODELS

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Abstract

The data extracted from financial reports plays has an important and critical role in shaping the financial and accounting decisions of economic entities. With the help of reports, the analysis and verification of a broad spectrum of economic and accounting issues across various departments is made easier. Profit management has become indispensable for many industries, which continually seek innovative techniques and methodologies to accurately calculate their revenues in alignment with management objectives. In the context of Albanian economic units, various factors influence profit management, either enhancing or diminishing it. This research aims to explore this relationship. Empirical studies will be conducted to assess how profit management correlates with commonly used financial metrics among small and medium-sized enterprises operating in the Republic of Albania. Additionally, we will explore Jones and modified Jones models' to study profit management using our dataset to understand how the effects of one model impact the others. In our research, data sources include information collected by the National Business Center regarding the businesses financial statements. Our primary contribution lies in providing a step-by-step guide for future studies, enabling a comprehensive comparison when evaluating earnings management practices within Albanian firms.

Keywords: Earning Management, ROA, Jones Model, Leverage, Discretionary Accruals, Random Effects

INTRODUCTION

The broad practice of earnings management includes equity issues, which can be categorized into two major public groups based on experience, namely: early stage and seasoned equity issues. Various researchers have thoroughly analyzed its impact on firm performance in the year following these events. Earnings management, as distinct from operational management, involves the deliberate manipulation of company earnings through various accounting methods and accrual strategies. Studies show that firms often increase earnings around listing events to increase firm value, ensure full subscription, or increase issue prices (Demirbag, M., Tatoglu 2006)[1]. Measuring firm performance is complex, with no single metric that captures all aspects. The literature distinguishes between market and accounting performance, leading to a consensus on measurement approaches (Rowe & Morrow, 2009)[2]. Our findings, along with those from other studies, can assist all stakeholders in making informed investment decisions by assessing the effects of earnings manipulation. The Jones model examines the assumption of constant non-discretionary accruals, taking into account economic conditions and using tangible fixed assets and sales variances as variables. Furthermore, it assumes no discretion in sales, potentially underestimating discretionary accruals if earnings are manipulated through earnings. Earnings management can distort financial information, affecting corporate performance and shareholder wealth.

Our study highlights the effect of earnings management on accounting performance, providing insights for policy makers to improve regulatory systems, transparency and financial reporting quality. Through our study, we will see how efficient the use of both models is in Albania, based on the data we have analyzed and how much our independent financial variables are explained by profit management for these subjects.Given the lack of transparency and the scarcity of comparable studies, it is anticipated that reports on earnings management will have a limited impact. This is further compounded by the expectation that subjects will employ income mitigation strategies, necessitating a more profound level of analysis.

[1] Demirbag, M., Tatoglu, E., Tekinkus, M., Zaim, S., & Ketikidis, P. H. (2006). An analysis of the relationship between TQM implementation and organizational performance: Evidence from Turkish SMEs. *Journal of Manufacturing Technology Management, 17*(6), 829–847. https://doi.org/10.1108/17410380610678828

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REVIEW OF RELATED LITERATURE

Earnings Management Concept

The variability of the ways in which profits are managed comes as a result of differences in accounting standards, but also as a result of cultural differences, etc. In Euro-Continental countries like France, the emphasis on bank debt and partnership governance aligns with stakeholders' financial information needs, underpinned by stringent state regulation[3]. This regulatory framework diminishes incentives for accounting manipulation[4]. Both models' standard setters strive to establish rigid accounting standards to ensure financial results' relevance and reliability, thereby safeguarding minority shareholders and enhancing investment outcomes[5]. Based on both contexts, the favorite which remains with the greatest scope in the whole world is the Anglo-American one. Earnings management can significantly affect corporate performance and shareholder wealth by distorting financial information to mislead investors or secure contractual benefits.[6] This practice involves strategic decisions on transaction timing and financial estimates, such as adjusting uncollectible accounts or employing LIFO inventory methods during inflation. Motivations for earnings management include income smoothing, maintaining accounting ratios, and exceeding analyst expectations.

Discretionary Accruals Model for earnings management

The use of different accounting methods and techniques in a purposeful way to carry out manipulations in company profits is called profit management, which has a drastic difference with the operational management of companies.Scholars investigate this phenomenon through the lens of accounting methods and accrual management. Accruals, which capture the timing of revenue and expense recognition, are particularly significant during initial public offerings. Two primary models are employed to measure earnings management: Total Accruals: Utilized by researchers such as Healy (1985) [7]and DeAngelo (1986)[8], this model encompasses all non-

[3] Gray, S. J. (1988). *Towards a theory of cultural influence on the development of accounting systems internationally*. Abacus, 24(1), 1-15.

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[6]Watts, R. L., & Zimmerman, J. L. (1986). *Positive Accounting Theory*. Englewood Cliffs, N.J.: Prentice Hall.

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cash changes.Discretionary Accruals: Examined by Jones (1991)[9], Dechow, Sloan, and Sweeney (1995)[10], Rangan (1997)[11], and Teoh et al. (1998a[12], 1998b[13]) this model represents managerial interventions.The distinction between discretionary and non-discretionary accruals is critical. Non-discretionary accruals are driven by a company's performance and external factors, whereas discretionary accruals reflect deliberate managerial actions. Comprehending these distinctions is essential for the academic study of earnings management.

Jones model and it's modifications

Jones's model critically examines the presumption of constant nondiscretionary accruals, factoring in the influence of a company's economic conditions on these accruals. It uses tangible fixed assets and sales variations as independent variables, dividing a company's profit time series into estimation and event periods. The model divides a company's profit time series into estimation and event periods.Estimation Periods: In this phase, Jones's model posits the absence of discretionary accruals, thereby establishing a baseline level of accruals devoid of earnings management. Event Periods: Conversely, during event periods, the model presumes the presence of discretionary accruals, suggesting potential earnings management activities. Nevertheless, the primary assumption of Jones's model—that firms abstain from earnings management during estimation periods—often proves to be unrealistic. This obstacle of the model can cause obstacles in the discovery of the profit management process. The model assumes sales are non-discretionary. If a firm manipulates profits via discretionary revenues, it may underestimate discretionary accruals, acknowledging this limitation.Several modifications have been proposed to refine Jones's model: Dechow, Sloan, and Sweeney (1995): The authors, in order to realize the reduction of errors during the measurement of discretionary accruals which come as a result of income manipulations, make it possible to adjust the changes in sales in relation to the changes in accounts receivable.

[9] Jones, J. (1991). Earnings management during import relief investigations. *Journal of Accounting Research, 29*(2), 193-228. https://doi.org/10.2307/2491047.

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RESEARCH METHODOLOGY

In scientific research, data collection is essential due to the significant time investment required. In this study, data from the National Business Center is used, focusing on main overviews reported by subjects. Statistical methods, such as multiple linear regression with three explanatory variables and one dependent variable, are applied, assuming non-linearity between explanatory variables. The methodology employs multiple linear regression, using earnings management as the dependent variable, measured by discretionary accruals from the Jones and modified Jones models. Independent variables include financial ratios like Return on Assets (ROA), Return on Equity (ROE), leverage, and EBIT/sales ratio. Two models are used to measure earnings management to observe the effect of model changes. The research data is quantitative, with a random selection of SMEs based on national accounting standards and participation in the tertiary sector. Subjects include restaurants, pharmacies, supermarkets, hotels, agritourism, and parking.

Profitability makes it possible to measure the profit of a company in relation to its invested capital (Harahap, 2007). Leverage compares a company's total assets to its debt financing, providing insights into structure and risk exposure. The solvency ratio assesses a company's ability to meet debt obligations, considering both long-term and short-term debts (Sunyoto, 2013).

ROE measures the efficiency of a company in terms of generating profits from shareholders' capital. The calculation of ROA is done by dividing the net income by the total assets in order to show the efficiency of the use of assets. The EBITDA to sales ratio, or EBITDA margin, compares gross revenues with profits, showing the percentage of profits remaining after operating expenses. The analysis interprets the objectives and empirical reports influencing the research process. The research questions that this paper seeks to address are as follows:

1. What relationship exists between ROA and earnings management?
2. What relationship exists between ROE and earnings management?
3. What relationship exists between Leverage and earnings management?
4. What relationship exists between EBIT to sales ratio and earnings management?
5. How do the results vary depending on the models employed?

The hypotheses are:

H_0- ROA has a negative effect on earnings management.

H_1- ROE has a positive effect on earnings management.

H_2- Leverage has a positive effect on earnings management.

H_3- EBIT to sales ratio has a positive effect on earnings management.

ANALYSIS AND RESULTS

To determine the coefficients necessary for analyzing the dependent variable, earnings management, it is essential to select an appropriate statistical method. The two main methodologies are: the fixed effects method and the panel least squares method. Consequently, we will formulate the hypotheses as follows:

H_0: The fixed effects model is employed in our analysis.

H_1: The panel least squares model is employed in our analysis.

The Panel Least Squares (PLS)

The Panel Least Squares (PLS) model is a widely utilized statistical technique for analyzing panel data, which encompasses observations across multiple entities (such as individuals, firms, or countries) over time. In this context,SPSS generates conclusions which are a part of the PLS model. Presented below are the outputs produced by SPSS for the Panel Least Squares model:

Table 1: Outputs from the Panel Least Squares Model

Dependent Variable: TA_ASETE_TOTALE
Method: Panel Least Squares
Sample: 2018 2022
Periods included: 5
Cross-sections included: 31
Total panel (balanced) observations: 155

Variable	Coefficient	Std. Error	t-Statistic	Prob.
_1_ASETE_TOTALE	1838275.	369936.1	4.969168	0.0000
NDRYSHIM_SHITJE_ASETE_TOTALE	0.010088	0.000174	58.14640	0.0000
PPE_ASETE_TOTALE	0.025459	0.076888	0.331118	0.7410
C	-0.049093	0.039633	-1.238689	0.2174
R^2	0.957793	Mean dependent var		-0.046384
Adjusted R^2	0.956955	S.D. dependent var		1.287558
S.E. of regression	0.267134	Akaike info criterion		0.223338
Sum squared resid	10.77548	Schwarz criterion		0.301878
Log likelihood	-13.30870	Hannan-Quinn criter.		0.255239
F-statistic	1142.208	Durbin-Watson stat		1.094653
Prob(F-statistic)	0.000000			

Interpretation of the Coefficients, R^2 and Variance Explanation

- _1_ASETE_TOTALE: The coefficient of 1,838,275 is positive and it is statistically significant (p-value = 0.0000), indicating a substantial positive effect on TA_ASETE_TOTALE.As _1_ASSET_TOTAL increases by one unit, TA_ASSET_TOTAL will also increase.
- CHANGE_SALES_TOTAL_ASSETS: The coefficient of 0.010088 is highly significant (p-value = 0.0000), suggesting a strong positive impact on TA_ASSETS_TOTAL.
- PPE_ASETE_TOTALE: The coefficient of 0.025459 is positive but not statistically significant (p-value = 0.7410), indicating no significant effect on TA_ASETE_TOTALE.
- C (Constant): The coefficient of the constant term is -0.049093 and is not statistically significant (p-value = 0.2174). This suggests that when all other variables are held at zero, the value of TA_ASETE_TOTALE is negligible and lacks statistical significance.
- R^2: The value of 0.957793 indicates that the model accounts for 95.78% of the variance in TA_ASETE_TOTALE, demonstrating a very high explanatory power and suggesting a robust model.
- Adjusted R^2: With a value of 0.956955, this metric confirms that the model remains well-fitted even after adjusting for the number of independent variables.
- Standard Error of the Estimate: The value of 0.267134 indicates that, on average, the predicted values of TA_ASETE_TOTALE deviate from the actual values by approximately 0.267 units.F-statistic: The value of 1142.208, coupled with a p-value (Prob(F-statistic)) of 0.000000, indicates that the model is highly significant overall, suggesting that the collective impact of all variables on TA_ASETE_TOTALE is substantial.
- Durbin-Watson statistic: The value of 1.094653 implies potential issues with autocorrelation in the residuals, as the ideal value for this statistic is close to 2.

The Random Effects (ANOVA)

This model is a statistical method frequently employed for the analysis of panel data, where observations are gathered from multiple entities (such as individuals, firms, or countries) over time. In this context, SPSS generates outputs that summarize the results of the Random Effects model.

Table 2: Outputes from the Random Effects model

Dependent Variable: TA_ASETE_TOTALE

Method: Panel EGLS (Cross-section random effects)

Sample: 2018 2022

Periods included: 5

Cross-sections included: 31

Total panel (balanced) observations: 155

Variable	Coefficient	Std. Error	t-Statistic	Prob.
_1_ASETE_TOTALE	1838275.	375038.6	4.901561	0.0000
NDRYSHIM_SHITJE_ASETE_TOTALE	0.010088	0.000176	57.35530	0.0000
PPE_ASETE_TOTALE	0.025459	0.077949	0.326613	0.7444
C	-0.049093	0.040179	-1.221837	0.2237

Effects Specification

	S.D.	Rho
Cross-section random	0.000000	0.0000
Idiosyncratic random	0.270819	1.0000

Weighted Statistics

R^2	0.957793	Mean dependent var	-0.046384
Adjusted R^2	0.956955	S.D. dependent var	1.287558
S.E. of regression	0.267134	Sum squared resid	10.77548
F-statistic	1142.208	Durbin-Watson stat	1.094653
Prob(F-statistic)	0.000000		

Unweighted Statistics

R^2	0.957793	Mean dependent var	-0.046384
Sum squared resid	10.77548	Durbin-Watson stat	1.094653

Interpretation of the coefficients

- _1_ASETE_TOTALE: The coefficient =1,838,275, with a p= 0.0000, indicating that this variable is statistically highly significant. The positive coefficient suggests that an increase in _1_ASETE_TOTALE is expected to have a substantial positive impact on TA_ASETE_TOTALE.
- CHANGE_SALES_TOTAL_ASSETS: The coefficient = 0.010088, which is also statistically highly significant (p-value = 0.0000). This result implies that an increase in

TOTAL_ASSETS_SALES_CHANGE has a significant positive effect on TA_ASSETS_TOTAL.

- PPE_ASETE_TOTALE: The coefficient = 0.025459 and is not statistically significant (p-value = 0.7444). This indicates that this variable does not have a significant impact on TA_ASETE_TOTALE.
- C (Constant): The coefficient = -0.049093 and is not statistically significant (p-value = 0.2237). This implies that when all other variables are zero, TA_ASETE_TOTALE is expected to be -0.049093, but this result is not significant.
- Cross-sectional Random Effects: The standard deviation (S.D.) is 0.000000, and the intra-class correlation coefficient (rho) is 0.0000, indicating an absence of variation between sections. This implies that there is no significant variation in the random effects across different sections (e.g., companies).
- Idiosyncratic Random Effects: The standard deviation (S.D.) is 0.270819, and the intra-class correlation coefficient (rho) is 1.0000, indicating that all observed variation within sections is attributable to idiosyncratic factors, which are not explained by the model.
- R^2: The value of 0.957793 indicates that 95.78% of the variation in TA_ASETE_TOTALE is explained by the model variables.
- Adjusted R^2: The value of 0.956955 suggests the model's robustness after adjusting for the number of variables.S.E. of Regression: The value of 0.267134 indicates a moderate standard error in the model's predictions.F-statistic: The value of 1142.208 with a p-value of 0.000000 signifies the model's overall high significance.
- Durbin-Watson Statistic: The value of 1.094653 may indicate autocorrelation of residuals, warranting further specific tests. The Random Effects model demonstrates high explanatory power, with _1_ASSETS_TOTAL and CHANGE_SALES_TOTAL_ASSETS significantly and positively influencing TA_ASSETS_TOTAL. The effect of PPE_ASETE_TOTALE is not statistically significant. Further investigation into autocorrelation is recommended, followed by the Hausman test for fixed and random effects.

Table 3: Hausman Test

Correlated Random Effects - Hausman Test

Equation: Untitled

Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	19.234930	3	0.0002

** WARNING: estimated cross-section random effects variance is zero.

Cross-section random effects test comparisons:

Variable	Fixed	Random	Var(Diff.)	Prob.
_1_ASETE_TOTALE	2174094.024954	1838274.524917	162362928583.0228	0.7921
NDRYSHIM_SHITJE_ASETE_TOTALE	0.010181	0.010088	0.000000	0.1808
PPE_ASETE_TOTALE	-0.534008	0.025459	0.074932	0.0410

Cross-section random effects test equation:

Dependent Variable: TA_ASETE_TOTALE

Method: Panel Least Squares

Sample: 2018 2022

Periods included: 5

Cross-sections included: 31

Total panel (balanced) observations: 155

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.139509	0.128347	1.086970	0.2792
_1_ASETE_TOTALE	2174094.	1328263.	1.636795	0.1043
NDRYSHIM_SHITJE_ASETE_TOTALE	0.010181	0.000189	53.83803	0.0000
PPE_ASETE_TOTALE	-0.534008	0.284618	-1.876226	0.0630

Effects Specification

Cross-section fixed (dummy variables)

R^2	0.965239	Mean dependent var	-0.046384
Adjusted R^2	0.955759	S.D. dependent var	1.287558
S.E. of regression	0.270819	Akaike info criterion	0.416343
Sum squared resid	8.874492	Schwarz criterion	1.083933
Log likelihood	1.733440	Hannan-Quinn criter.	0.687503
F-statistic	101.8163	Durbin-Watson stat	1.273083
Prob(F-statistic)	0.000000		

The null hypothesis H_0 supports the random effects model as consistent and efficient, while the alternative hypothesis H_1 favors the fixed effects model. With a p-value of 0.0002, we reject H0, indicating the fixed effects model fits the data better.To decide between the fixed effects model and the Pooled OLS model, the F-test for fixed effects is used. If the p-value of the F-test is below the significance level (e.g., 0.05), we reject H_0 and use the fixed effects model. If the p-value is above the significance level, we do not reject H_0 and use the Pooled OLS model. Regression analyses were then conducted using both JM and the MJM.The results are presented below:

Table 4: Outputs from Jones Model and Modified Jones Model

	Jones Model	Modified Jones Model
Multiple R	0.335374462	0.333830862
R Square	11%	11%
Adjusted R Square	9%	9%
Significance F	0.001225409	0.001326139
F	4.752379956	4.70326

Table 5: Coefficients of Jones and Modified Jones

	JM coefficients	p-value JM	MJM coefficients	p-value MJM
Intercept	4654530.327	0.010	4708530.828	0.009574
ROA coefficient	-20780572.02	0.00486	-20581009.66	0.00526
ROE coefficient	-3189010.771	0.0518	-3244511.96	0.04792
LEVERAGE coefficient	1762533.819	0.5254	1750231.628	0.52826
EBIT/sales ratio coefficient	9924032.75	0.0039	9698368.547	0.004789

The R-square of both models is 11%, indicating low explainability. Studies suggest that a low R-square does not necessarily imply a poor model due to various influencing factors. Additionally, numerous works highlight that these models inadequately explain the relationship between profit management and the variables. Therefore, an in-depth statistical analysis is conducted. The coefficient is 4,654,530.327 (p-value: 0.010) in the Jones model and 4,708,530.828 (p-value: 0.009574) in the Modified Jones model, both statistically significant. The ROA coefficient is -20,780,572.02 (p-value: 0.00486) in the Jones model and -20,581,009.66 (p-value: 0.00526) in the Modified Jones model, indicating high statistical significance and a strong positive relationship with earnings management. The ROE coefficient

is -3,189,010.771 (p-value: 0.0518) in the Jones model and -3,244,511.96 (p-value: 0.04792) in the Modified Jones model, both statistically significant. The Leverage coefficient is 1,762,533.819 (p-value: 0.5254) in the Jones model and 1,750,231.628 (p-value: 0.52826) in the Modified Jones model, not statistically significant. The EBIT/sales ratio coefficient is 9,924,032.75 (p-value: 0.0039) in the Jones model and 9,698,368.547 (p-value: 0.004789) in the Modified Jones model, not statistically significant. Data for the sum of squares explained and the sum of squares of the residuals are provided.

So we test the hypotheses as follows:

H_0 : $\beta_1=\beta_2=\beta_3=\beta_4=\beta_5\neq 0$ indicating the model is insignificant.

H_1 : $\beta_1 \neq \beta_2 \neq \beta_3 \neq \beta_4 \neq \beta_5 \neq 0$ indicating the model is significant.

Using the Fisher test, the calculated F-value is 4.75, exceeding the critical F-value of 2.45. This rejects the null hypothesis, confirming the β coefficients are different from zero. The p-values for both models (0.001 and 0.0013) are less than 0.05, indicating statistical validity.

CONCLUSIONS AND RECOMMENDATIONS

The juxtaposition of the Jones Model and the Modified Jones Model unveils unexpected insights. While the Jones Model employs revenue fluctuations as a proxy for accruals, Dechow et al. (1995) proposes enhancing the model by incorporating changes in receivables to achieve superior accuracy. This augmented model has since become a seminal reference in the literature, extensively cited and utilized. Empirical findings indicate that a one-unit variation in all independent variables precipitates a more pronounced diminution in earnings management when employing the Modified Jones Model compared to the standard Jones Model. The PLS model demonstrates robust explanatory power, as evidenced by the high R^2 value. Although two of the independent variables are statistically significant, the coefficient for PPE_ASETE_TOTALE is not. The presence of autocorrelation in the residuals warrants investigation and remediation if necessary. The Random Effects model exhibits substantial explanatory power, with _1_ASSETS_TOTAL and CHANGE_SALES_TOTAL_ASSETS significantly and positively influencing TA_ASSETS_TOTAL. The effect of PPE_ASETE_TOTALE remains statistically insignificant. The Hausman test is employed to discern whether a fixed effects or random effects model is more appropriate in econometric analysis. This model accounts for unobserved heterogeneity across entities (e.g., companies) by incorporating a unique, time-invariant effect for each unit. Under these conditions, the fixed effects model is preferred. Companies with higher ROA are generally perceived more favorably by regulators and auditors. This favorable perception diminishes the likelihood of aggressive accounting practices being overlooked, as strong performance is less likely to attract scrutiny for

potential earnings manipulation. Similarly, companies with higher ROE are less likely to face regulatory scrutiny for potential earnings manipulation. Robust performance tends to be less questioned, thereby reducing the necessity for discretionary accruals. Furthermore, companies with higher ROE are often viewed more favorably by investors and analysts. This credibility mitigates the need for aggressive accounting practices, as the company's financial health is already perceived positively. Additionally, an increase in a company's Earnings Before Interest and Taxes (EBIT) to Sales ratio signifies higher profitability. Managers might employ discretionary accruals to smooth earnings, thereby making the financial performance appear more stable and predictable.

In both models that we studied, the low explainability can be attributed to the fact that the financial statements were declared incorrect in the national business center. This is because the subjects, perhaps in order to avoid fines for not declaring the financial statements, make declarations with wrong results which also affect our results. This is because, unfortunately, factors such as the lack of professional staff, the lack of reading and applying the law at the right time, etc. affect the delay of controls and the preparation of accurate and reliable financial statements.Future research can build upon this study by selecting entities with robust accountability or shareholders who are subject to expert audits. Such a selection is anticipated to enhance the model's explainability, as the financial statement outcomes will be more credible. Additionally, the sample size should be increased by focusing on a specific sector to determine the sector-specific impact, or by expanding the sample to include entities across Albania. These recommendations would enable a more comprehensive assessment of the model's applicability to Albania.

Our findings indicate that the models are appropriate for Albania; however, the inclusion of explanatory note analyses in the reports would further extend the scope of this research. The government must take measures because beyond the wrong statements, even scientific research results in results that have low explainability. Accountants and managers must stop using such manipulation techniques because the fines translate into unknown expenses for them and this then brings and impact on the profits of the following year.

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