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FIRM SIZE AND EARNINGS MANAGEMENT: UNLOCKING THE STRATEGY OF UPWARD OR DOWNWARD EARNINGS?

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Abstract: *Previous empirical studies on earnings management have often found conflicting findings regarding factors that contribute to such practice. They also found that the practice of earnings management has been abused by manipulating accounting figures and taking advantage of the relaxation of accounting rules. This study examined the effects of firm size on earnings management practices among Malaysian public listed firms. Secondary data from 2014 to 2021 obtained from DataStream and the Annual Reports of 492 firms, were analysed using Fixed Effects Estimation methodology. Findings indicate that larger firms often have a higher tendency to engage in earnings management, especially downward earnings management. This lends evidence of the Political Costs Theory and Political Power Theory underlying the earnings management practice among large, listed firms in Malaysia. The findings have a significant implication on regulatory bodies, such as the Securities Commission, which has to tighten accounting rules and increase oversight among large, listed firms. This measure can reduce the manipulation of financial reports by managers who take advantage of regulatory weaknesses to achieve their opportunistic objectives.*

Keywords: *Large-Listed Firms, Upward Earnings, Downward Earnings, Political Power Theory, Political Costs Theory.*

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Introduction

One of the topics frequently discussed in accounting literature is earnings management (EM), which serves as an indicator of the quality of financial information provided by firms to the stakeholders and society. Theoretically, EM occurs when managers use their discretion when preparing financial reports and structuring transactions aimed at altering financial reports, which influences stakeholders' perception on the firm's economic performance or contract opportunities that rely on reported earnings (Healy & Wahlen, 1999). Excessive practices of earnings management are often associated with negative implications, such as damaging the reputation of companies and professions, as well as having adverse consequences on the country's economy at the micro and macro levels (Khan & Shoaib, 2024).

Previous research has discussed various factors that influence earnings management, such as corporate governance (Chee & Tham, 2021;Pham et al., 2022; Hong et al., 2023), insolvent status (Park et al., 2021), as well as the firm's characteristics such as firm size, financial leverage, age, survival and audit quality (Cudia et al., 2021; Elhawary & Hassouna, 2021; Gajdosikova et al., 2022). Some studies had focused on positive accounting theory aspects, namely bonus plan, debt hypothesis and political cost factors that influence earnings management (Aboud et al., 2023; Avabruth & Padhi, 2023; Capalbo et al., 2021; Saksessia & Firmansyah, 2020). Besides that, some studies have focused solely on firm size (Gonçalves et al., 2022; Siekelova et al., 2020).

Nevertheless, firm size remains the area of focus and interest in accounting due to previous conflicting findings related to determining suitable underlying theories, which have led to different proxies and measurements of firm size, as well as the type of firm size that influences earnings management practices (Aljughaiman et al., 2023; Belz et al., 2019; Gross et al., 2016; Truong et al., 2020).

Hashmi et al. (2020) argued that there are different theories providing different explanations on the size factor that affects EM, which can lead to differences in the definition and proxy measures of firm size used by studies, eventually leading to different results. Ulfa et al. (2018) examined the effect of firm size on earnings management based on Agency Theory, whereas Tham et al. (2019) examined the relationship between various directorships and the level of EM based on the Theory of Resource Dependence. Moreover, Soliman (2019) examined firm size and earnings smoothing (proxy for earnings management) based on the Political Costs Theory. In relation to political power, one study on earnings management generally referred to political power based on political connection (Gross et al., 2016). Nevertheless, there is still insufficient evidence to support the relationship between firm size and earnings management from the Political Power Theory perspective.

As far as firm size's effect on EM is concerned, some studies found a positive relationship between firm size and EM (Bugshan et al.,2022), while others found a negative relationship (Elhawary & Hassouna, 2021). It is crucial to note that firm size, especially the large firms, often has a negative relationship with EM, as large firms tend to exhibit lower earnings quality, revealing potential manipulation of financial statements by firms of that size.

Therefore, this study applied key assumptions from the two substituting theories (Political Costs and Political Power Theories), which is mainly discussed in the context of tax avoidance and re-examining whether it can be applied to EM. Current studies on EM mostly apply the Theory of Resource Dependence (Hoang et al., 2022; Kamarudin et al., 2021) and Agency Theory (Al-

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Absy et al., 2021; Ghazali et al., 2022). Furthermore, there is lack of studies that examine firm size and EM strategy except Abdullah (2022), who examined small firms and their EM strategy from 2012 – 2014 and Al-Absy et al. (2021) who examined EM strategy among firms with family directors. Therefore, it is relevant to consider firm size and EM strategy in the Malaysian context as it can help understand how large firms responded to political uncertainty, particularly during the 14th General Election (GE-14) in 2018, when managing their earnings. The change of government triggered instability in political and economic policies, and large firms used EM as a strategy to deal with political risk. This present study posited that large firms would have a greater capacity, hence, a tendency to lobby political parties as well as manage political costs through EM practices.

Therefore, this study aimed to address the following research question: *Does firm size influence EM strategy?* . The objective of this study is to investigate the EM strategy used by large versus small firms.

Literature Review and Hypothesis Development

Theoretical Background

Firm size's influence on EM is often based on two substituting theories, namely Political Costs Theory and Political Power Theory. Political Costs Theory is a prominent theory in accounting and states that large firms are more visible to regulatory and social attention. A previous study on taxation found that large firms have a high effective tax rate (ETR), which means less tax avoidance (Belz et al., 2019). Therefore, EM proposes that large firms tend to choose downward EM as they would like to avoid transferring their wealth to a third 'party', such as taxation or social contribution (Watts et al.,1978; Soliman, 2019).

Conversely, Political Power Theory states that large firms have greater resources that enhances their ability to influence the political process, develop expertise in tax planning and organise optimal tax saving activities (Salamon & Siegfried, 1977; Stickney & McGee, 1982). The larger the size of the firm, the easier it will be for the firm to obtain financing resources, both internal and external financing (Hendra et al., 2018). Larger companies, with their vast economic resources and expertise, can effectively influence policy decisions in their favour. Watts et al. (1978) and Watts and Zimmerman (1990) elaborated on this phenomenon by stating that large corporations often leverage their resources to negotiate with authorities. These negotiations are aimed at reducing the tax burden or influencing legislation through lobbying activities. Research on taxation also found that larger firms have lower effective tax rate, which indicates a higher chance for tax avoidance (Belz et al., 2019).

In a nutshell, large companies might use strategies to reduce their reported income to avoid high tax burdens. At the same time, large firms also take advantage of negotiations with the authorities by reporting lower earnings. Therefore, concerning discussions on the EM strategy issue, this study proposed that the Theory of Political Power is a theory equivalent or having the potential to substitute the Theory of Political Cost, which supports the tendency of large firms to practice downward EM.

Firm Size and Earnings Management

Previous studies found that larger firms were more likely to engage in EM by using accrual discretion than smaller firms. Cudia et al. (2021) argued that large firms have more incentives to smooth earnings, while Ghani et al. (2019) stated that larger firms tend to engage in EM

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practices to meet the expectations of the firm's shareholders and stakeholders. Meanwhile, Al-Okaily et al. (2020) found that large companies are more likely to engage in EM due to political cost factors, similar to Aljughaiman et al.(2023), who found that large companies with more accounting alternative options were better positioned to manipulate earnings to reduce political costs and avoid political risks.

Meanwhile, Nguyen et al. (2022) stated that corporate financial performance, size and leverage negatively influenced earnings in the context of a firm's business activities in Vietnam's economic environment. They found that discretionary accruals are often positive for small firms, which is associated with aggressive EM. This is due to the fact that it is worthwhile for them to come up with a better financial reputation for the purpose of securing investors (Durana et al., 2021).

Other studies had focused on assessing EM strategies to determine whether firms specifically engage in practising downward or upward EM. Michalkova et al. (2022) studied European transport companies during the pre-pandemic crisis and found that firm size significantly impacted the quality of reported earnings for all firm sizes. The direction of accounting manipulation varies in this case. Companies that were categorised into small, medium and large corporations had adopted downward EM to a greater extent; however, very large companies increased their accounting profits. In a similar vein, Siekelova et al. (2021) focused on V4 companies in Czech and Slovak and found that these companies used EM techniques to increase their profits. On the other hand, Polish and Hungarian companies used EM techniques to reduce their earnings.

Wagener (2024) specified that managers in larger firms manage earnings significantly by using a downward EM strategy. Du et al. (2024) studied how firms in areas vulnerable to natural disaster risks responded to rising political costs and found that firms tended to engage in downward earnings management after a natural disaster crisis. Gupta et al. (2024) opined that earnings management upwards (downwards) increases (decreases) with increased exposure of firms to political risks. In addition, they found that managers build a reserve of 'cookie jars' with downward earnings management for future use when the firm is exposed to political risk.

Conversely, other than the downward strategy, previous studies have found that managers of large firms use the upward EM strategy via discretionary accruals to signal their earning stability when disclosing the manager's performance as well as reducing information asymmetry between managers and stakeholders. In line with this notion, they found evidence indicating that a firm with high market value and growth opportunity would be positively related to discretionary accruals (Duong & Pescetto, 2019). Their study strongly indicated that overvalued firms tend to practice upward earnings management when facing pressure from the capital market that would require them to sustain a high market valuation.

Nevertheless, this study posited that larger firms are more likely to practice downward earnings rather than upwards earnings management. Therefore, based on the theoretical and empirical review of past studies, the hypothesis of this study is as follows:

H1: Large firms have a higher tendency to engage in downward EM.

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Models, Methods, and Materials

This study chose a sample of 492 Bursa Malaysia listed firms across 11 types of industries for a period spanning from 2014 to 2021. The sample is selected based on completed information on discretionary accruals (EM measurement) and market capitalisation information for the consecutive 8 years period of study. Earnings management was measured by using residual value discretionary accruals (denoted as DACC), based on Kothari et al. (2005). González-Sánchez et al. (2023); Hribar & Nichols (2007); Nguyen et al.(2023) had utilized the residual value of DACC to test whether the EM strategy is downward or upward based on the residual DACC coefficient sign, which is meant for testing this study's hypothesis .

The following estimation model was proposed to test this study's hypothesis:

$$DACC = \beta_1 SIZE_{it} + \beta_2 ROE_{it} + \beta_3 DTE_{it} + \beta_4 GROWTH_{it} + \beta_5 CIR_{it} + \beta_6 ATO_{it} + \beta_7 LOSS_{it} + \beta_8 BOARD_{it} + \beta_9 INDEP_{it} + \beta_{10} AFEE_{it} + \beta_{11} POL_{it} + \beta_{12} ELECT_{it} + \varepsilon_{it}$$

where:

DACC	:	Discretionary accruals as proxy for EM.
SIZE	:	Market capitalisation in natural log and in robustness check, measured by dummy variable 1=large listed (> RM2billion market capitalisation),0=small listed (< RM2 Billion of market capitalisation).
ROE	:	Return on equity , calculated as Net Income divided by Total Equity.
DTE	:	Leverage calculated as Debts to Total Equity ratio.
GROWTH	:	Sales Growth calculated as Current Year Sales – Previous Year Sales / Previous Year Sales.
CIR	:	Capital intensity measured by Total Assets divided by Total Sales.
ATO	:	Assets turnover ratio measured by Total Sales divided by Total Assets.
LOSS	:	Dummy variable for current year loss (1= loss's year , 0=otherwise)
BOARD	:	Board size (number of board of directors)
INDEP	:	Board independence (percentage of independent directors on board)
AFEE	:	Audit expenses paid to auditors measured in Log RM
POL	:	Political connection measured a scale of 1 to 4 (number of connections to a politician that reflect the degree of connection 1 with 1 connection and so on)
ELECT	:	Dummy for 2018 during which GE2018 took place. (1=2018, 0=otherwise)

Correlation analysis using the Pearson Correlation Matrix was conducted on all variables, and no variable was found to exceed the mean VIF of 0.8. The Hausman test indicated that the Fixed Effect estimator was preferred, corrected for heterogeneity and tests for serial correlation problems in the dataset were carried out.

Table 1 presents the descriptive analysis for this study. The Normality test was carried out by evaluating skewness and kurtosis for each variable. Data for this study had met the assumption of normality with skewness and kurtosis being in the range of less than 2 and less than 10, respectively (Watson, 2018).

Table 1: Descriptive Analysis

Variables	Obs	Mean	Std. Dev.	Min	Max	Skew.	Kurt.
DACC	3936	0.0410	0.0820	-0.0600	0.2030	0.7270	2.4260
SIZE	3936	19.6400	1.7180	15.9790	25.1780	0.7440	3.3050
ROE	3936	0.0560	0.0830	-0.0830	0.1950	0.0090	2.1730

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DER	3936	0.7870	0.5540	0.1680	1.8690	0.7340	2.2990
GROWTH	3936	0.0340	0.1810	-0.2470	0.3610	0.2290	2.2460
CIR	3936	2.4540	1.8710	0.7560	6.5510	1.1620	3.0270
ATO	3936	0.6740	0.4020	0.1550	1.3770	0.3660	1.8930
LOSS	3936	0.7620	0.4260	0.0000	1.0000	-1.2320	2.5170
BOARD	3936	7.5260	1.9100	4.0000	16.0000	0.7440	3.5490
INDEP	3936	0.4760	0.1170	0.3000	0.6670	0.1230	1.8520
AFEE	3936	12.5590	1.0130	10.2400	17.1110	1.1740	4.8720
PCON	3936	0.5100	0.6790	0.0000	3.0000	1.0830	3.3430
ELECTION	3936	0.1250	0.3310	0.0000	1.0000	2.2680	6.1430

Table 2: Fixed effects estimation

	Model1	**Model2**
	DACC	DACC
Constant	0.777***	0.237***
	-0.0803	-0.0555
SIZE (LgMCap)	-0.0319***	
	-0.0033	
SIZE (1=Large, 0=Small)		-0.0337***
		-0.0067
ROE	0.116***	0.0277
	-0.0255	-0.0246
DER	0.0003	0.0056
	-0.0054	-0.0060
GROWTH	0.0754***	0.0721***
	-0.0056	-0.0057
CIR	0.00352***	0.00256*
	-0.0013	-0.0014
ATO	0.0108*	0.0096
	-0.0066	-0.0072
LOSS	-0.00897***	-0.00737**
	-0.0032	-0.0031
BOARD	-0.000711*	-0.0006
	-0.0004	-0.0004
INDEP	0.0095	0.0101
	-0.0144	-0.0157
AFEE	-0.0101***	-0.0162***
	-0.0039	-0.0044
PCON	-0.00570*	-0.00701**
	-0.0030	-0.0032
ELECTION	-0.00779***	-0.00667***
	-0.0019	-0.0019
R-squared	0.17	0.105
F-Statistic	27.1***	24.29***
No. of observation	3936	3936

*** p<0.01, ** p<0.05, * p<0.1

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Table 2 shows the findings of the study. Both models measured earnings management using the residual (sign) discretionary accruals (DACC) method. As for Model 1, firm size was proxied by log market capitalization. Results indicate that there is a negative relationship between firm size and DACC, with the negative coefficient value being at a significant level of 1%. This shows that the larger the firm's size, the more negative the discretionary accruals, which signify a downward earnings management. Therefore, this study's hypothesis is supported. This is consistent with Delgado et al. (2023), Githaiga et al. (2022) and Michalkova et al.(2022), whose collective findings was that large corporations reduce their tax burden through deferred tax methods and aggressive tax planning. This result contrasts with Sánchez-Ballesta and Yagüe (2021), who suggested that smaller firms facing less pressure to present high earnings are more likely to engage in downward earnings management.

This study also performed a robust analysis using the other measurement for firm's size. In reference to Table 2, in the column for Model 2, firm size is proxied by a dummy variable, large, listed firm=1 and small listed firms =0. According to the Malaysian Corporate Code of Governance (MCCG,2021), large, listed companies are defined as companies with a market capitalization > RM2 Billion or more. Therefore, results indicate that based on Model 2, there is a negative relationship between firm size (large, listed versus small, listed) and DACC, with a negative coefficient value being at a significant level of 1%. This explains why large, listed firms have more negative DACC, compared to small, listed firms. This means that the larger the firm, greater the tendency to practice downward earnings management. Therefore, this study's hypothesis was confirmed by this robustness analysis.

Discussion of The Findings

Based on the results, this study's hypothesis is supported. It was found that the inclination of listed firms in Bursa Malaysia to practice earnings management is significant. This is consistent with the Political Cost Theory when considering all firm sizes regardless of whether the firm is a large, listed firm or a small, listed firm. This result also considers the inclusion of data for 2018, the year the14th General Election was held in Malaysia and used that year as the control variable in this study.

Results also indicate that the larger the firm, greater the tendency to perform downward earnings management. This view is consistent with Belz et al. (2019), who concluded that the relationship between firm size and political cost is based on two arguments. First, larger firms are subject to more government regulations, and second, large firms are more prone to pressure and attention from the public, which forces them to act responsibly towards the social environment and hence, adjust their corporate actions and behaviours based on the expectation of their social environment. In summary, Political Cost Theory states that when a firm's management reckons that the risk of political costs is high or there is a potential for rent seeking, either from politicians or social and regulatory parties, the firm is more inclined to reduce reported earnings, either pre-tax or post-tax earnings. Hence, firms will reduce their post-tax earnings through measures such as tax saving or tax earnings management.

Likewise, this is aligned with the Political Power Theory, which contents that most large firms tend to practice downward earnings management to avoid political or social attention (Cahan, 1992; Simamora, 2022). Even though large firms with high visibility will exploit their negotiation and lobbying power yet be engaged in the downward earnings strategy to reduce political risks and risk of transferring their wealth to other 'parties' (taxation etc.).

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Conclusion and Recommendations for Future Research

In conclusion, firm size has a significant relationship with earnings management (EM). In the context of this study, large firms in Malaysia are more likely to practice downward EM, in line with both the Political Cost Theory and the Political Power Theory. This tendency allows firms to reduce political costs, such as taxes, by leveraging negotiating power and lobbying activities as part of their corporate strategy. This study believes that Political Costs Theory and Political Power Theory act as substituting theories when explaining the earnings management strategy.

This study provides several contributions. It provides literature on the influence of firm size on earnings management based on two substituting theories, namely Political Costs Theory and Political Power Theory, which is more widely applied to ETR (taxation). Regulatory bodies should conduct a more detailed analysis of listed firms on Bursa Malaysia. This is due to evidence that, regardless of their size of being large or small, all managers tend to manipulate the loopholes in accounting rules, depending on their motivation. They will opportunistically choose the most effective strategy to achieve their objectives.

Therefore, it is recommended that future studies look at the broader scope of political factors, such as the status of being politically connected, good governance and macroeconomic events (crises, pandemics or elections). Finally, it is suggested that other earnings management proxies, such as real earnings management, should be used.

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