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Large Firms and Deflating Earnings Strategy: Empirical Evidence from Malaysia

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ABSTRACT

Earnings management can be practice through inflating or deflating the firm's earnings. This research investigated the inclination of large firm on deflating earnings as one of the earnings management strategies among Malaysian public listed firms. This quantitative study utilised data of 492 public listed firms from 2014 to 2021, analysed using the Fixed Effects Model. Results revealed that larger firms often inclined to be involved in earnings manipulation, particularly in deflating earnings. This result is supported by the Political Costs Theory and Political Power Theory. The result of the study makes a significant contribution to regulatory bodies, such as the Securities Commission, which needs to strengthen accounting regulations and improve supervision among large, listed firms. This can reduce the activity of either inflating or deflating the reporting of earnings that contributes to the manipulation of financial reports by managers to achieve their personal opportunistic objectives or the company as a whole.

Keywords: Income deflating, income inflating, large-listed firms, political costs theory, political power theory

INTRODUCTION

Earnings management occurs when managers use discretion in structuring transactions due to the flexibility in accounting rules. For example, the accrual principle which provides opportunities for managers to modify the facts of the company's actual financial condition by either inflating or deflating the earnings (Beneish, 2001).

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Why firm size remains the area of interest in this study is due to conflicting previous findings related to determining suitable underlying theories as well as the proxies and measurements of firm size (Aljughaiman et al., 2023). Yet, there is still insufficient evidence to support the relationship between firm size and earnings management from the integration of Political Costs and Political Power Theory perspective. Hence, there is a lack of studies that specifies EM strategy (inflate or deflate) in Malaysia except Abdullah (2022) whom used a different sample. The research question is "Does firm size influence EM strategy?" Thus, the objective of this study is to investigate the EM strategy (inflate or deflate) among large firms.

MODELS, METHODS, AND MATERIALS

This study utilised 492 Bursa Malaysia listed firms across 11 types of industries from a period of 2014 to 2021, with completed information on discretionary accruals and market capitalisation information. The residual value discretionary accruals (DACC) is utilised to test whether the EM is decreasing (deflate) or increasing (inflate) (Hribar & Nichols, 2007). The model of study is shown by Model 1.

$$DACC = \beta_1 SIZE_{it} + \beta_2 ROE_{it} + \beta_3 DTE_{it} + \beta_4 GROWTH_{it} + \beta_5 CIR_{it} + \beta_6 ATO_{it} + \beta_7 LOSS_{it} + \beta_8 BOARD_{it} + \beta_9 INDEP_{it} + \beta_{10} AFEE_{it} + \beta_{11} PCON_{it} + \beta_{12} ELECT_{it} + \varepsilon_{it} \quad \text{[Model 1]}$$

Where DACC=Residual value of Discretionary accruals; FSIZE=Market capitalisation in natural log and in robustness check, measured by dummy variable 1=large listed (> RM2 billion 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; SG=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); BSIZE=Board size (number of board of directors); BIND=Board independence (percentage of independent directors on board); AUDFEE=Audit expenses paid to auditors measured in Log RM; PCON=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 year 2018 during which GE14 took place. (1=2018, 0=otherwise)

RESULTS AND DISCUSSIONS

In Table 1, as for the column of the main analysis, the firm size was proxied by a dummy variable using 1 = large, listed, and 0 = small, listed. Results revealed that there is a

negative association between firm size and DACC (proxied for earnings management) at a significant level of 1%. This shows that the larger the firm's size is, the more negative the discretionary accruals, which signify earnings management by deflating their earnings. Thus, the hypothesis of this study is verified. It is constant with the study by Delgado et al. (2023). As for column of the robust analysis, this study also discovers that there is a negative association between firm size (proxied by log market capitalisation) and DACC. The main result is confirmed by this robust analysis.

Table 1
Fixed effects model

	Main	Robust
Constant	0.237***	0.777***
	-0.0555	-0.0803
FSIZE (LgMCap)		-0.0319***
		-0.0033
FSIZE (Dummy)	-0.0337***	
	-0.0067	
ROE	0.0277	0.116***
	-0.0246	-0.0255
DTE	0.0056	0.0003
	-0.006	-0.0054
SG	0.0721***	0.0754***
	-0.0057	-0.0056
CIR	0.00256*	0.00352***
	-0.0014	-0.0013
ATO	0.0096	0.0108*
	-0.0072	-0.0066
LOSS	-0.00737**	-0.00897***
	-0.0031	-0.0032
BSIZE	-0.0006	-0.000711*
	-0.0004	-0.0004
BIND	0.0101	0.0095
	-0.0157	-0.0144
AUDFEE	-0.0162***	-0.0101***
	-0.0044	-0.0039
FPOL	-0.00701**	-0.00570*
	-0.0032	-0.003
ELECT2018	-0.00667***	-0.00779***
	-0.0019	-0.0019
R-squared	0.105	0.17
F-Statistic	24.29***	27.10***
No. of observation	3936	3936

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

CONCLUSION

The larger the firm is, the greater the inclination to deflate their earnings. The reason is that larger firms are subject to more government regulations and high public visibility which will affect wealth transfer. As a result, large firms will exploit their lobbying power to reduce political risks and risk of transferring their wealth to other parties (Salamon & Siegfried, 1977; Stickney & McGee, 1982). This study contributes two main aspects. First, it enriches the literature on EM based on the Political Cost Theory and Political Power Theory as the substituting theory. Other than that, it provides guidance to regulatory bodies to notice that all managers have opportunistic behaviour towards inflating or deflating their earnings. Future studies are recommended to explore EM during the events of crises, pandemics, or elections.

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