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Firm Characteristics and Earning Management: Moderating Role of Ownership Structure

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Abstract
Prior studies examine the influence of Firm characteristics and ownership structure on earning management with competing interests. This research investigates the inconsistent results with a proposed framework through the interaction effect of ownership structure (concentrated ownership and institutional ownership) on the relationship between Firm characteristics (firm size and leverage) and earning management. The study carried out a test using a sample of 139 firms listed on Pakistan stock exchange from 2008-2019. This study's tests are carried out using the Stata programme and the fixed effect panel least squares regression model. The results indicates a negative and significant impact of concentrated ownership on earning management while, firm size, leverage and institutional ownership shows insignificant relationship with earning management. Additionally, the results seem to indicate that concentrated ownership diminished the influence of firm size on earning management. Moreover the relationship between business characteristics and earning management is also unaffected by institutional ownership.This is perhaps because most businesses in Pakistan are family-owned and concentrated.

Key words: Firm size, Leverage, Institutional ownership, concentrated ownership, Dictionary accruals, Pakistan Stock Exchange

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1. Introduction

In this information era, individuals have instant access to essential information via the internet, social media, newspapers, and magazines, but such information does not ensure accuracy or transparency. Earnings are the essential component of a financial statement, and they are regarded as the most crucial indicators of a company's financial status in the perspective of potential investors from the outside. According to the study by Byun et al. (2011) Managers have a financial motive to alter earnings of their stock holdings when there is asymmetric knowledge between insiders (management) and outsiders (stockholders). Earning management is a term used to describe attempts by company executives to modify accounting data to make their financial statements appear less transparent.

First, it is critical to have a basic understanding of earnings, followed by a quick discussion of earnings management. Earnings are the most crucial asset of every company since not a single company would survive in the market without profit. As a result, every company needs to improve this asset to maintain a strong position in the market. Earnings management perception is critical since earnings determine the stock value of a company. In comparison to small firms, large enterprises incur higher costs in earnings management because of their higher market status. Because more financial analysts examine them, large companies deal with earnings less than small companies (Kim et al., 2003). In other words, when compared to small businesses, huge businesses are much better at keeping track of their profits and financials. According to LA & DJ (2000), large size enterprises do not display actual earnings progress for at least 14 quarters after acquiring accurate data.

Firm characteristics are defined by Zou and Stan (1998) as a firm's demographics and management characteristics that are part of the firm's operating environment. Firm size, leverage, firm age, revenue growth, asset growth, and turnover are all examples of firm characteristics. Several research uses positive accounting theory to investigate managerial motives for application of accounting policies adoption. According to Cotter (1999);ul Mustafa, Abro, and Awan, (2021); and Deckop et al. (2006), managerial motives to choose accounting methods result from interactions between a stakeholders, such as managers, stockholders and lenders. In general, these researchers have found that political expenses, tight debt covenants, and bonus schemes influence the selection of accounting methods. However, because they focus on a single accounting decision at a time, their findings often provide an incomplete view of managers' intentions.

Missonier Piera (2004) noted that the choice of accounting system by Swiss managers was severely influenced by dispersion of ownership ,private lending, banks, labour market, and managers' individual compensation. The study deemed business size and leverage unimportant in the Swiss setting. In contrast to Missioner's study, Meek and Thomas (2004) discovered that Japanese managers found that firm size and leverage were important factors in the decision of which accounting system to use. The study reveals three key factors—taxation, international political costs, and ability of the business to finance its own operations—that influence Japanese managers' decisions regarding accounting procedures.

In any organisation, four significant attributes, such as ownership structure, board composition, payroll, and management board, have been recognised globally.(Watts & Zimmerman, 1990). Numerous corporate governance theories demonstrate that the structure of ownership is an important component of the corporate governance practices. Solid and proper ownership structure is required to control earnings, maintain financial statement reporting monitoring and play a key role in mitigating agency problem. The ownership structure helps to decrease the agency cost of separating ownership and management, which can protect companies' proprietary rights (Barbosa & Louri, 2002).

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The study of CG ideas shows that board composition and ownership are the critical parts of the whole CG set-up (Jentsch et al., 2014). Any enterprise's ownership structure is considered to be a powerful CG tool. It is considered that the EM must be curbed and supervised by an efficient and proper ownership structure. Hashmi et al. (2015) states that the ownership structure may be divided into two categories, the first being the concentration in ownership of ownership, the second being ownership of identities, the second being that the block holders own more than 10% of a company's shares. Jensen and Meckling (1976) said corporate block holders address shareholder interest divergence because they pressure management to act for stakeholder interests.

However, several issues limit earning management. Some research has shown that specific characteristics of corporate governance affect corporate accounting, particularly income management (DECHOW et al., 1996; Jiambalvo et al., 1996; Warfield et al., 1995) believe, for example, that management owns a substantial share of the company's equity has less incentive to distort reporting facts. Chung et al. (2002) discover that institutions restrict the management of accumulations by managers to attain the target income level. These studies show that the ownership structure of a company impacts significantly on the magnitude of profit and earnings management.

Clarifying the moderating effect of ownership structure on the relationship between firm characteristics and earning management is the goal of the current study. Section 2 analyses prior research and formulates testable hypotheses about how business characteristics, ownership structure, and earning management are related. The sample used for the study is provided in Section 3, along with an explanation of the econometric technique used for analysis. In Section 4, the findings are interpreted, and the research concept produced from the study is discussed. Section 5 suggests further research as well as a conclusion to the study.

2. Literature Review and Hypothesis Development

2.2. Firm characteristics and earning management

2.2.1. Firm size and earning management

Firm size describes the size of a corporation in terms of its importance. While proxy values used to measure company size often include employee headcount, total assets, total revenue, and market capitalization. Firm size and earning management have an opposed relationship: (1) the first, defended by (Dwi Lusi Tyasing Swastika, 2013; Ahmad et al., 2014), proposed a negative association, claiming that big firms with superior internal control systems, more capable auditors, and a stronger reputation are better equipped to avoid earning management.

According to the opposing viewpoint, firm size and earnings management have a positive affiliation, with larger firms being more inclined to manage earnings due to increased capital market pressure and bargaining power (Younis et al., 2016; Degeorge et al., 1999; Tambun et al., 2017). Moreover Llukani, 2013; Siregar and Utama, 2008; Bassiouny, 2016; Naz et al., 2011) found no appreciable differences in earning management strategies and practises amongst large and small enterprises.

H_1: Firm size has positive and significant relationship with earning management.

2.2.2. *Financial leverage and earning management*

Leverage is crucial to reduce costs related to information asymmetry and confrontations between shareholders and managers, but it also causes problems with divergent interests between shareholders and bound holders as well as between bound holders and managers. The new agency conflicts undoubtedly result in agency costs, such as asset replacement costs. The issue of moral hazard is undoubtedly related to debt contracts.Managers can work in terms of wealth transfer from

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the restricted holder to the shareholder by investing in high-efficiency, high-risk initiatives or modifying the financing policy or dividend policy.

When a business applies debt, the managers typically seek accounting strategies that boost your income to meet the debt covenant established by banks and debt-holders, allowing them to prevent renegotiation fees (Beatty & Weber, 2003). Some research discovered a negative relationship, owing to two factors. First, leverage implies debt repayment, this restricts the amount of funds accessible to management for wasteful spending. Second, when a firm uses borrowed funds, it is subject to lender oversight and, in most cases, to lender-imposed expenditure constraints (Jensen, 1986). According to signalling theory, highly leveraged organisations are heavily involved in earning management to empowered them to acquire new investment at a reasonable cost. Managers of high-leverage companies use discretionary accruals to prevent debt covenant violations (Jiambalvo et al., 2002; Jiang et al., 2008).

H_2: Financial leverage has negative and significant relationship with earning management.

2.3. Ownership structure and earning management

Ownership structures are essential in minimizing agency problems because they can monitor business performance and manager behaviour and impact management decision-making. Gautama and Daromer (2017) discuss how managers' opportunistic behaviour might result in conflicts and how an ownership structure-based monitoring mechanism can resolve this issue. The primary agency issue is not a confrontation between managers and shareholders but rather the potential of expropriation at the expense of monitoring shareholders by the dominant or controlling shareholder. Some studies revealed that corporate governance limits a manager's incentive to manage profitability (Dechow et al. 1996; Jiambalvo 1996).

2.3.1. Concentrated ownership and earning management

The concentration of ownership may provide problems for an agency between knowledgeable and uninformed inventors. Further insider information is available to informed investors. In order to safeguard their interest, they can use insider information, which breaches the rights of minority holders, using corporate resources to get them. In turn, agency costs are driven to the agency's problems because of conflict of interest exists between minority and majority stockholders.

There are two possible viewpoints on the likelihood of concentrated ownership having a significant impact on companies. Some studies argue that increased corporate ownership concentration correlates with lower earning management, while others believe it has a positive influence since it drives managers to focus on earning management. Consistent with a pessimistic outlook Usman and Yero (2012) investigate the concentrated ownership and earnings management methods of publicly traded enterprises in Nigeria. The findings indicated a significant and unfavourable link between concentrated ownership and earning management, which has a moderating effect on both. Grimaldi and Muserra (2017) demonstrate that earning management is adversely connected to concentrated ownership. The data imply that by limiting the intensity of earnings management. Concentrated ownership enhances the efficiency of annual earnings in a certain agency context.

In underdeveloped nations, concentrated ownership has a significant benefit because individual rights are vaguely defined and not protected by the legal system(Shleifer & Vishny, 1997). When the opportunity presents itself, managers who are also owners have a proclivity for expropriating minority shareholders (La Porta et al., 1999). According to Liu and Lu (2007), the amount to which a majority shareholder controls a business is directly related to minority shareholder

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expropriation. Furthermore, they identified a strong and favourable interaction between concentrated ownership and earning management. Accordingly, (Kim and Yoon 2008; Abdoli 2011; Halioui and Jerbi 2012) demonstrate the existence of a positive relationship among concentrated ownership and earnings management. On the other hand, other research has discovered that concentration ownership did not affect discretionary accruals (Bhutta et al., 2016).

H3: Concentrated ownership has negative and significant relationship with earning management.

2.3.2. Institutional Ownership and earning management

Institutional shareholders are far more important in corporate governance since they are essential tools in regulating management behaviour. The establishment of a large level of ownership by institutional investors led to lesser earnings management (Elyasiani et al., 2017). Jiambalvo et al. (2002) found that institutional shareholders are considered more competent investors than non-institutional investors, who use current knowledge to forecast future income.

There are two opinions on institutional ownership and management of earnings in the literature review. First, high-level institutional ownership has incentives to limit management actions. Latif et al. (2017) studies have proven that institutional shareholder control in corporations is connected with less earning management. In second view, a lesser degree of participation and shareholding, institutional investors focus on profits generated in the near term rather than the company's long-term interest Furthermore, a study (Popoola et al., 1916; Charitou et al., 2007) found that there was a positive correlation between institutional ownership and effective earnings management.

H4: Institutional ownership has negative and significant relationship with earning management.

2.4. Firm characteristic, ownership structure and earning management

A company's resources are distributed by two groups: corporate managers and external block holders. Leverage decisions are influenced by ownership structure during the decision-making process. The firms owned by managers are unlikely to utilise debt to finance their projects. Comparatively, firms with managerial control should retain a larger portion of their profits than those with owner control. The usage of debt limits a manager's options and increases the likelihood of delinquency (Jensen 1986).

When large corporations have to create favourable financial results and have more negotiating power with accountants, they can fabricate the company's earnings (Ali et al., 2015). Small enterprises hold managerial ownership more often than large ones (Imanta, 2011). Ali et al. (2010) propose that Small businesses should encourage managerial ownership to fill the gaps in the current corporate governance framework.. Large enterprises should have fewer earning management incentives since their political expenses are higher and more mysterious to financial specialists and investors (Watts and Zimmerman, 1999). Firms of large size should be more careful in designing its ownership structure and ther are adviced to keep balance between ownership concentration and equity block holders (yang et al., 2009).

However, In cases of free cash flow, Mechli Nekhli (2019) investigate the moderating effects of corporate governance and ownership characteristics on earnings management practises. The findings highlight the opportunistic conduct of managers who engage in earning management tactics to raise reported earnings. In addition, institutional investors and managerial ownership both contribute to a reduction in the amount to which earnings are managed. Due to their financial and technical expertise, institutional investors invest substantial capital in corporate control and rely on financial experts to more accurately determine the worth of their assets (Jensen and meckling, 1976; Agrawal et al., 1992). Consequently, institutional ownership may defend shareholder interests and alleviate agency problems

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(Wang, 2018). Institutional investors who control a significant amount of capital discourage managers from acting opportunistically and can therefore limit aggressive earnings management.

H_5: Concentrated ownership can moderate the interaction between firm size and earning management.

H_6:Institutional ownership can moderate the interaction between firm size and earning management.

H_7: Concentrated ownership can moderate the interaction between financial leverage and earning management.

H_8: Institutional ownership can moderate the interaction between financial leverage and earning management.

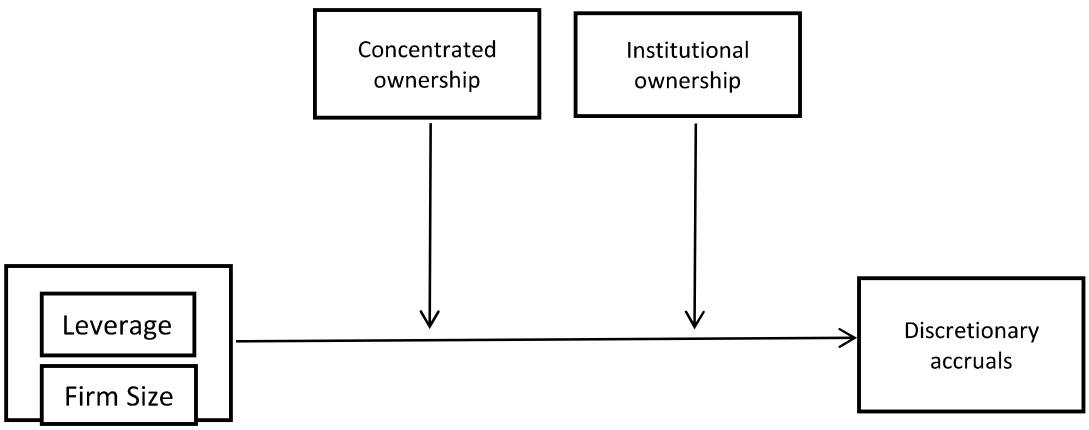

Figure 1. Conceptual framework

3. Methodology

3.1 Sample:

The focus of this study is to analyse the impact of Firm characteristics (firm size, financial leverage) on earning management, using Ownership structure (concentrated ownership, and Institutional ownership) as a moderating variable. This quantitative research is analysed and reported on secondary data. The current study analyses panel data from chosen companies from 2008 to 2019; the sample size is 139 publicly traded companies spanning all non-financial sectors on the PSX.

Earnings management (EM) is the dependent variable in this study.Discretionary accruals (DA) are substitutes for earning management. There are two methodologies or procedures for estimating DA: one is to use the balance sheet figures, referred to as the balance sheet method, and the other is to use the cashflow statements to estimate total accruals, referred to as the cashflow statement approach. To determine total accruals, we use a cashflow technique. The following equation determines total accruals.

$$TA_{it}=NI_{it}-CFO_{it} \quad (1)$$

Where

TA_{it} = Total accruals at t period for firmi

NI_{it} = Net income before tax at t period for firmi

CFO_{it} = Net cashflow from operating activities at t period for firm i

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The modified jones model (Dechow et al., 1995) extracts DAC and NDAC from overall accruals.This model indicates that changes in receivables (REC) offset the changes in revenue (REV). The NDA component is measured by the following formula:

$$\mathrm{NDAC}_{i,t} = \alpha_0\left(\frac{1}{A_{i,t-1}}\right) + \alpha_1\left(\frac{\Delta\mathrm{REV}_{i,t-1}-\Delta\mathrm{REC}_{i,t-1}}{A_{i,t-1}}\right) + a_2\left(\frac{PPE_{i,t}}{A_{i,t-1}}\right) \quad (2)$$

Where

$A_{i,t-1}$ = Total asset for firm i in year t-1,
$REV_{i,t-1}$ = Change in net revenues for firm i in year t-1,
$REC_{i,t-1}$ = Change in account receivables for firm i in year t-1,
$PPE_{i,t}$ = Gross property plant and equipment for I in year t-1,

The Delta value represents a one-year change in variables. (α) Represents the estimated coefficients. To estimate these coefficients, the following formula is used:

$$\frac{TA_{i.t}}{A_{i,t-1}} = \alpha_0\left(\frac{1}{A_{i.t-1}}\right) + \alpha_1\left(\frac{\Delta REV_{i,t-1}-\Delta REC_{i,t-1}}{A_{i,t-1}}\right) + \alpha_2\left(\frac{PPE_{i,t}}{A_{i,t-1}}\right) + e_{i,t}$$

Where

TA = Total accruals for firm *i* in year *t* divided by totalassets for firm *i* at the end of year *t*-1;

$$DAC_{i,t} = \frac{TA_{i,t}}{A_{i,t-1}} - NDAC_{i,t} \quad (3)$$

3.2. Model

In this study, two models of regression analysis were utilised for hypothesis testing. Regression analysis investigates the correlation between independent and dependent variables by testing the following equation:

$$DAC_{i,t} = \beta_0 + \beta_1 SPZ_{i,t} + \beta_2 LEV_{i,t} + \beta_4\, COWN_{i,t} + \beta_5 + \beta_6 IOWN_{i,t} + \beta_7 GROWTH + \beta_8 ROA + \varepsilon_{i,t} \quad (4)$$

Second, moderated regression analysis conducts a moderating variable test using the following equation:

$$DAC_{i,t} = \beta_0 + \beta_1\,(SPZ * COWN)_{i,t} + \beta_2(SPZ * IOWN)_{i,t} + \beta_3\left(LEV * COWN_{i,t}\right) + \left(\beta_4(LEV * IOWN)_{i,t} + \beta_5\left(GROWTH_{i,t}\right) + \beta_6\left(ROA_{i,t}\right) + \varepsilon_{i,t} \quad (5)$$

Where

$DAC_{i,t}$ = Discretionary accruals proxy for earning management.
$COWN_{i,t}$ = Shares held by top 5 shareholders/ total shares outstanding.
$IOWN_{i,t}$ = Number of shares held by institutions / total shares outstanding.
$SPZ_{i,t}$ = Size of company measured by log submission Total Asset.
LEV= Leverage (total debt to equity ratio).
GROWTH= Revenue Growth; (revenue $_t$ – revenue $_{t-1}$)/ revenue $_{t-1}$.
ROA= Return on the asset;net income to total asset ratio.

4. Results and Discussions

4.1. Multiple regression analysis

The Hausman test's p-value is 0.00001, which is statistically significant. It refers to employing the fixed-effects model as opposed to the random-effects approach.

Table 1: Correlated Random Effect - Hausman Test

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Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	29.163950	6	0.0001

Table 2: Fixed Effect Regression Results of Model 1

Variable	Coefficient	Std. Error	t-Statistic	Prob.
FIRM_SIZE	-0.046290	0.032018	-1.445765	0.1484
LEVERAGE	-0.017087	0.042604	-0.401076	0.6884
INS	0.086849	0.148586	0.584500	0.5590
OCONC	-0.336617	0.072391	-4.649990	0.0000
ROA	-0.012252	0.102947	-0.119009	0.9053
GROWTH	-0.002447	0.001557	-1.571246	0.1163
C	0.623746	0.713573	0.874116	0.3822

R-squared	0.173927	Mean dependent var	-0.594967
Adjusted R-squared	0.095821	S.D. dependent var	0.688912
F-statistic	2.226818	Durbin-Watson stat	1.185742
Prob(F-statistic)	0.000000		

The dependent variable in Table 3 above shows Discretionary accruals (DAC) whereas Firm size, leverage, INS, OCONC are the independent variables of the study,as control factors; the study also inspects the return on assets and growth rate.The statistical significance of a result is shown by 5%,0.05.

Based on the results of testing the hypothesis H_1 shows that Firm size has insignificant and negative effect on earning management. This is seen from insignificance level of 0.148, which is greater than 0.05. The study findings are in accordance with (Llukani, 2013; Siregar and Utama, 2008; Bassiouny, 2016; Naz et al., 2011; Robin and Wu, 2015), they observed no substantial variation between big and small companies in terms of earning management practises and strategies. Hence H_1 is rejected.

The result of financial leverage show a insignificant and negative relationship with the earning management as its value is greater than 0.05, which leads to rejection of H_2. Results are similar to the findings of (Tonye & Seth Sokiri, 2020). While in the third hypothesis, the relation between concentrated ownership and earning management is confirmed. We found a negative and significant relationship with p-value (0.000), so H_3 is accepted. Indeed, concentrated ownership is beneficial for preventing the management temptation to manipulate earnings. The observed negative association is congruent with Jensen and Meckling's agency theory (1976), which contends that concentrated ownership helps managers realign their interests with those of corporations (usman and yero, 2012).

Institutional ownership value is positive but insignificant. The H4 of this study is rejected, indicating that institutional shareholders are interested in short-term benefits and are more inclined to sell their investments in a short period of time. Looking at control variables, ROA is negatively related to earning management, which is insignificant. These results are in line with (Grimaldi and Muserra, 2017) and contradicts with (Usman and YERO,2012). Similarly GROWTH has a negative

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coefficient and is statistically insignificant. These results contradicts with the study of (Syed Hamid Ali Shah et al., 2021).

The F-value is 2.22 with probability of 0.000, this shows the significance of model. R square value of 0.17 shows that 17% variation in earning management is explained by firm characteristics and ownership structure. Furthermore, the Durbin-Watson statistic is utilised to detect whether or not autocorrelation exists in the residual through regression analysis (prediction error), is less than 2 (Durbin-Watson statistics =1.18), demonstrating the existence of a positive serial correlation

4.2 Moderation Analysis

Table 3: Correlated Random Effects - Hausman Test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	38.528956	10	0.0000

Table 4: Fixed Effect Regression Results of Model 2

Variable	Coefficient	Std. Error	t-Statistic	Prob.
FIRM_SIZE	-0.102907	0.039902	-2.578961	0.0100
LEVERAGE	-0.017673	0.075296	-0.234712	0.8145
INS	-1.466434	1.570361	-0.933820	0.3505
OCONC	-2.020607	0.848430	-2.381582	0.0174
ROA	-0.017296	0.102877	-0.168122	0.8665
GROWTH	-0.002478	0.001555	-1.593102	0.1113
FS x IOWN	0.079654	0.070318	1.132767	0.2575
FS x COWN	0.074257	0.037723	1.968493	0.0492
LEV x IOWN	-0.309039	0.200962	-1.537798	0.1243
LEV x COWN	0.016575	0.108408	0.152891	0.8785
C	1.892773	0.885181	2.138289	0.0327
R-squared	0.178217			
Adjusted R-squared	0.098149			
F-statistic	2.225813			
Prob(F-statistic)	0.000000			

The result of hypothesis verification can be seen in table. Hypothesis testing about the influence of firm size on earnings management moderated by institutional ownership shows the coefficient of 0.0796 with p-value is not significant, this means that H_5 is rejected. While the result of hypothesis testing H_6 shows that concentrated ownership can moderate the firm size relation to earning management. This is seen from the significance level of 0.04 with the coefficient value 0.0742. With concentrated ownership, the prospect of earning management decreases as firm size increases. As a result, H6 is approved.

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Further more, testing of H_7revealed that Institutional ownership had no statistically significant moderating influence on the relationship between leverage and earnings management. Coefficient value -0.309 with p-value 0.124. H_7 is also rejected. The coefficient of leverage is positive with concentrated ownership and is also statistically insignificant with p-value. This indicate that leverage moderated by ownership concentration cannot effect the quality of earnings.

5. Conclusion

This study was carried out to determine the relationship between firm characteristics (firm size, leverage) with earning management under the moderating effect of ownership structure (concentrated ownership, institutional ownership) on 139 firms listed on Pakistan Stock Exchange. The findings of this study indicate that just 17% of the diversity in firms' earning management techniques can be ascribed to the firm's characteristics and ownership structure, which, while modest, is quite close to and consistent with previous study examining the same effect. Considering the outcomes of this study firm size, leverage and institutional ownership does not influence earning management, while concentrated ownership shows significant and negative relationship with earning management. Concentrated ownership is helpful in preventing the management tendency to mange the earnings.

Additionally, the results seem to indicate that concentrated ownership diminished the influence of firm size on earning management. The relationship between business characteristics and earning management is also unaffected by institutional ownership.This is perhaps because most businesses in Pakistan are family-owned and concentrated.

5.1. Implications

This study expands previous studies on the importance and quality of financial reporting. For the purpose of making investment decisions, stakeholders and investors in developing nations rely on the published financial information; hence the findings are crucial. The findings can help organisations such as the Pakistan stock market and investors comprehend how ownership structure and corporate characteristics influence earnings management.

5.2. Limitations

This study has some limitations, including a small sample size of 139 Pakistani non-financial enterprises. Because of the differences in accounting procedures and regulatory restrictions, the findings of this study cannot be applied to financial firms. Additional proxies of ownership structure and firm characteristics, such as firm age and managerial ownership, may be included in future research projects.

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