

## ***THE ROLE OF FIRM CHARACTERISTICS IN THE ACCOUNTING RESEARCH***

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### **Abstract**

Since the early 1970s a new stream of positive accounting research started to overwhelm the field. It is the idea of predicting managers' behaviour based on specific facts. A part of this research stream examines the linkages between firm-specific characteristics and accounting activities within firms.

This paper aims to provide a literature review of this particular body of research. This review is concerned with collecting the main idea and theories behind the proposed effect for each characteristic. What distinguishes this paper is that it provides future researchers with an intellectual collection of different ideas and theories which make a complete frame for advanced research. Firm characteristics are extensively used in both finance and accounting research. However, only the characteristics that appear most frequently in the accounting literature are considered here. The author tried to be extensive in withdrawing ideas and theory but this does not mean that all extent studies are covered.

Key Words: accounting, firm size

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### **1. Introduction**

At the beginning of the seventies accounting researchers started a new direction of research in which they try to find the factors that explain quality and extent of disclosure for instance Singhvi and Desai, 1971 and (Buzby, 1975). Using the frame of the Positive accounting theory they propose that some firm characteristics are driving management's behaviour of which accounting decisions are a part. A wider range of characteristics is used in explaining financial theories but still what has been employed in accounting is less. Disclosure studies

continues to be dominant until now; nevertheless during the nineties researchers thought of using the same disclosure literature to explain other accounting aspects such as the compliance with International standards, choice of specific accounting policies, adoption of accounting software and voluntary purchase of audit. Characteristics discussed below are only the ones which are most frequently examined in the accounting literature but not all ones. Furthermore, whereas results depicted here refer to latest studies arguments are mainly taken from the earlier studies which are considered to be the roots of this literature.

## 2. Firm size

Firm size is the most common factor in our target literature. In modern economies, large companies work in an environment, with different laws, different market statuses, different segments in stock exchanges, and different relationships with government. A variety of arguments are introduced for the size hypothesis. **Agency costs** is the main argument for the size. Jensen and Meckling (1976) explain that agency costs increase with the amount of outside capital. Agency costs rise as a result of the separation between management and ownership (this includes shares and debt). Conflicts of the interests between managers (agents) and both shareholders (principals) and debt-holders create the need for bonding and monitoring contracts between the managers and both shareholders and debt-holders. The costs of such contracts are the components of agency costs divided into equity agency costs and debt agency costs. Bonding and monitoring costs of equity will include the costs of external auditing and performance compensation schemes, whereas debt bonding and monitoring costs will include the costs of writing covenants. Leftwich, Watts and Zimmerman (1981) suggest that in larger firms, the proportion of the capital held by outsiders is higher than in smaller firms (ownership structure hypotheses). Ettredge et al (1994, p.138), on the other hand, explain that agency costs are affected by size in two dimensions: internal agency costs and external agency costs. At the internal level the assumption is that “the number and complexity of intra-company relations and, in turn, agency costs increases with the size and complexity of the company” (p.138). In larger and more complex firms, managers cannot control both planning and operations. Thus these activities will be separated and this leads to multidivisional organisations and as a result of that to an increase in internal agency costs. **Costs and benefits:** Chow (1982) puts forward this argument suggesting that costs of setting up a “monitoring/bonding” system are almost fixed and that it is a costly process, especially for smaller firms. Therefore, the marginal cost of operating this system

is likely to decrease with firm size. Another Chow (1982) also states that because of the fixed component of costs, the cost per unit of size decreases. **Proprietary costs** is about small firms being competitively disadvantaged when compared to their counterparts of larger firms in the same industry. Another dimension is **Political costs** introduced by Watts and Zimmerman saying that larger firms are more vulnerable to government scrutiny and political pressure (Tendeloo, 2003). Political costs can also be the result of the implicit contracts which larger companies have with particular groups in society such as trade unions, consumers and environmental groups (Milne 2001). Finally, **Analysts following** suggested by Barry and Brown (1986) states that annual reports of large companies are more likely to be examined by financial analysts. Furthermore, Lang and Lundholm (1993) argue that incentives for private information acquisition are greater in larger firms. Hence, profit for trading private information is higher in larger firms.

The use of these arguments in disclosure studies says that disclosure increase in large firms to reduce agency costs, lessen political costs, attract analysts whereas disclosure decrease in small companies because of proprietary costs. The literature on voluntary choice of IFRSs<sup>1</sup> hypothesizes that choice of developed standards is highly supported in large firms for the same reasons of adhering to voluntary disclosure. Whereas, the literature on the choice of specific accounting policies put forward the size arguments according to the expected effect of each policy. Another type accounting studies is on the choice to adopt accounting software such as ERP or accounting systems such as ABC. The vast majority of studies in the literature support the size hypothesis. Chow (1982), Chow and Wong-Boren (1987), Cook (1989, 1991), Ettredge (1994), Hossain et al (1994, 1995), Naser and Wallace (1995), Inchausti (1997), Dumontier and Raffournier (1998), and Leuz (2004); and more lately, Untari (2010), Abdel-kader and Luther (2008), Aledo, Martinez and Diazaraque (2011), Galani, Alexandridis and Stavropoulos (2011), Lucyanda and Siagian (2012) are just a sample of a large number of studies that show a significant relationship between size and different companies' financial reporting practices.

However some find contradicting results such as, Turrent and Ariza (2012), who found insignificant effect for size on the corporate transparency on the Internet; Takhtaei and Mousavi (2012), who concluded that size has a significant but negative relationship with disclosure quality.

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<sup>1</sup> This is a general term used to mean both IFRS and IASs.

### 3. Ownership structure and corporate governance

As indicated earlier agency costs result from conflicts between managers and shareholders. Ownership structure may be defined<sup>2</sup> as the allocation of companies' shares between investors. It should show the concentration of shares and proportions of equity held by outsiders and insiders (management).

It should be indicated here that ownership structure and size are quite interlinked, but the way the ownership of a firm is structured may determine the level of agency costs in the firm. For example, in a firm owned completely by managers, there will be no external agency<sup>3</sup> costs because there is no separation between ownership and control. On the other hand, in a firm with outside shareholders, external agency costs will emerge. Furthermore, the allocation and concentration of these shares held by outsiders can be a decisive factor in the size of the agency costs. Literature on the impact of the ownership structure on accounting is discussed from different perspectives. While some authors discuss the impact of management ownership (management shareholding), others discuss the impact of the diffusion of ownership. Drawing on Holthausen and Leftwich (1983), Craswell and Taylor (1992, p.299) state that, although it is difficult to determine to what extent a firm is owner rather than manager controlled, "the extent to which ownership of the firm is widely held, rather than closely held is likely to reflect this distinction". According to the disclosure literature, disclosure is expected to increase in companies with defused ownership, companies with small shareholdings blocks, companies with insignificant management ownership in order to reduce agency costs. This same argument applies to support the choice to adopt IFRSs. Chow (1982) hypothesises that the propensity to engage in voluntary auditing is inversely related to managers' ownership share.

"Corporate governance" is also another angle to argue for the effects of ownership structure and agency costs. Bowen, Rajogopal and Venkatachalam (2008) study the association between corporate governance and accounting policy discretion. Adeyemi and Fagbemi (2010), say that corporate governance represented by the composition of board can significantly affect the audit quality. Nandi and Gosh (2012) look at the effect of corporate governance on disclosure. Waweru and Riro (2013) consider ownership structure and board composition main characteristics of corporate governance influencing earning management.

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<sup>2</sup> A simple definition suggested by the researcher to introduce the argument and the hypothesis.

<sup>3</sup> as discussed in the size hypothesis, Ettredge (1994) divides agency costs into internal and external costs

Results of studies examining the effect of ownership structure are mixed. Studies by Craswell and Taylor (1992), Raffournier (1995) and Wallace and Naser (1995) find that there is no significant relationship between ownership structure and the extent of disclosure. However, Hossain et al (1994) and Ruland, Tung and George (1990) find that this factor is significantly related to voluntary disclosure levels. Leuz (2004) finds that firms' free float is positively associated with cash flow and segment disclosures by German companies. For the studies related to compliance with IFRSs, Dumontier and Raffournier (1998) conclude that ownership structure has an important influence on voluntary compliance with IFRSs. On the other hand, Cuijpers and Buijink (2005) find that it is not correlated with the tendency to adopt non-local GAAP. Lucyanda and Siagian (2012) find that management ownership has no effect on corporate disclosure. Lately, Mulyadi and Anwar (2012) could not find significant influence for governance on CSR disclosure. Also, Duo et al (2013) found that reputable block-holders have significant association with financial reporting quality. Contradiction is found and may be explained by various traditions of corporate governance in different countries, differences in organisations' cultures and may be defective proxies.

#### **4. Leverage**

The leverage ratio show how the capital of a firm is structured (capital structure). The way leverage is measured may differ across studies according to different perceptions about debt and equity. Jensen and Meckling (1976) argue that managers of highly levered companies will have a strong incentive to engage in risky activities which promise high profits with a low probability of success. Gains from the success of such activities will be captured by owner-managers, whereas their failure will be borne by creditors. This argument suggests that potential wealth transfers from debt-holders to shareholders increase as leverage increases. Most of the arguments in the literature on leverage and its effect on managerial decisions and accounting practices were based on this suggestion by Jensen and Meckling (e.g., Leftwich et al (1981), Craswell and Taylor (1992), Hossain et al (1994), Hossain et al (1995), Dumontier and Raffournier (1998)). The main notion of these studies is that with increasing leverage, agency costs increase. The idea of agency costs caused by the conflict of interests which arises between shareholder and debt-holders and using accounting practices to reduce them is criticised by Schipper (1981) in her comments on the work by Leftwich et

al (1981)<sup>4</sup>. The relationship between accounting and leverage may take various forms. In some cases the process of setting debt covenants, which are a tool for monitoring the agency relationship between management and debt-holders, make use of the accounting figures. Furthermore, debt covenants may also refer to accounting data when they impose constraints on leverage ratios (Weintrop, 1990). Craswell and Taylor (1992) indicate that managers tend to avoid accounting methods which lead to probable violation of technical borrowing limitations expressed in accounting numbers. Dumontier and Raffournier (1998) argue that the volatility of profits can be used to monitor the agency relationships between shareholders and creditors. Therefore, using accounting standard which restrict earnings management helps in facilitating this monitoring role, which is more needed in highly levered companies. However, although the role of US GAAP in restricting earnings management is fairly evident in the literature, the role of IFRS in restricting earnings management is still debatable. Zarzeski (1996, p 24) proposes that companies with lower leverage are likely to “have higher levels of investor-oriented disclosure”. The explanation provided is that companies with high leverage are expected to exist in countries with high uncertainty avoidance (conservatism), developed bank-firm relationships and cross-holding ownership. In such cases firms will share private information with their creditors. Tarca (2004) argues for using leverage as a proxy to capture the firm’s dependence on equity capital. This implies that firms with higher leverage are relatively less dependent on equity capital, and are hence less likely to face shareholders’ demands for information. This, in turn, means less pressure to use disclosure to reduce information asymmetry with shareholders. Results are mixed and not consistent with the predictions of agency theory. Chow (1982) and Ettredge et al (1994) find a positive relationship between the firm’s leverage and voluntary auditing. For voluntary disclosure studies, Chow and Wong-Boren (1987) conclude that there is a positive but insignificant relationship between leverage and voluntary disclosure. The univariate analysis by Craswell and Taylor (1992) provides a moderately significant positive relationship between leverage and the disclosure of reserves by oil and gas companies. Hossain et al (1994), Hossain et al (1995) find a marginally significant relationship between leverage and voluntary disclosure. With regard to studies related to compliance with IFRSs, Dumontier and

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<sup>4</sup> One of the earliest studies examined the relationship between leverage and accounting practices (interim reporting), where one can follow such arguments.

Raffournier (1998), Cuijpers and Buijink (2005) find that effect of leverage on voluntary adoption of international standards is insignificant. Lately, leverage found to be insignificant by Lucyanda and Siagian (2012) on social disclosure and by Turrent and Ariza (2012) on transparency on the Internet. Finally, Takhtaei and Mousavi (2012) exclude leverage because of being insignificant in long list of studies.

## **5. Profitability**

Figures related to profitability are used by analysts and investors to evaluate companies' performance. The importance of profit figures have persuaded many researchers to think that profitability can have an effect on managers' behaviour which includes the choice of accounting practices. Profitability can be related to three important issues arrangements for managers' compensations where profitability is desired, signalling theory where profitability is considered as a signal of good news to avoid undervaluation, and political costs where pressures are put on profitable companies (Inchausti, 1997). Results of previous studies on profitability are not very supporting. Inchausti (1997) does not find any significance in the relationship between voluntary disclosure and the profitability of Spanish firms. Leuz (2004) finds a negative but insignificant association between profitability and cash flow statement disclosures, whereas a significant negative association is found between profitability and segment reporting. Dumontier and Raffournier (1998), in turn, do not find any significant association between profitability and the tendency of these companies to comply with IFRSs. Finally, Street and Gray (2002) do not find significant relationship between profitability and the extent of compliance with IFRSs. Turing to recent results, Merkley (2010) proved significant effect of profitability on R&D disclosure but with contradicting directions. Mensah (2011) find it to be an important determinant of Internet financial reporting; whereas Ghanem (2011), find it statistically insignificant on the same issue. Finally, Mulyadi and Anwar (2012) prove profitability's influence on CSR disclosure.

### ***Auditor Identity***

Interest in the influence of auditors' identity goes back to DeAngelo (1981), who concludes that the larger the auditor<sup>5</sup>, the less the opportunistic behaviour, and the

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<sup>5</sup> DeAngelo assumed that the larger companies are the ones which have a larger number of clients.

higher the quality of audit and suggests that being the Big-8 maybe a good proxy for auditor quality. Later research by Palmrose (1988) and Caplan and Raedy (2003) support the conclusion of DeAngelo.

The number of audit firms which are considered to be the biggest in the international auditing market and good quality providers has changed several times during the last three decades to become the Big-4. Watts and Zimmerman (1986, p323) argue that “Auditors have incentives to lobby with the SEC and FASB for more complicated accounting. Such increased complexity could increase the quantity of auditing and the demand for the auditor’s services”. With developed standards such as IFRS, the Big 4, in particular, have an advantage over other firms and auditors generally may be better informed than the preparers of accounts. Watts and Zimmerman (1986) indicate that the role of auditors can increase the market value of a firm by imposing increased disclosure and consequently reducing its agency costs. Hossain et al (1994) refer to the role of auditors in reducing agency costs by limiting the opportunistic behaviour of agents (see size hypothesis). Nobes (2000) argues that international accountancy firms are one of the groups involved in the process of accounting harmonisation. His point of view is that their work across the world, which includes preparation, consolidation and auditing of financial statements, will be easier with harmonised accounting practices. Moreover, it will increase the mobility of their staff, lead to cost savings for these international firms. Furthermore, it will make it easier and cheaper for the central offices of these firms to monitor the quality of the work achieved by their offices abroad and by other partners. According to Watts and Zimmerman (1986) large auditor firms may strengthen and enhance their reputation as independent auditors by encouraging their clients to adopt a stringent set of accounting standards. Chan, Lin and Mo (2006) find that local auditors in China are subject to more political pressures than non-local ones.

Empirical results are, to some extent, inconsistent with each other. In Hossain et al (1994), a partly<sup>6</sup> significant effect is found on voluntary disclosure, but no significance is found by Hossain et al (1995). Dumontier and Raffournier (1998), find also partly significant on voluntary adoption of IFRSs. Craswell (1992) on the other hand, shows significance on the extent of discretionary disclosure. Looking at more recent results, Francis and Wang (2008) find a significant joint effect for auditor identity and investor protection on earning quality. Ozkan and Balsari (2009) do not find that identity of auditor is influential on accounting

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<sup>6</sup> “Partly” is used by the author to mean significant in just part of the analysis and not all of it.



policies disclosure. However, Lorencini and da Costa (2010) find it to be an influencing factor in the choice of specific accounting policies..

## **6. Listing Status (Cross-listing)**

Listing status is about whether companies are listed only on one domestic stock market, listed on more than one domestic stock market or listed on both domestic markets and foreign markets. Giray et al (1995a, p43-44) suggest some major reasons for listing on foreign markets: the need to access additional capital, the desire to improve the marketability of a company's shares by broadening the shareholder base, the perceived benefits of an enhanced firm image in international markets and as a general reason to lower the cost of capital. Furthermore, Cooke (1989) states that multiple listed companies are often interested in foreign exchange since foreign operations are often financed by foreign capital (hedging reasons). Burgstahler, Hail and Leuz (2004) consider another aspect to listing status which is about a company being private or public; but this aspect is not considered in this paper. Cooke (1989) argues that multi-listed companies have higher agency costs than those which are solely listed on domestic markets, because they probably have a larger number of shareholders and more dispersed shares (monitoring problems) (see size hypothesis). Moreover, Cooke also states that multiple listed firms are much more visible to the public than other firms (the same arguments for size). Gray et al (ibid) argue that in the context of capital market pressures a motivation for companies to voluntarily disclose more information is the desire to lower the firm's cost of capital through the reduction of information risk. Leuz and Verrecchia (2000) also hypothesise that multi-listed firms will decrease their cost of capital by compliance with an "international reporting regime" such as IFRSs which give investors better frame for comparability. In several studies such as Gray et al (1995a) and Saudagaran and Meek, (ibid), it is difficult to separate the discussions about listing status from that on internationality. However, studies on the effect of internationality are limited. Latest results seem, in general, to be supporting the cross listing hypothesis in the disclosure literature such as Ballas and Tzovas (2010) and Bhayani (2012); Crawford, Lont and Scott (2013) both find that listing status significantly affect disclosure . However, Galani et al (2011) finds it to be insignificant with environmental disclosure.

## 7. Industry (line of business):

Accounting regulations and standards can be sometimes tailored for specific industries. Banks and financial institutions, for example, are usually regulated by a different set of accounting rules and standards. Companies operating in the oil and gas sector for example, have different accounting issues which, in some cases, need a separate set of rules or standards. In fact, many industries have certain accounting problems of their very own, which need special attention on the part of standards setters. The choice of specific accounting policies can be crucial for specific industries. A Research by KPMG and Goldman Sachs in 2002 proposes that development costs and environmental provisions and major repairs are important for the Chemicals and Pharmaceuticals sector, whereas revenue recognition and intangibles are important to the Media and Telecom sectors. Watts and Zimmerman (1986) indicate that some auditing firms specialise in certain industries. Cuijpers and Buijink (2005) report that firms in some industries may prefer to use non-local GAAP because of certain provisions they do not find in local regulations. In industries with lower proprietary costs, compliance with detailed disclosure or well developed GAAP may be more likely. From the latest studies one can find Beest, Braam and Boelens (2009) test the effect of industry on accounting quality, Martinez and Diazaraque (2011), test its effect on the choice of options within IFRSs, and finally Turrent and Ariza (2012) examine the effect of industry on information transparency on the Internet.

As in most the previous hypotheses, results of previous studies are inconclusive. Leuz (2004) concludes that voluntary segment disclosure is higher in industries with low proprietary costs<sup>7</sup>. Harris (1998) and Shin (2002) find evidence of a relationship between market competition and voluntary disclosure. Cuijpers and Buijink (2005), on the other hand, do not find a significant difference in the tendency to adopt non-local GAAP across manufacturing and non manufacturing industries. Finally, Street and Gray (2002) find a significant impact of industry type on the extent of compliance with IAS. Lately, all of Beest, Braam and Boelens (2009), Martinez and Diazaraque (2011) Turrent and Ariza (2012) conclude that industry is an influencing factor on different accounting practices.

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<sup>7</sup> At the sample period (1999), the German firms were not required to provide complete segment reporting.

### ***Summary and Conclusion***

Using firm characteristics in the accounting research has been exists in several subjects including disclosure, voluntary adoption of non-local standards, choice of accounting policies, Internet financial reporting (IFR), voluntary auditing, interim reporting, and the adoption of sophisticated management accounting. The characteristics chosen in this paper are most frequently examined ones, namely firm size, ownership structure, leverage, profitability, listing status, auditor identity and industry. Size seems to be the most effective factor that drives managers' accounting decisions. Companies' size is interlinked with most of the other factors which may mask the effectiveness of those factors. Ownership structure is also an effective factor. However, there are several concepts of what should be considered as ownership structure. Results about leverage and profitability, on the other hand, are somehow mixed up. Although research examines the influence of firm characteristics started as early as 1971, it is still attracting researchers in 2013. The largest proportion of this body of research is about disclosure, but new related issues are still emerging.

The researcher suggests that concentration should be on diversified accounting issues and more attention should be given to the actual compliance with IFRSs, and the choice of specific IFRS options.

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