CHAPTER I
INTRODUCTION

1.1 Research Background

Due to the world economy changed in this past decades, the financial fraud is increasing drastically especially at the beginning of 21st. The major factors that have changed were in globalization, business integrity, and technology. There have many cases that related to earnings management frauds. These problems impact to the global economy also brings lack of trust of investor for the market stock and lead the misleading information about the earning in company's financial reporting. Earnings management play a crucial role for income statements and balance sheets, as they obtain for some self-interested goal (Febriyanti, Putri, & Suyono, 2016).

The vast majority of research on earnings management is using the references of all public companies but there is still less study has examined earnings management using the sample of family firms. This study believes that family companies can provide an interesting topic to analysis the hypotheses formulated on earnings management. For the purpose of this study, family companies are defined as a commercial organizational, in which the decision making is influenced by two or more family members that related by blood and marriage (Suyono, 2016).

The level and quality of corporate governance that occupied in Indonesia companies are very weak, this is due to the protection rules in Indonesia are not strong enough to control the companies in Indonesia (Hidayanti & Paramita,

2014). Thus, for the researcher who is finding the topic of good corporate governance is easier to find the evidence for analyzing each factor of corporate governance in Indonesia. Then, Indonesia's government realize that the public concern is important. Therefore, the regulator of Indonesia such as financial service authority (*Otoritas Jasa Keuangan*) and Indonesia stock exchange (*Bursa Efek Indonesia*) have tried to protect the companies' activities by implementing the concept of good corporate governance for the purpose of companies to survive in the long-term period.

The majority of companies in the Indonesia Stock Exchange are highly concentrated ownership structures that indicating with the high existence of family firms in Indonesia (Suyono, 2016). As well as, the earnings management has become an important issue for companies that have controlled by family members because the family-controlled companies are less likely to have agency problems than non-family-controlled companies. They are rarely in separating of ownership and management in family-controlled companies. However, in family-controlled companies do have more serious of type-II agency problems that between family-controlled and minority shareholders (Adıgüzel, 2013).

The manager might manipulate the earnings in the real activities are because of several conflicts of interest and the existence of asymmetry information between the agent and the principle. To minimize the case of manager do earnings management for negative purposes and to alignment all the stakeholders' interest, the company need to do a monitoring mechanism for the company. The way for overcoming the problems of unbalanced interest between

agent and principle can be done via good corporate governance. Good corporate governance is important in a company for reaching the company's target. It can help a company operates well because it is a system that could control and leas the company (Febriyanti, Putri, & Suyono, 2016).

Family firms is an organization controlled by family members. Family-controlled companies usually manage by multiple family members and also the multiple generations of family members. In the family-controlled companies usually monopolized the ownership of shareholders. Thus, the family members intensely will take care of their business' reputation and have a sense to responsible for the sustainability of the company (Paiva, Lourenço, & Branco, 2016).

Family firms have been characterized by the relationship between managers and controlling family. This can analyze from both agency theories and the stewardship theory. The agency related theories point to the problems as the family firms' managers are chosen more on the basis of the personal relationship rather than by formal interview and searching for the best candidate. The stewardship related literature is stewardship that set at the highest level of the company, they can apply different complementary and suggestion for family firms' owners. The manager who operates in a business with a long-term period of time would more likely for them to be farsighted stewards of the business and they would like to manage, maintain and establish for the better performance of the company. In this time, they are less focus on short-term period operations and performance, this impacts them lacked in making opportunistic at that moment

and do not have good decisions making on firm operations (Annalisa, Garen, & Lorenzo, 2008).

There has profitability difference between family companies and non-family companies in the industries while every company has a goal of earning in an effort to maintain business sustainability. Companies have better performances are effectiveness in utilizing companies' assets to generate profit (Singapurwoko, 2013). In general, the companies' performance both in operations and profitability in family-controlled companies have gained relatively little attention when compared to the non-family companies that listed on The Indonesia Stock Exchange.

Due to the financial crisis in 1997, the corporate governance structures in companies have become weak. The drastically financial crisis has occurred financial fraud in some large companies like Enron, Merck, WorldCom and other companies in U.S. Thus, for the companies, they need to improve their corporate governance mechanism to make sure that the financial report is reliable, believable, and transparently (Kamran & Shah, 2014) and for the government, they need to stricter the country regulatory (Kusumaningtyas, 2014). This improvement needs to implement in Indonesia and its companies because most of Indonesia companies still lack in providing good corporate governance. Thus, there is high percentage of those companies' manager to manipulate their earnings for both the self-interest actions and for making the earnings look better on the financial statements.

There are five constructs of corporate governance that might impact on earnings management such as the audit characteristic, firm characteristic, ownership concentration, board concentration, and environment determinant. From those corporate governance constructs, this study chooses one or two classifications of each construct. The constructs that used in this study are the audit committee of accounting expert, audit committee independence, audit committee size, audit committee meeting, board size, independent commissioners, managerial ownership and institutional ownership.

In order to examine the earnings quality that provided by Indonesia listed companies. This study seeks to evaluate the factors of corporate governance that may impacts on earnings management in listed family firms in Indonesia Stock Exchange. To evaluate how the corporate governance structures relate to the quality of financial reporting. The title that has formulated by the explanation above is "The Impact of Corporation Governance on Earning Management: Evidence from Family Companies in Indonesia".

1.2 Research Issue

The sample used in this study is all listed family-controlled companies that listed on The Indonesia Stock Exchange. The reason for analyzing family-controlled is because family-controlled business in Indonesia nowadays is increasing continuously, as the same of increasing earnings management frauds. This study is interesting on this topic to know whether the family-controlled firms are more frequently to manipulating the earnings management or not. While most

of the family-controlled companies always face agency theory type-II, which is the conflict between insider stockholder and outsider stockholder. This may lead the misunderstanding of those parties and due to giving them the reason to manipulate earnings for their self-interest reason.

The actions of manipulating the earnings management have raised some cases of accounting reporting is widely known in Indonesia such as PT. Lippo Tbk and PT. Kimia Farma Tbk. For the example of PT. Kimia Farma Tbk manufacturing company listed in Indonesia. PT. Kimia Farma is the oldest pharmacy company in Indonesia that producing and distributing pharmacy. In 2001, the ministry of state-owned enterprise (BUMN) and the capital market supervisory agency and financial institution (BAPEPAM-LK) caught up that Kimia farma's financial report has contained some elements of manipulating and marking up its profit of 30 billion. The markup values were from both sales and inventories.

From the financial fraud that has made by Kimia farma was effect to the reputation of its external auditor which is Hans Tuanakotta & Mustofa (HTM). Due to the failure in detecting the fraudulent in the financial report, HTM suffered for 100 million that need to deposit to state treasury since it is country's regulation. The problems that made by one party might impacts to its related parties as well, therefore, it is expected for companies to provide accurately and transparently information to the public, for not manipulate its financial reporting values.

1.3 Problem Formulation

From the case example above, it can occur questions of some corporate governance factors that might have an impact on earnings management. Therefore, this study is research about the factors of corporate governance that impact to earnings management to analyze the probability of the companies' management in manipulating its earnings is as the following:

1. Is there has a relation between audit committee in accounting expert and earning management in ISE Listed Family Firms?
2. Is there has a relation between audit committee independence and earning management in ISE Listed Family Firms?
3. Is there has a relation between audit committee size and earning management in ISE Listed Family Firms?
4. Is there has a relation between audit committee meeting and earning management in ISE Listed Family Firms?
5. Is there has a relation between board size and earning management in ISE Listed Family Firms?
6. Is there has a relation between independent commissioners and earning management in ISE Listed Family Firms?
7. Is there has a relation between managerial ownership and earning management in ISE Listed Family Firms?
8. Is there has a relation between institutional ownership and earning management in ISE Listed Family Firms?

1.4 Research Objectives and Contributions

1.4.1 Research Objectives

The purpose of this study is to examine whether Indonesia Stock Exchange Listed Family Companies that engage in corporate governance have any factors on earnings management in the financial reporting. The corporate governance includes audit committee of accounting expert, audit committee independence, audit committee size, audit committee meeting, board size, independent commissioners, managerial ownership, and institutional ownership.

Therefore, this study would like to examine the relationship between audit committee in accounting expert and earnings management, audit committee independence and earnings management, audit committee size and earnings management, audit committee meeting and earnings management, board of director and earnings management, independence commissioners and earnings management, managerial ownership and earnings management, lastly, institutional ownership and earnings management.

1.4.2 Research Contributions

a. Author

The author would like to acknowledge more about corporate governance and earning management in Indonesia stock exchange companies, especially in family-controlled companies in Indonesia. This research can give the author a deeper understanding of earnings management in the real activity. It also could be as the author next research reference.

b. Company's management

The result that can give to family-controlled company's management as references on making the decision that related to corporate governance and earnings management. This research also can help management to more understand and easier to make a right decision.

c. Company

The result of this research can give family-controlled company to understand what factors that might give the manager the opportunistic to do earnings management. The company also could more understand its business operation as well as it has adopted good corporate governance. Therefore, the company can operate better and either can generate more profit for the business sustainability.

d. Investor

By acknowledge company's earnings management factors, it can give investor to analyze which firm is better for investing. Although most of the investors only focus on the financial report, but for knowing and understanding the quality of the financial report is necessary for the investor.

1.5 Systematics of Writing

A systematic of writing is written for the purpose to summarize the contents of this reports and short discussions of each chapter in outline, which is as follow:

CHAPTER I: INTRODUCTION

This chapter consists of the research background, research issue, problem formulation, research objectives and contributions, and systematics of writing.

CHAPTER II: THEORITIES AND HYPOTHESIS DEVELOPMENT

This chapter consists of the theories of such as agency theory, stakeholder theory, stewardship theory, corporate governance theory that might have related with the earnings management. This chapter also consists of literature review, hypothesis development, and this study research model.

CHAPTER III: RESEARCH MODEL

This chapter consists of research design, research objectives, operational variables definition, data collection techniques, and data analysis method. The data analysis method uses outlier test, statistic descriptive analysis, and panel regression to analysis the observation data, which using the Chow test and Hausman test for choosing for the best method.

CHAPTER IV: RESULTS AND DISCUSSIONS

This chapter consists of the analysis results such as outlier test result, descriptive statistics, regression panel test result, and hypothesis test result.

CHAPTER V: CONCLUSION, LIMITATION, AND RECOMMENDATION

This chapter consists of the research summary of the overall discussions from chapter one to the chapter four and has given some limitations and recommendations of this study.