CHAPTER II
THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

2.1 Theoretical framework

A corporation consider as a family company is when the member of family has owned more than 20% of shares in the company, or if the family member has not owned more than 20% but they are the director of the company who can directly control the business operation also can consider as a family company (Surifah, 2013). Family companies also can define the business, which has controlled by more than two members of the family in the organization (Suyono, 2016). Therefore, the family companies are more likely to happen the agency conflict type-II, which is the conflict between family ownership and minority shareholders due to the different interest between manager and shareholder (Adıgüzel, 2013).

Agency theory was founded by Ross (1973) and it has further developed by Jensen and Meckling (1976). Jensen & Meckling (1976) define the agency theory is the theory of the relationship between the agent (management) and principal (shareholders) of the corporation. In the agency theory, there has a contract that given from principal (shareholders) to agent (management) for operates their company because it states that between management and owners have different interest. The management who perform the contract has the obligation of their jobs to show their good performance and make the best decision for shareholders. The agency theory was developed for the purpose to fulfill

management goal, which is to maximize and enhance shareholder value (Jensen & Meckling, 1976).

Agency theory arises due to having some different opinions and different ways of operating company between manager and shareholders. Managers tend to do something obtain on their self-interest, they focus on short-term period investment and project to generate higher earnings or it could call as manipulating the financial report to manage the corporation financial looks better. The management result will cause failure in maximizing shareholders wealth (Reny & Denies, 2012).

Earnings management practices also have related to stakeholder theory, which the stakeholder is defined as the party both internal and external that has a contractual relationship between manager and shareholders, whereby manager has the sole objective of maximizing the stakeholder wealth (Jeffrey & Andrew, 2013). The stakeholder is all parties that have or has no relation to a company, that has or has not intent to a company including the minority shareholders, majority shareholders, investors, creditors, employees, and customers.

According to Freeman *et al.* (2010), stakeholder theory is a management theory and business ethnic that discuss the value and moral of managing an organization. The emergence of stakeholder is very important for business because it can strengthen the company to not only focusses on shareholder but also to stakeholders instead (Harrison & Wicks, 2013). Freeman *et al.* (2010) also argue that managers cannot just focus on stakeholders in the company. Otherwise, both

shareholders and stakeholders also need to be considered as individual or group who can affect or is affected by the achievement of the firm's objectives.

The family business has a perspective of doing a long-term period business, it has a target, which is to maintain the sustainability of its company. This characterized of family-controlled companies may give the benefits to their future generation through the business than the business which is non-controlled companies. The stewardship theory has been emerging recently in the literature on earnings management in family-controlled business and it is also as a complementary theory in many others findings (Paiva *et al.* 2016).

Stewardship theory definition that according to Davis, Donaldson, & Schoorman (1997), is a theory that develops for the purposes of management alternatives to agency theory. Thus, the stewardship theory is defines as the situation in which the manager is motivated to do his duties and obligations well that has the same objectives between the agent and principals in the corporation rather than to maintain his individual interests.

There is another theory called corporate governance theory, it is a theory that has a relationship with the company whether to do earnings management or not. If companies have a good corporate governance are less likely to manipulate their financial report but vice versa, if companies could not distribute a good corporate governance so they are likely to manipulate their financial reports (Susanto & Pradipta, 2016). According to Reny & Denies (2012), they stated that the first publication of Forum for Corporate Governance (FCGI) using Cadbury Committee definition, the corporate governance theory is defined as a controlling system and

it is a rule that can maintain the relationship between the internal and external parties of the company. The parties consist of shareholders, company management, lenders, government, creditors, employee, and customers. Corporate governance objective is to maintain a company to have an effective and better performance.

According to *Komite Nasional Kebijakan Governance* KNKG (2011), good corporate governance definition as a guideline for the company to operates, to establish and to communication between agents, principles, and stakeholders. Good corporate governance concepts arose because there was lack of solutions to solving problems that occur between agents and principles.

In accordance with *Organization for Economic Corporation and Development* (OECD) (2004), good corporate governance has some principles such as transparency, accountability, responsibility, independency, and fairness. Those principles of corporate governance used to measure how far the corporate governance has implemented in the company. *Komite Nasional Kebijakan Governance* KNKG (2011) explain those principles as the following:

a. Transparency, this principle is to maintain the transparency of company by providing relevant and materialistic information to stakeholders.

b. Accountability, this principle states that the board should have to communicate with shareholders and other stakeholders frequently. They should have an understandable assessment of how the company is achieving in the business purposes and meets other responsibility.

c. Responsibility, the company must take its own responsibility in making a decision, like how the management understanding of earnings

management, and how the management act on its profits, the management must be fully responsible to the result of the decision they made in the company.

d. Independency, the company must have a complete organizational structure and clearly have each structure job description, so nobody can intervening in other party's job.

e. Lastly is fairness, the company needs act fairly between internal and external parties, or either shareholder and other stakeholders.

Earnings management is a legal strategy for management to manipulate earnings by decided what accounting policy to use in financial statements. This is an intentional act that may influence the process of financial reporting and may harm the company due to some self-interested. It deals with manager choices of policies and procedures while a manager is responsible for the performance of their operation, but most likely are for personal gain. Earnings management thus take place without contravening accounting regulation (Chandrasegaram, Rahimansa, & Rahman, 2013). The definition of earnings management that given by Healy & Wahlen (1999) is the actions by company's managers to use for judgment in reporting financial statements. The earnings management will mislead the shareholder's objectives, which will impacts on the company economic performance, and it also will influence the different accounting number in financial reporting base on managers' decision on providing the financial statements.

There are two concepts of accruals an earnings management, which are discretionary accruals and non-discretionary accruals. The discretionary accruals

are the non-obligatory expense (an anticipated bonus for management) or assets that are recorded in the accounting book that has yet to be realized. Scott (1997) in (Kusumaningtyas, 2014) journal, earnings management is a way to minimize earnings report that is difficult to detect through the manipulation of accounting policies that relating to accrual, in example, to increase the cost of amortization and depreciation, record a large obligation, contingencies and recording obsolete inventories. Non-discretionary accruals is a mandatory assets or expense. It follows the right accounting policies and procedures, which the asset or expenses transactions are recorded instead of has to be realized. When non-discretionary accruals are violated it will influence the quality of the financial report.

2.2 Literature Review

There is mixed evidence on the relationship between corporate governance and earnings management. Following are some prominent studies reviewed in regards.

Susanto & Pradipta (2016) conducted a study on earnings management and corporate governance in the Indonesia Stock Exchange manufacturing companies conclude that audit committee meetings, board of directors and institutional ownership have found that they have relationship with the earnings management. Whereas, the audit committee with accounting background, audit committee size, independent commissioners and managerial ownership have found no any relationship with the earnings management. They state that audit committee is an external party of company, so they have less information related to company's real activities. Otherwise, board of director is an internal party of company, they do have

more information about company's activities, so the director could supervise properly all of the company activities to prevent occurring of any errors and fraudulent by management.

The prior research, Iqbal *et al.* (2015) have analyzed the relationship between corporate governance and earnings management. These research samples are all the non-financial companies that listed on Kirachi Stock Exchange, for the period of 2003-2012. The factor of corporate governance variables used for this research is board size, managerial ownership, CEO-chair duality, and audit committee size. The board size and managerial ownership have found insignificantly related to earnings management, while audit committee independence has found a significant and negative relationship between earnings management. Similarly, CEO-chair duality has found a significant and positive associated with earnings management. The control variables used are namely, firm size, firm performance, leverage, and firm growth. The relation of those four control variables has found insignificantly related to discretionary accruals.

Abdullah, Bt, & Ismail (2016) has conducted the research on the topic of women directors, family ownership, and earnings management. The sample has used in this study is all non-financial companies listed on Bursa Malaysia for the period of 2008 to 2011. This study uses discretionary accruals to measure the earnings management, the proxy for discretionary accrual is the modified Jones model. The variables of women director and women audit committee have found no significantly correlated with earnings management. The insignificant relationship between women director and women audit committee has influenced

to the family ownership which is also found no any significant related to earnings management. The variable controls such as board size, audit committee size, audit committee expert, firm size, return on asset, leverage, and audit committee. the board size, audit committee size, audit committee expert, firm size, and audit quality have found no any significant relation to earnings management. Furthermore, the return on asset has found a significant and negative relationship to earnings management, in contrast, which the leverage has found a significant and positive relationship on earnings management.

Krespi (2013) conducted the practice of earnings management in family-controlled business tend to have lower profits than the profits shown in non-family business. This study confirms that family-controlled business tends to worsen the business continuity than non-family business. Because family-controlled business try to protect their information, so it makes those company hard to make a decision because of no suffering from external pressure.

Prior accounting research that has examined about the relationship between corporate governance and earnings management are namely Susanto & Pradipta (2016), Mappanyukki, Prakoso, & Irwandi (2016), Nurlis (2016), Larastomo, Perdana, Triatmoko, & Sudaryono (2016), and Saleem & Alzoubi (2016). For example, Haddad, Ez-Zarzari, & Student (2017), Saleem & Alzoubi (2016), Ph.D & Elijah (2015), Kusumaningtyas (2014), and Amar (2014), both of them have examined the relation between audit committee size and earnings management.

Saleem & Alzoubi (2016) found that managerial ownership has a significant and negative relation to earnings management. Other prior research has different research result as managerial ownership has no relation on earnings management, which are the journals of Nugraheni, Nugrahanti, & Andreas (2015), Suhendra & Wardani (2013), Agustia (2013) and Nelson & Devi (2013).

Prior research also analyzed the relationship of institutional ownership and earnings management, in which Susanto & Pradipta (2016) resulted that there has an inverse relationship between institutional ownership and earnings management. Nurlis (2016), Saleem & Alzoubi (2016), and Setianingsih (2013) stated that institutional ownership is the individual who knows all of the information about the company's activities and financial reporting. By the information, the institutional is able to reduce the real practice of earnings management. While Nugraheni, Nugrahanti, & Andreas (2015), Asward & Lina (2015) have found a significant and positive relationship between institutional ownership and earnings management. Also some research Mappanyukki, Prakoso, & Irwandi (2016), Kusumaningtyas (2014), Hidayanti & Paramita (2014), Agustia (2013) and Khafid (2012) have found there is no significant relation between institutional ownership and earnings management because institutional has no right, ability and obligation to monitor and control the manager to be more focused on the value of the company.

The relation between board size and earnings management in Saleem & Alzoubi (2016), Larastomo, Perdana, Triatmoko, & Sudaryono (2016), Asward & Lina (2015), Abed (2012), Farida (2012) journals are significant and negative. Which Abdullah, Bt, & Ismail (2016), Baimukhamedova & Baimukhamedova

(2015), Latif & Abdullah (2015), Hidayanti & Paramita (2014), Agustia (2013) and Nelson & Devi (2013) found that there was no significant relation between board size and earnings management.

The relation between control variable, firm size and earnings management in Saleem & Alzoubi (2016), Ph.D. & Elijah (2015), and Asward & Lina (2015) has found significantly positive related to earnings management. In contrast with Kusumaningtyas (2014) who did not find the same result as the study above, which Kusumaningtyas (2014) has stated that the firm size has a significant and negative relationship with earnings management. The larger size of company can mitigate the company in managing its earnings in the financial report. While Abdullah *et al.* (2016), Baimukhamedova & Baimukhamedova (2015), and Amar (2014) has found that the size of the company is not significantly related to the company in managing its earnings in financial statements.

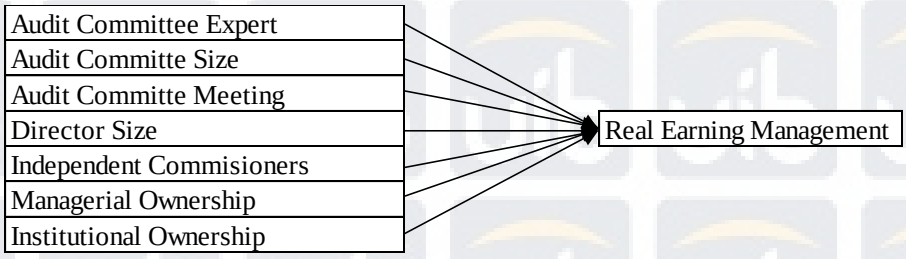

Figure 1 Research Model of Corporate Governance and Real Earnings Management

Source Susanto & Pradipta, 2016

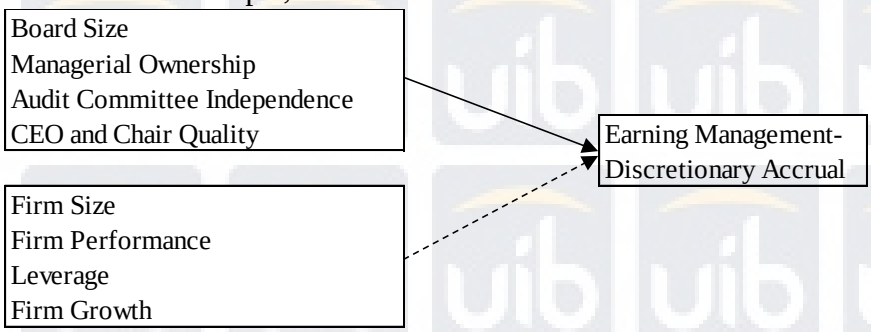

Figure 2 Research Model of Corporate Governance and Earnings Management: A Case Of Kirachi Stock Exchange Listed Companies

Source Iqbal *et al.* 2015

2.3 Hypothesis Development

2.3.1 Relationship between audit committee of accounting expert and earnings management in family-controlled companies

Audit committee accounting expert is a new brand profession. The audit committee who has accounting background are persons who needed to accept huge responsible on the financial statement. Therefore, the standard to be an expert in audit committees must understand the accounting policies and procedures. They must have the ability to access a general application, they have the experience in preparing, auditing, analyzing and evaluating financial statement that is really complex, they also must understand of the internal control and the financial reporting procedure, and lastly, they must know the duties and obligations of audit committee (Nelson & Devi, 2013). Audit committee expert has the ability to influence to other audit committees in reducing the earnings management that might occur in family-controlled firms. Thus, the existence of audit committee expert in family-controlled firms is expected to reduce the opportunities for the management in doing earnings management.

The audit committee of accounting expert has the ability and financial skills in detecting error or any frauds in financial reports (Qi & Tian, 2012). And family-controlled business management always believes in each other. Somehow, they are flexible on whose have the right to make decisions, in this situation, there

are often occur agency problems in the business and may occurring financial frauds in the business. So the accounting expert can detect if there have any errors or frauds, otherwise, they can restrain management in doing earnings management.

Susanto & Pradipta (2016) have found that there is insignificant relation between audit committee expert and earnings management. This result is consistent with Abdullah, Bt, & Ismail (2016), and Amar (2014) they believe that the number of audit committee expert does not impacts to earning management due to they are still an external party of company agency. Although large amount audit committee expert could result better in financial statement and monitoring, in case serving a large number of audit committee who has accounting background are not able to do their role effectively because it incurs the problems of the lack coordination and communication between each members (Abdullah, Bt, & Ismail, 2016). Agustia (2013) who believe that the existence of audit committee in Indonesia is still only to meet the regulatory requirements, so the size of the audit committee cannot restrain manager in doing earnings management.

From the prior study, there has no result has shown significantly relationship between audit committee of accounting expert and earnings management. Therefore, this study believes that there is a significant and negative relation between accounting expert and earnings management in family firms. According to the explanation above this study's hypothesis for audit committee of accounting expert and earnings management is:

H_1: Audit committee of accounting expert has a significant and negative relation on earnings management in family-controlled companies.

2.3.2 Relationship between audit committee independent and earnings management in family-controlled companies

The audit committee independent is a person with educational, professional, and experience in practicing. The independent auditor must express an opinion on the financial statements (Saleem & Alzoubi, 2016). Audit committee independent need to analyze the whole detail of financial statements so they would know how to detect risk management and prevent company's management to do earnings management for negative reasons.

Chandrasegaram *et al.* (2013) and Adıgüzel (2013) have found that audit committee independent has no significant relation to earnings management. Although board members are formally independent in family-owned firms, they may be not independence in substance because of implicit ties to the controlling family (Adıgüzel, 2013).

In another prior study, Saleem & Alzoubi (2016) documented that significantly negative relation between audit committee independent and earnings management. This study consistent with Iqbal *et al.* (2015), Ph.D. & Elijah (2015), Latif & Abdullah 2(015), Nugraheni *et al.* (2015) and Amar (2014). They believe that the outsider member of the audit committee is independent in firm's management, therefore, they can better influence in managerial discretion.

Nelson & Devi (2013) they documented significant positive between audit committee independent and earnings management, they believe audit committee independent can lead the manager in manipulating the financial statement. Based on the explanation above, this study hypothesis is as the following:

H_2: Audit committee independent has a significant and negative relation on earnings management in family-controlled companies.

2.3.3 Relationship between audit committee size and earnings management in family-controlled companies

The audit committee size is the number of audit committee in the company and audit committee is represent the board and enable personal contact and communication between the board, internal auditor, external auditor, finance director and operating executives. They are purposely to monitoring financial reporting and it needs to responsible for all the financial reporting. Financial reporting must be approved by audit committee before releasing to shareholders and other stakeholders (Susanto & Pradipta, 2016). Therefore, the number of audit committee is expected to reduce opportunistic and self-interested manipulation of financial information by manager.

Susanto & Pradipta (2016), Mappanyukki *et al.* (2016), Nurlis (2016), Abdullah, Bt, & Ismail (2016), Febriyanti *et al.* (2016), Larastomo *et al.* (2016), Latif & Abdullah (2015), Nugraheni *et al.* (2015), Hidayanti & Paramita (2014), Chandrasegaram *et al.* (2013), Adıgüzel (2013) and Agustia (2013) use audit committee size as an independent variable as the proxy of corporate governance. These prior studies found that there is no effect of audit committee size on earnings management. Because the number of audit committees has not been enough in representing the real basis of the performance of the audit committee of the company (Agustia, 2013).

Haddad *et al.* (2017), Saleem & Alzoubi (2016), Iqbal *et al.* (2015), Ph.D. & Elijah (2015), Kusumaningtyas (2014), Amar (2014) has examined audit committee size and earnings management. The result shows that the audit committee size is a significant and negative relation with earning management, this relation means that the larger boards increase the expertise diversity on the board including financial reporting expertise and in turn, can be effective in monitoring managerial behavior, therefore reducing earnings management and improving FRQ. This study hypothesis of audit committee size is:

H_3: Audit Committee size has a significant and negative relation on earnings management in family-controlled companies.

2.3.4 Relationship between audit committee meeting and earnings management in family-controlled companies

Audit committee meeting shows the reasonable in frequency meeting held by the audit committee along the year. The meeting purpose is to protect shareholders and stakeholders interest, the audit committee must maintain the value of stakeholders. Therefore, by how often the meeting was held may anticipate the manager to manipulate in earnings management. The most often of audit committees held the meetings, the manager would have less opportunity to manipulate financial reporting.

The relationship between audit committee meeting and earnings management is still rare to found in prior researchers. Here have some studies resulted that there is no significant relationship between how many times the audit

committee meeting and the earnings management of the company such as Nurlis (2016), Chandrasegaram *et al.* (2013) and Farida (2012). This is because the company only meet the regulation of accounting, the audit committees are not really effective in the company (Nurlis, 2016).

While Saleem & Alzoubi (2016) documented that the audit committee and earnings management has a significant and negative relation. Finally, Susanto & Pradipta (2016) and Amar (2014) said that there is a straight-line relationship between the number of meeting of audit committee and earnings management. For the hypothesis of the audit committee in this study is as the following:

H_4: Audit Committee Meeting is a significant and negative relation on earnings management in family-controlled companies.

2.3.5 Relationship between board size and earnings management in family-controlled companies

The board of director is an internal party in the company, they know all the operation cycle on the business. So if there has something error in operational activities, the board could supervise properly. The manager would less likely to manipulate the earnings on the financial reports due to having the director in the company who has to monitor and controll the operational activities (Susanto & Pradipta, 2016). They also stated that the larger number of director in company claimed to be better in mitigating earnings management

Abdullah *et al.* (2016), Iqbal *et al.* (2015), Baimukhamedova & Baimukhamedova (2015), Latif & Abdullah (2015), Hidayanti & Paramita (2014),

Agustia (2013) and Nelson & Devi (2013) also analyze the impact of corporate governance on earnings management, by using the board size as the proxy of corporate governance. Those studies found that there has no significant relation between board size and earnings management.

Saleem & Alzoubi (2016), Larastomo *et al.* (2016), Asward & Lina (2015), Abed (2012), Farida (2012) are both studies that have board size variable as the proxy of corporate governance. Those studies result that there is a significant and negative relation between board size and earnings management. The board size variable hypothesis in this study is:

H_5: Board Size has a significant and negative relation on earnings management in family-controlled companies.

2.3.6 Relationship between independent commissioners and earnings management in family-controlled companies

The independent board commissioner is a commissioner who has the responsibility for monitoring the information quality contained in the financial statement. If a company has large number of independent commissioners, it will less likely to happen the earnings management practice in the company because independent commissioners is the outsider parties of the company, they do not side both the agent nor principle and they are capable of detecting earnings management.

Susanto & Pradipta (2016), Mappanyukki *et al.* (2016), Febriyanti *et al.* (2016), Baimukhamedova & Baimukhamedova (2015), Latif & Abdullah (2015), and Hidayanti & Paramita (2014)showed that there is insignificant relation between

independent board of director and earnings management. Agustia (2013) stated that the size of independent commissioner does not have the right in monitoring management in the company. So independent commissioner may not reduce the earnings management would occur in the firm.

Nurlis (2016) showed that independent commissioner is a significantly negative relation with earnings management. This result is consistent with prior studies such as Abdullah *et al.* (2016), Saleem & Alzoubi (2016), Larastomo,*et al.* (2016), Iqbal *et al.* (2015), Ph.D & Elijah (2015), Nugraheni *et al.* (2015), Setianingsih (2013), and Farida (2012). The independent commissioner in the company can act as a counterweight in the decision making process in order to provide protection to minority stakeholders and other parties related to the company. The hypothesis of independent commissioner in this study is:

H_6: Independent Commissioner has a significant and negative relation on earnings management in family-controlled companies.

2.3.7 Relationship between managerial ownership and earnings management in family-controlled companies

Managerial ownership is the separation of ownership between internal parties and external parties, which is purposely to reduce the agency problems in the company. Managerial ownership's goal has the same with shareholder's with is increasing company's profit, has better financial report and disclosure for company sustainability. So managerial ownership will be more effective in supervision company activities and more aware of doing earnings management. In this study

believes that the greater of managerial ownership has more incentives to monitor the performance of management companies.

Saleem & Alzoubi (2016) found that managerial ownership has a significant and negative relation on earnings management. This result is consistent with Asward & Lina (2015) and Hidayanti & Paramita (2014), they believe that higher percentage of managerial ownership is more motivate management to improve company performance so the earning will be increasing and this makes management no need to do earnings management.

Other prior research has different research result as managerial ownership has no relation on earnings management, which are the journals of Susanto & Pradipta (2016), Iqbal *et al.* (2015), Nugraheni *et al.* (2015), Suhendra & Wardani (2013), Agustia (2013) and Nelson & Devi (2013). The number of managerial ownership is influenced by company earnings, the smaller number of managerial may give managerial opportunistic to doing earnings management. The hypothesis for managerial ownership in this study is:

H_7: Managerial Ownership has a significant and negative relation on earnings management in family-controlled companies.

2.3.8 Relationship between institutional ownership and earnings management in family-controlled companies

Institutional ownership is the ownership of shares by financial institution such as bank, insurance company, pension bank and investment banking. Institutional ownership is considered as more skill investor in interpreting financial

report and have the ability in detecting on earnings management (Agustia, 2013). The higher number of institutional ownership can prevent management in earnings management, and in this study believe that institutional ownership is significant and negative on earnings management.

Prior research also analyzed between institutional ownership and earnings management which Susanto & Pradipta (2016) has found that there is a significant and negative relation between institutional ownership and earnings management. This result consistent with Nurlis (2016), Saleem & Alzoubi (2016), Setianingsih (2013) stated that institutional ownership is an individual who knows all of the information about the activities in the company and the financial reporting. The institutional could reduce the happening of earnings management in the company by the information that they gained. Whereas, Nugraheni *et al.* (2015), and Asward & Lina (2015) have found that institutional ownership has a significant and positive relationship on earnings management because the institutional ownership was only focus on the current earnings.

Other empirical research such as Mappanyukki *et al.* (2016), Kusumaningtyas (2014), Hidayanti & Paramita (2014), Agustia (2013) and Khafid (2012) have found no significant relation between institutional ownership and earnings management, because institutional has no right, ability and obligation to monitor and control the manager to be more focused on the value of the company. The hypothesis for institutional ownership in this study is:

H_8: Institutional Ownership is a significant and negative relation with earnings management in family-controlled companies.

2.4 Research Model

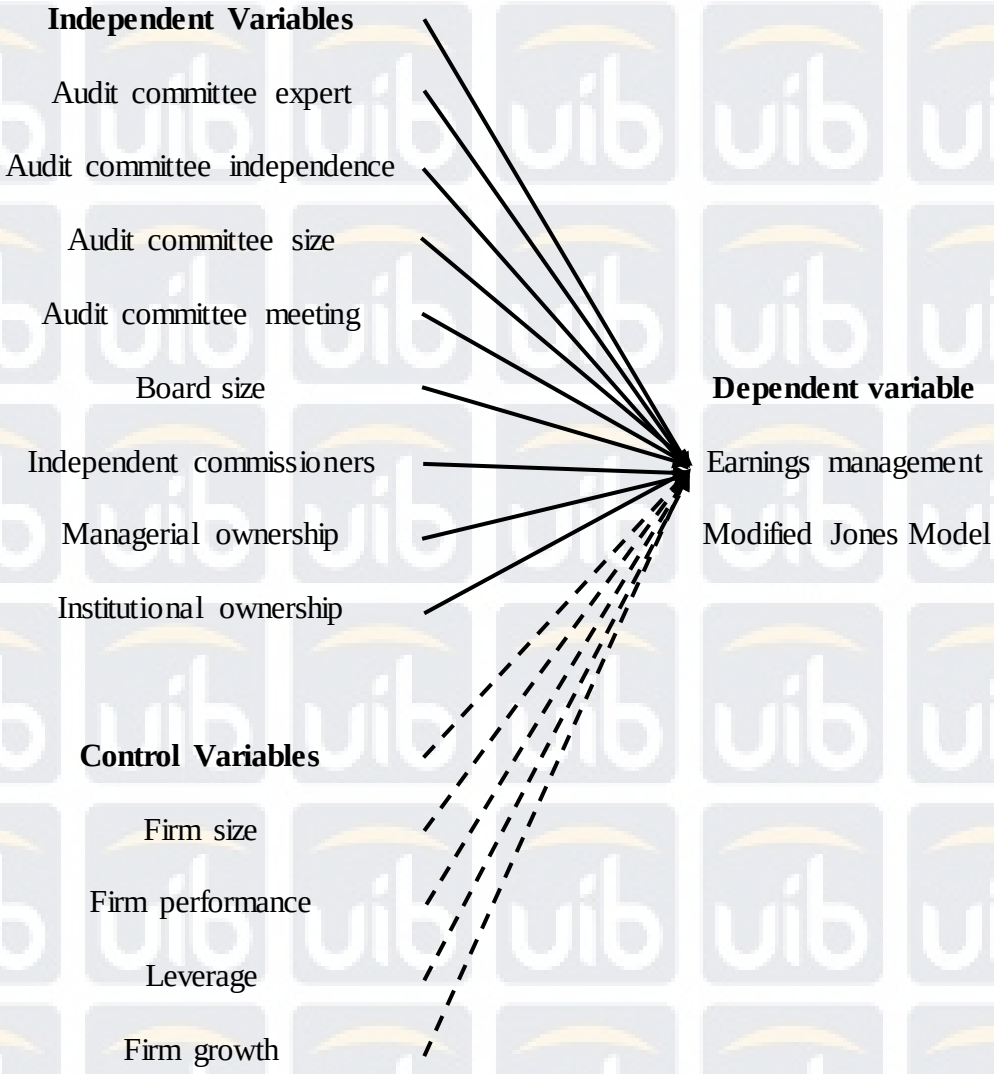

Figure 3. Research model of the impact of corporate governance on earnings management: evidence from family firms in Indonesia

Source: Author research, 2018.