

CHAPTER II LITERATURE REVIEW

2.1 Agency Theory

Agency theory whose found by Ross (1973), then further studied by Jensen and Meckling (1976) is a relationship happen between the agent serves as management of company and principal serves as shareholders where different interest risen from contract given from the principal (shareholders) to the agent or management in command to operate their company. Management who performs as job contract has to take the best decision for company and shows up good performance. Purpose of agency theory was to fulfill management goal in maximizing and enhancing shareholders value (Jensen & Meckling, 1976).

Agency theory risen cause by different ways and opinion between management and shareholders in operating company activities. Managers whose focus on short period will do something to fulfill their self-interest and job to generate higher earnings therefore this behavior lead to shareholders wealth not reaching its maximum potential (Reny & Denies, 2012). For that, one of way to monitor management, shareholder implement a good corporate governance system to control the behavior risen from the opportunity of management.

2.2 Stakeholder Theory

Stakeholder is known as all parties that may has or no link to a company. This mean party nor have or no interest to a firm include the majority and minority shareholder, investor, creditor, employee, and customer.

As stated by Parmar et al., (2010), the stakeholder theory focuses on value and moral in managing a business organization. Presence of stakeholder has been crucial for business because it helps firm to focus on stakeholders instead just shareholders (Harrison & Wicks, 2013). This statement is strengthened by Parmar et al., (2010) whose claims that manager can't just focus on stakeholders in firms, due a firm sustainability is support by both shareholder and stakeholders.

2.3 Stewardship Theory

A steward describe as someone who protect and taking care need of others. Stewardship theory is opposite with agency theory in company. Main focus of this theory is on manager who is describe as a good steward in company and they can manage with responsibility (Davis, Schoorman, & Donaldson, 1997). Differ from agency theory which take cautious on manager, stewardship theory claim that manager are loyal servant to company and motivated to achieve best performance for shareholders.

Family business has known to do a long-term period business, which mean to maintain company sustainability and pass it to next generation. This has been family controlled company characteristic which next generation will be demand to carry on its business.

Davis et al. (1997) interpret stewardship theory as steward whose work in company with no motives for self-interest instead they are motivated to achieve company goal in line with their principal.

2.4 Corporate Governance Theory

Reny and Denies (2012) has studied rule and controlling system of corporate governance that supports the relationship between the external parties and the internal parties of the company. Party in here include the company management, shareholders, governments, lenders, creditors, employees, and customers. Corporate governance risen to ensure that the money invested by investor in company are being used as it should be and efficiently. Furthermore, good corporate governance can lead to an effective and better performance in a company (Mahrani & Soewarno, 2018).

As stated by Regan (1998), firm whose is commitment to good corporate governance system could strive managements' reputation as well as provide good performance in company and benefits to shareholder. Therefore, an efficient corporate governance system is necessary for a firm's success and market stability.

2.5 Earnings Management

Earnings management is known as legal tactic used by manager to manipulate earnings. This strategy came from accounting policy regulation in preparing financial statements. This intention act may cause bad reporting quality in financial statement and cause shareholder to make a wrong decisions. Practice of earnings management occur without violate accounting policy (Chandrasegaram, Rahimansa, Rahman, Abdullah, & Mat, 2013). Earnings management will mislead stakeholders' perception regarding the real economic performance of the company, and cause different reporting in accounting number which will lead to bad decision making (Healy, 1998).

To measure earnings management, earnings management has considered into two general classification, which is discretionary accruals and non-discretionary accruals. The first model, discretionary accrual is known as non-mandatory expense or assets that are recorded in the accounting system and hasn't been realized yet. Previous study by Scott (1997) stated that earnings management is considered as a tactic to reduce the income for company. This strategy is difficult to reveal by person without experience in accounting background. For example, to increase amortization and depreciation costs, recording a large obligation, contingency, and outdated inventory. Second model, non-discretionary accruals is a mandatory assets or expense. It obeys the correct accounting policy and accounting procedure in which transactions of assets or expenses are recorded even if it hasn't been realized yet. Examples of non-discretionary accruals are obligation expenses like wages and bills that are yet to be paid but has to recorded in accounting system of the period.

2.6 Literature Review

Firm performance had gained a lots of attention by scholar and reseachers in business practical, but evidence based on earning management as mediating variable in Indonesia is very rare (Mahrani & Soewarno, 2018).

Former studies have been examined on several factors of governance in U.S and Europe and found that good corporate govenance has positive significant influence to firm performance (Bacon, 1973; Kiel & Nicholson, 2003; Zahra & Pearce, 1989). Next, Anderson (2003) studied relation between board in family firm to firm performance and result in perfomance in members of the family which serve as a CEO is better than company with an outsider CEO. Moreover, Jackling & Johl (2009) conducted study on the relationship from governance mechanism to financial performance, measuring governance variables by board size, the proportion of outside directors, number of board meetings, and CEO-chair duality. But, number of board meeting have negative effect on firm performance and board size shows positive relationship to firm performance. Proposing that “busyness” didn’t add value to enhance firm performance (Jackling & Johl, 2009).

Next, Wu, Lin, and Lin (2009) investigated on good corporate governance on firm performance in Taiwan which result in board size and CEO duality negatively impact on firm performance. In the contrast, firm performance is significantly positive affect to insider ownership and board independence. This finding has consistent result followed by Ahmed and Hamdan, (2016) Faatihah, Fuzi, Abdul, & Julizaerma (2016) and Mashitoh & Irma (2013) whose found positive significant relationship firm performance.

Nevertheless, La Porta, Silanes, & Shleifer-Andrei (1998) found that the corporate governance in Asian companies are relatively poor, suggest that East Asian corporations are often operating in an environment with weak legal system, poor law enforment and corruptions. Followed by Sheikh, Wang, & Khan, (2013) and Vintilă, Gherghina, & Păunescu (2018) whose also found corporate governance has negatively affect firm performance.

However, there were several study found that corporate mechanisms did not have any relationship to firm performance. It is because board independence

does not guarantee the improvement of performance of a firm due to poor monitoring roles of the independent directors (A. Abdullah & Page, 2009; Coskun & Sayilir, 2012; Garg, 2007; Hermalin & Weisbach, 2013; Leung, Richardson, & Jaggi, 2014; Vintilă et al., 2018).

Abdullah and Ismail (2016) studied the topic of family ownership, women directors, and earnings management. Women director and women auditing committees have no significance & influence to earnings management in family company. This finding provide further insights that board size, firm size, audit committee size, audit quality and expert in audit committee have no relationship to earnings management. This is proven by Hermiyetti and Manik (2010), Nuryana and Surjandari (2019) and Rahman and Ali (2014) whose findings also confirm same and that corporate governance has no significant relationship related to earning management.

In the contrast, there is conflicting literature in previous study whether corporate governance has negatively influence to earnings management (Alzoubi, 2016; Larastomo, Perdana, Triatmoko, & Sudaryono, 2016; Mappanyukki, Prakoso, & Irwandi, 20116; Nurlis, 2016; Susanto & Pradipta, 2016). In this respect, Haddad, Ez-Zarzari, & Student (2017), Alzoubi (2016), Ph.D & Elijah (2015), Kusumaningtyas (2014), and Amar (2014) showed that earnings management are significant and negatively correlated by audit committee size, which means that the higher boards including the financial reporting expertise can monitor executive behavior effectively, hence reduce earnings management and enhancing financial reporting quality (Iqbal, Zhang, & Jebran, 2015). This study confirms findings of Epps & Ismail (2009), Inaam & Khamoussi (2016), Johari, Saleh, Jaffar, & Hassan (2009), Lee, Road, Ku, Chen, & Chen (2012) and Uwuigbe, Ranti, & Bernard (2015).

Lee and Jung (2016) study effect on corporate social responsibility on firm performance which result in firm performance is significant and positively correlated by corporate social responsibility in Korea Listed Firm. This is because corporate social responsibility can robustly affect on the willingness of customers to buy more products (Hsueh, 2014), boost customer's satisfaction (Luo & Bhattacharya, 2013), and the firm's social reputations are closely related to the

firm performance (J. Y. Chen & Slotnick, 2014). In this respect, this study confirm findings of Ahamed, Almsafir, & Al-smadi, (2014), Chen, Wang, Chen, & Wang (2011), Ghelli (2013) Palmer (2012), Rajput, Batra, & Pathak (2019) and Saleh, Zulkifli, & Muhamad (2010).

In arguments to findings above, corporate social responsibility does not necessarily translate into firm performance. Mwangi and Jerotich (2013) has found there are no significancy relationship from corporate social responsibility to firm performance. This study support finding of Aras, Crowther, & Crowther (2016), Fan (2013) dan Margolis & Elfenbein (2009).

Evidence from Chih, Shen, & Kang (2008) found corporate social responsibility correlates negatively with earning management. Company that engages in corporate social responsibility activity continue a long-term relationships with investors so that the company will struggle to not exercise earnings management. Accordingly (Carroll, 1979; Y. Kim, 2012; Prior, Surroca, & Tribó, 2008; Scholtens & Kang, 2012), when a firms increase its social activity, earning management will tend to decrease.

Next, and Krespi (2013) has examined earnings management to family-owned financial performance and found family company tends to have a lower profit than the profit seen in a non-family controlled company. This study stated that family-owned businesses tend to have a worse business continuity compared to non-family businesses. This is because family-owned businesses will try to protect their information, so it made them difficult to came up with a good decision due a lack of external pressure from outsiders.

Evidence from Cornett, McNutt and Tehranian (2009), Kothari, Leone, & Wasley (2005) and Akram, Hunjra, Butt, & Ijaz (2015) also found earning management has negatively affect firm performance. Futher study done by Nuryana and Surjandari (2019) contradict with previous findings which found earning management have no significancy relationship with firm performance. While, Makaryanawati (2002) and Asih et al (2015) found earning management positively and significantly affect on firm performance.

Sial and Chunmei (2018) study earnings management as moderator variable between corporate social responsibility to Chinese firms' performance

and results that higher level of CSR contributed by higher value of earnings management thus results to a lower firm performance in Chinese firms. This finding support Bebachuk and Weisbach (2010) and Dianita (2011) whose also found earning management negatively moderate corporate social responsibility and firm's performance.

Other researcher has found same results. Liu, Shi, & Wilson (2017) conducted study in China Family Firms on accrual-based earnings management as intervening variable CSR to firm performance. As result found family firms certainly have higher CSR performance and also play a less part in accrual-based earnings management.

Kawatu (2009) studied earning quality as mediating variable on relationship between corporate governance to firm performance. Result opined that earning quality can mediate the relationship between GCG to firm performance. GCG has significantly influence on firm performance and earning quality has correlated positively with firm performance. Futher research done by Kang & Kim (2011) and (Nasser, 2008) whose confirmed that earning management can moderate the relationship between good corporate governance and firm performance.

2.7 Hypothesis Development

2.7.1 Relationship between good corporate governance and financial performance

One of the most important element in building a confident marketplace as well as attracting positive investors in the organization and for the economy is corporate governance. Promoting a good corporate governance standard is very important if a company wants to attract investment capitals, reduce any risks and develop a firm performance (Ahmed & Hamdan, 2016).

Research done by Ahmed and Hamdan (2016), Anderson, (2003), Bacon (1973), Kiel & Nicholson (2003), Mashitoh & Irma (2013), Zahra & Pearce (1989), and Faatihah et al., (2016) found company with good corporate governance positively influence firm performance. But, there are some conflict found in La Porta et al., (1998), Sheikh et al. (2013), Vintilă et al., (2018) and Wu et al. (2009) study that corporate governance negatively affect firm performance. Futher study done by Coskun & Sayilir (2012), Abdullah & Page (2009), and Peters & Bagshaw (2014) found corporate governance has no significant effects on firm performance.

Past decades had categorized three views, first study found positive relationship due key element to have a good corporate governance is having an effective board of independent commissioner. Hence, the more high percentage of independent commissioner, decision making process will free from bias and more objective so it can improve company financial performance (Ahmed & Hamdan, 2016). Second, a view from negative relationship between corporate governance mechanism and firm performance because when the board consists of more than one member of a family, company financial performance will be affected negatively (Ehikioya, 2009). Further study has witness there is no significant relationship due to the minority of independent directors in family firms as compared to non-family controlled firms in Hongkong (Leung et al., 2014).

Based on above asserted, hypothesis opined for corporate governance mechanisms and financial performance is:

H₁: Good corporate governance has significantly positive associated with financial performance

2.7.2 Relationship between corporate social responsibility and financial performance

Corporate Social Responsibility (CSR) theory focus on participating in community by business companies. It suggests that a private company does not merely concern itself in making profit but also has responsibilities to society and making sure that it acknowledges the relationship the company has with the customers. Therefore it is crucial for a businesses to keep its commitments to behave well and contribute to the development of economy while improve life quality of the work force and surrounding community (Mwangi & Jerotich, 2013).

The relationship between CSR and financial performance exists mainly in the next three point of views: positive correlations, negative correlations and no correlation whatsoever. The first argument is that CSR would improve financial performance (Van der Laan et al., 2008; Ruff et at, Chen et al., 2011; Ghelli, 2013; Palmer, 2012; Rajput et al., 2019; Saleh et al., 2010). When company contribute to society especially to customer customers will buy more product so company financial will improve.

Nevertheless, past research that has been conducted revealed that existing a negative relationship (Vance, 1975; Davidson and Worrell, 1988; Becchetti and Ciciretti, 2006) or no relationship (Abbott and Monse, 1979, Fan, 2013; Mwangi & Jerotich, 2013, Aras et al., 2016; Margolis & Elfenbein, 2009) from CSR to financial performance.

Therefore, hypothesis opined as the following:

H₂: Corporate social responsibility has significantly positive associated with financial performance

2.7.3 Relationship between good corporate governance and earnings management

Good corporate governance implies a clear responsible for the boards in the process of financial reporting. This risen the expectation that the boards will restrict the exercise of earnings management (Epps & Ismail, 2009). When managers' incentives are determined by company financial performance, it will be

possible for manager to exercise earnings management to a better performance for their own self-interest.

Johari (2009) study the relationship on earning management impacted by board independence, competency and ownership to in Malaysia company. Result indicated that good corporate governance affect significant and negatively on earnings management. According to Klein (2002), the main effective mechanism in monitoring an accounting process is an independent board (Klein, 2002). This findings is consistent with Epps and Ismail (2009), Inaam and Khamoussi (2016), Lee et al. (2012), Uwuigbe et al. (2015) results.

However, there is also studies that do not support above findings (Chtourou et al.,2001; Park and Shin, 2004; Agrawal and Chadha, 2005; Siregar and Utama, 2008; Hermiyetti & Manik, 2010; Nuryana & Surjandari, 2019; Rahman & Ali, 2014). They conclude that good corporate governance does not have any relationship to earning management. The non-existent effect is because of the existence of a corporate governance mechanism which only serves as a platform to fulfill the government law and regulation, so implementation of corporate governance become not optimal and ineffective at control management actions (Hermiyetti & Manik, 2010). Therefore, this study hypothesis is :

H₃: Good corporate governance has a significant negatively associated with earnings management

2.7.4 Relationship between corporate social responsibility and earnings management

To defense against stakeholders alertness and activism, that may cost managers' job and effect firms' good name, managers have their own interests to compensate the stakeholders through CSR. In example, managers who manipulate earnings has role to play a social-friendly mask, opined that CSR activities considered as a great tool for gaining stakeholders' supports. Using this trick, the risk of the manager getting fired because of unhappy and unsatisfied shareholders or stakeholders whose interests are ruined because of an application of earnings management practices, are significantly decreased. With this tactic, corporate

social responsibility is used as an entrenchment tools for earnings manipulation (Cespa & Cestone, 2007).

Several research asserted that CSR have significant negative impact on earning management (Carroll, 1979; J. Kim & Yi, 2006; Y. Kim, 2012; Prior et al., 2008; Scholtens & Kang, 2012). Firm with low earning management practices have lesser motives to seek public attention by promoting CSR activities (Prior et al., 2008). Firm that participate in CSR activities will suitable to limit earning management, therefore has transparency and reliable financial reporting for investor as compared to firms that do not match the same social criteria (Y. Kim, 2012).

While support from negative relationship seems to have gained more attention recently, there are those researchers who take opposite findings. Some researcher maintain that firm whom committed to CSR, which manager may choose to smooth earning to lower the earning volatility (Goel & Thakor, 2000). Therefore, these argument lead to the following hypothesis:

H₄: Corporate social responsibility has significantly and negatively associate with earnings management

2.7.5 Relationship between earnings management and financial performance

In this point, author used Schipper (1989) definition of earnings management as a process of deliberately taking steps within the constraints of GAAP or Generally Accepted Accounting Principle to present a desired quality of reporting. Earnings management executed in order to achieve higher performance in the company. This leads to result in earning management (Akram et al. 2015).

Evidence found from Kothari et al. (2005), Cornett et al. (2009) and Akram, Hunjra, Butt, & Ijaz (2015) studied that earning management has negatively affect firm performance. This opined that the more profitable companies will less engage in earning management. Further study done by Nuryana & Surjandari (2019) contradict with previous findings which found earning management have no significancy relationship with firm performance. While, Makaryanawati (2002) and Asih et al (2015) found earning management

have significantly and positively relationship to firm performance. Thus, following hypothesis developed as:

H₅: Earning management has a significant positively relationship on financial performance.

2.7.6 Relationship between good corporate governance and financial performance with earnings management as mediating variable

Financial performance in a company can be improved by GCG, reduce risks created by board decisions that only benefit their interests, and in general GCG could rise shareholders' confidence to invest their money and that will affect on company performance (Mahrani & Soewarno, 2018).

The presence of good corporate governance and independent auditor can deliver a great monitoring management in order not to commit fraud on financial reporting and minimize the possible fraud action taken like earnings management. Because when management decrease the level earning management, management's efforts to boost profits is to increase the number of operational activities by the company. Management will increase operational activities by personal interests so that they can get bigger incentives from profits earned by the company. Therefore, company will motivated to investigate its operational activity and detecting earnings management.

Study by Ching, Teh, San, & Hoe (2015), Setiawan (2007) and Kang and Kim (2011) discover evidence that earnings management can mediate the relationship between GCG to financial performance and earning managements could strengthen the causal relationship between GCG and financial performance.

However, previous findings from Kawatu (2009) has study effect of earning quality as intervening variable between GCG and financial performance and found earning quality was not the intervening variable between corporate governance to firm value. Therefore, proposed hypothesis based on above study is:

H₆: Good corporate governance affects financial performance through earnings management as mediating variable.

2.7.7 Relationship between corporate social responsibility and financial performance through earnings management as mediating variable

Presence of CSR activities helps company to operate calmly and obtain support from society. Transparent financial report can be achieved by disclosure of social responsibility, which turns to encourage manager to reduce earnings management practice. Therefore, employees' morale will improve through CSR and maintain good relationship with investors (Waddock & Graves, 1997).

Investors' confidence can be boosted by the low practices of earnings management and it would lead to an improvement of the company's financial performance. Prior research found that earnings management can mediate the relationship between corporate social responsibility and financial performance (Liu et al., 2017; Rahmawati & Dianita, 2011; Sial & Chunmei, 2018). Therefore, the proposed hypothesis is:

H₇: Corporate Social Responsibility affect financial performance through earnings management as mediating variable.

2.8 Research Model

Figure 1.

Research model : The effectiveness of earnings management in mediating the relationship between corporate governance, corporate social responsibility and financial performance in Indonesia Family firms

Source: Author research, 2018 (Adopted from Mahrani & Soewarno, 2018)

