

Effects of Ownership Structure and Company Conditions on Earnings Management

Cynthia Jane and Friska Firnanti

Trisakti School of Management, Kyai Tapa No. 20, 11440, Jakarta, Indonesia

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Abstract: This research aims to obtain empirical evidences about effects of ownership structure, return on asset, size, leverage, operating cash flow and sales growth on earnings management. The samples used in this research was secondary data from annual report of non-financial company listed in Indonesia Stock Exchange from 2013-2015. The samples of this research are 285 data using purposive sampling method. The result of this research shows that institutional ownership, return on asset, leverage, operating cash flow and sales growth had effect on earnings management, while managerial ownership, board of director size and firm size had no effect on earnings management.

1 INTRODUCTION

In globalization era and dynamic economic growth, competition in business area becomes very real. Each company is trying to be the best to win over the competition and keep its survival (Scott, 2015). Management tried to fill the desire of its shareholders by showing the company's performance through the result of financial statement (Bassiouny, 2016). However, the question is if the result of financial statement can be reflected as the real condition faced by the company. The financial statement can be used for investor and stakeholders to consider their investment in a company. However, sometimes, investor and stakeholders have no further consideration about the truth behind its financial statement. Management is the authorized part who published and made its financial statement. It is possible for them to make or arrange the financial statement based on their will which give them the best result for themselves or other advantages. This can be called as earnings management practice (Yogi and Damayanthi, 2014).

Earnings management is an intentional act of management in order to choose accounting policies used in the firm for several reason or to make benefit for themself (Fishcher dan Rosenzweig, 1995). Management always aims to keep the resources or fund needed in the company to keep it working well so external parties cannot intervene them. Several cases in the world, such as Enron, Xerox, and World

Com, has witnessed that some of management actions are intentional acts to manage the amount that showed in financial report for some certain benefit or another reason (Bassiouny, 2016). Generally, investor will trust the financial report and asses the company by the number that showed in financial statement. So, the number that showed in financial statement is really important. Both investor and shareholder will seek management responsibilities in the company (Ngamchom, 2014).

Earnings management is a signal and can be seen as an opportunistic behaviour to achieve the targets. Ownership structure and board of director are important aspect in corporate governance to lessen earnings management practice (Liu and Tsai, 2015). There are different results in previous studies, where managerial and institutional ownership theoretically reduces earnings management (Alves, 2012; Alzoubi and Selamat, 2012). But on the other hand, managerial ownership and the board of directors are the decision makers in the company. In addition, institutional ownership usually has a great strength in the company, so that it can encourage earnings management (Al-Fayoumi et al., 2010; Cheng and Warfield, 2005)

2 LITERATURE REVIEW

2.1 Agency Theory

Agency Theory by Jensen and Meckling (1976) is a theory that underlies current business practice. This theory is about contractual relationship between agent and principal. Where there are two parties that have an interest towards each other called agent and principal. Agent is the one who was given the job and responsibilities from principal to do principal's job and act like principal for making some decisions in the company. Agent should also meet principal's desires such as maximum principal wealth. Principal is a person who owned the firm that run by Agent. Agent also has a self-interest for its own self and trying to do the work to gain some benefit for itself besides principal's benefit.

Earnings management activity is done by management to fulfill principal's will by presenting a financial report according to principal expectations (Bassiouny, 2016). Management can choose methods that are used in financial statement which expected to maintain fluctuation of company's income in current period as management will. If company does not work as well as principal wants, management will try to hide bad condition from principal. It can be called asymmetry information which is the condition which principal's knowledge is just as far as Agent's reports to principal. Principal will give some rewards to management who has a good performance (Subramanyam, 2014). Agent also can do earnings management activity for attracting public and raising funds from the public. Agents are required to meet principal's desire and caused earnings management activities (Scott, 2015).

This research focuses on accrual based earnings management. This study aims to see whether managerial ownership and institutional ownership play an active role in helping company to suppress earnings management.

2.2 Managerial Ownership and Earnings Management

Managerial ownership is amount of shares that are owned by company's management, who does operational activity in the company (Tarigan and Yulius, 2007). Management that owned shares in a company will have bigger the control of the company. The management should be engaged to the company so they will give the best contribution to the company. When the company makes profit

and achieves its goals, it also gives advantages to management (Aygün et al., 2014). Thus, managerial ownership encourages management to make earnings management. Based on the explanation above, the following hypothesis will be tested:

H1: Managerial ownership has an effect on earnings management.

2.3 Institutional Ownership and Earnings Management

Institutional Ownership is a shared ownership that owned by institution (Llukani, 2013). Institutional ownership could give impact to management's activity if compared with shares that are owned by individual (Bukit and Nasution, 2015). It has power or tools to direct management's activity and tends to increase earnings management. Based on the explanation above, the following hypothesis will be tested:

H2: Institutional ownership has an effect on earnings management.

2.4 Board of Director and Earnings Management

Board of directors is people that have great impact in a company and they can decide policies that have to be implemented by a company (Ngamchom, 2015). The quantity of board of directors can possibly decrease activity of management earnings in a company. The more board of director, the stricter the control to management, so they can work better and give reliable financial report (Aygün et al., 2014). The larger the number of board of director can increase knowledge and capability to prevent earnings management. Based on the explanation above, the following hypothesis will be tested:

H3: Board of director has an effect on earnings management.

2.5 Return on Assets and Earnings Management

Return on assets is the ability of asset to produce net income. Company that has high return on assets is a company that has good performance. It means that the management has done their job well, so the possibility of earnings management will be reduced. If a manager has satisfied with the result of the performance, they will create financial report with the real data (Aygün et al., 2014). Based on the explanation above, the following hypothesis will be

tested:

H4: Return on assets has an effect on earnings management.

2.6 Firm Size and Earnings Management

Firm Size can be seen from how many assets that a company has. The larger the company, management has responsibility to protect company's name and reputation. It will reduce earnings management because it will affect the reputation that company has built for years. A big company also has good internal control. Thus, management has to be more careful and it reduces earnings management (Bassiouny, 2016). Based on the explanation above, the following hypothesis will be tested:

H5: Firm size has an effect on earnings management.

2.7 Leverage and Earnings Management

Leverage is the ratio of total debt to total asset. Higher leverage means higher debt. Company with high leverage has credit covenant that must be fulfilled so creditor can trust that the company will pay off the debt (Gitman and Zutter, 2015). Higher leverage will make strict control from creditor and it means management will be harder to do earnings management (Bassiouny, 2016). Based on the explanation above, the following hypothesis will be tested:

H6: Leverage has an effect on earnings management.

2.8 Operating Cash Flow and Earnings Management

Operating cash flow is a tool to measure the operational activity of a company that shows whether the company can produce cash flow to maintain for operational activity and pays short-term debt. The flow from operational cash flow can be used as determinants of a profit quality of a company because cash flow can be more permanent than the accrual component (Subramanyam, 2014). The ratio of high cash flow shows the quality level of income. Management that has done operational activity well, do not have to initiative to do earnings management because the performance of management has been acknowledged by the investor (Yuliana and Trisnawati, 2015). Based on the

explanation above, the following hypothesis will be tested:

H7: Operating cash flow has an effect on earnings management.

2.9 Sales Growth and Earnings Management

Sales growth is the increase of sales from previous year to the current year. When there is an increase of sales, it can be assumed that the company has a good growth and a fulfilling development. High sales growth makes management does not have to do earnings management because they already performed well (Gonzalez and Meca, 2014). Based on the explanation above, the following hypothesis will be tested:

H8: Sales growth has an effect on earnings management.

3 METHODS

The populations used in this research are non-financial companies listed in Indonesian Stock Exchange (IDX). The samples of this study were selected by purposive sampling method with several criteria such as the company should be constantly listed on IDX since 2013-2015, reports financial statement using IDR as its currency, has December 31 as its closing period, and has managerial ownership and institutional ownership. Samples which meet the criteria above are 95 companies with 295 data.

Earnings management in this study is measured by discretionary accruals (modified Jones model). Discretionary accrual is the accrual component that is chosen by management to report or the component that management can intervene for financial statement. Discretionary accrual is measured by the following regression (Aygun et al., 2014):

$$TAt = NIt - CFOt \quad (1)$$

$$TA = DA + NDA ; NDA_t = \beta_1j [1/At-1] + \beta_2j [\Delta REV_t - \Delta AR_t/At-1] + \beta_3j [PPE_t/At-1] \quad (2)$$

$$TAC_t/At-1 = \beta_1j [1/At-1] + \beta_2j [(\Delta REV_t - \Delta AR_t)/At-1] + \beta_3j [PPE_t/At-1] + \epsilon_t \quad (3)$$

$$DA_{jt} = TAC_{jt}/A_{jt-1} - NDA_{jt} \quad (4)$$

Where:

TAt: Total Accrual in year t; NIt: Net Income in year t; CFOt: Cash flow from operating activities in year t; TA: Total accruals; DA: Discretionary

Accruals NDA: Non – Discretionary Accruals ; NDA_t: Non-discretionary accruals in year t ; A_{t-1}: Total asset in prior years ; ΔREV_t : change in income in year t ; ΔART_t : change in receivable in year t ; PPE_t: gross PPE in year t ; β_{1j} , β_{2j} , β_{3j} : specific parameter.

Managerial Ownership is percentage of share that owned by management, measured by ratio scale and calculated by percentage of share that is owned by management (Aygun et al., 2014). Institutional ownership is percentage of share that is owned by institutional such as bank, insurance company, investment company, and other institutional companies. Institutional ownership measured by ratio scale and calculated by percentage of shares that owned by institutional shareholders (Aygun et al., 2014).

Board of director is a person that has so many impacts on the company, the one who has a part of making decision and deciding other policies in the company. Board of director measured by ratio scale and calculated by number of board of directors in the company (Aygun et al., 2014). Return on Asset is the ratio which divided net income and total assets. ROA is measured by ratio scale and calculated by net income to total asset (Aygun et al., 2014).

Firm Size is the size of company which can be seen from total asset, average of sales, and market price of share in the company. Firm size in this study measured by ratio scale and calculated by natural logarithm of total asset (Aygun et al., 2014). Leverage is an analysis of credit in company and used to assess amount of debt to finance its asset in order to do their operations beyond the resources of capital and equity. Leverage measured by ratio scale and calculated by total debt to total asset (Aygun et al., 2014).

Operating Cash flow is measured by ratio scale and calculated by cash flow from operating activities to total asset (Yuliana dan Trisnawati, 2015). Sales growth is an increasing of total sales in compare with sales prior year. Growth is measured by ratio scale and calculated by percentage change of sales (Gonzalez and Meca, 2014).

4 RESEARCH RESULT

The result of the statistical test can be seen in hypothesis result shown in table 1 below:

Table 1: Hypothesis Result.

Model	t	Sig.
(Constant)	0.318	0.751

Managerial Ownership	1.828	0.069
Institutional Ownership	2.748	0.006
Board of Director	-1.223	0.222
ROA	31.098	0.000
Firm Size	-0.479	0.633
Leverage	-2.586	0.010
CFO	-46.584	0.000
Sales Growth	-3.110	0.002

Table 1 shows that managerial ownership has no effect on earnings management activities. Shares that owned by management are only a small fraction of total shares outstanding so it has no effect on management acts and decisions. The result of this research is consistent with Yogi and Damayanthi (2016), Susanto (2013), Destriana and Arifin (2016), and Agustia (2013). Institutional ownership has an effect on earnings management activities. Company with a large number of shares that are owned by an institution makes the institution can control the existing activity in the company directly or indirectly. The possibility of earnings management activity for institutional purposes will be higher than personal ownership. The result of this study is consistent with Destriana and Arifin (2016).

Return on Asset has an effect on earnings management activities. It means when the performance of company is in poor or good condition, management will intend to do opportunistic activity, such as increasing or decreasing company's income according to real condition that is faced by the company. The result of this study is consistent with Usman and Yero (2012). Leverage has an effect on earnings management activities. It shows low leverage levels in a company made the management tried to do some activities to keep showing good circumstances to its shareholders and stakeholders. The result of this study is consistent with Yuliana and Trisnawati (2015), and Kusumaningtyas (2012).

Cash flow from operation has an effect on earnings management activities. When operating cash flow increases, the income of the company will decrease, thus cash inflow is getting smaller and it encourages management intention to do earnings management activities to show the good state of company. The result of this research is consistent with Christiani and Nugrahanti (2014), Yuliana and Trisnawati (2015).

Sales Growth has an effect on earnings management activities. Company with great number of sales and growth of sales from year to year shows good circumstances and improvements of the company, so it suppressed management intention to do earnings management. The result if this study is consistent with Llukani (2013).

On the other hand, board size and firm size have no effect on earnings management activities. It shows that the number of board of directors has no effect on the board's optimal function to detect earnings management and no matter how big or small the company, management does not make it as a consideration to do earnings management activities.

5 CONCLUSIONS

The result of this research shows that institutional ownership, return on asset, leverage, operating cash flow, and sales growth have effect on earnings management and on the other hand, managerial ownership, board size, and firm size have no effect on earnings management activities. Institutional ownership as a shareholder who has a large portion of the company can play a role in earnings management practices. While managerial ownership in non-financial companies in Indonesia has a relatively small portion of shares, it does not have the power as much as institutional ownership. This research has some limitations. The research only used samples three years period from 2013-2015, and the samples were only non-financial companies listed in IDX. Another research should add period of the research of the samples, and compare conditions in different countries. Further research may add another variable such as audit quality.

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