# THE INFLUENCE OF ULTIMATE OWNERSHIP ON EARNINGS MANAGEMENT: EVIDENCE FROM INDONESIA

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**ABSTRACT**

*Governance of public companies in Indonesia is concentrated in a particular group of controlling shareholder. The group is constituted in various ways like family, government, widely owned financial institutions, widely owned companies or others as a controlling shareholder. The controlling shareholder has two rights, control rights and cash flow rights. Differences between the two rights affect agency problems. Siregar documents that 99% of public companies in Indonesia have a concentrated ownership structure with a cut off of 10% control rights. Febrianto (2005) suggests that 92% of public companies have concentrated ownership structures in Indonesia at a cut off of 20%. Based on this phenomenon, the objective of this study is to investigate whether cash flow rights and leverage influence earnings management. This study collected data from Indonesian Stock Exchange regarding manufacturing companies during the period 2001-2007. There are 786 firms year at a cut off of 10% control rights. The results suggest that the cash flow leverage rights positively influence earnings management. The result indicates that larger differences between control rights and cash flow rights, imply it is easier for the controlling shareholder to manage earnings for his/her personal benefit. The controlling shareholder manipulates earnings to hide the acquired private benefits through expropriation.*

**JEL**: G32; M41

**KEYWORDS:** Ultimate Ownership, Control Rights, Cash Flow Rights, Cash Flow Right Leverage, and Earnings Management

## INTRODUCTION

The objective of this research is to investigate whether the cash flow right leverage of controlling shareholders influence earnings management. This issue is most important because ownership of public companies listed on the Indonesian Stock Exchange (IDX) is concentrated (Claessens, Djankov and Lang, 2000; Febrianto, 2005; and Siregar, 2006) and low protection for non controlling shareholders (Johnson et al., 2000; and Leuz, Nanda and Wysocki, 2003). Therefore, this condition is opportunity for controlling shareholder to manage earnings.

According to Claessens, Djankov and Lang (2000), most public companies in Indonesia are owned by a single controlling stockholder. A controlling shareholder ultimately owns the largest portion of the firm. Febrianto (2005) suggests that 92% of public companies are owned ultimately. The finding is consistent with Siregar (2006). He documents that 99% of public companies in Indonesia are owned ultimately at a 10% cut off of control rights. The concentration generates separation between cash flow rights and control rights. The separation is termed cash flow right leverage.

Leverage entrenches controlling shareholder to expropriate non controlling shareholders. A case in point is Bank of Century. Tbk is an expropriation by controlling shareholder in Indonesia. Expropriation happened because the controlling shareholder has lower financial incentives compared with his/her control to the company. The situation indicates the agency problem between controlling and non-controlling shareholders. The controlling shareholder can make decisions exclusively for her/his benefit. According to Fan and Wong (2002) when the controlling shareholder is entrenched by a large separation of control rights

and cash flow rights, credibility of the accounting information decreases. This results because the controlling shareholder effectively controls the firm and also controls the process of financial reporting.

The remainder of the paper is organized as follows. Section 2 discusses the relevant literature. The research methodology is described in Section 3. Section 4 provides the results and Section 5 concludes the paper.

## LITERATURE REVIEW

La Porta, Lopez-de-Silanes and Shleifer (1999) were the first researchers to conduct research of ultimate ownership. Based on a cut off 20% of control rights, La Porta, Lopez-de-Silanes and Shleifer (1999) find 36% of world companies are owned widely. Family controls 30% of companies and 18% of companies are controlled by the state. The controlling shareholder controls 26% of companies through a pyramid in the case of family control. Managers in 69% of companies are part of the controlling shareholder family. Claessens, Djankov and Lang (2000) develop La Porta, Lopez-de-Silanes and Shleifer (1999). Claessens, Djankov and Lang (2000) investigate separation of ownership and control in nine countries of East Asia. Claessens, Djankov and Lang (2000) find that control rights of controlling shareholder were larger than cash flow rights in Indonesia. More than 2/3 of companies are controlled by a single controlling shareholder.

Faccio and Lang (2002) develop a study of La Porta, Lopez-de-Silanes and Shleifer (1999) and Claessens, Djankov and Lang (2000). Faccio and Lang (2002) find that 37% of companies were owned dispersedly and 44% were controlled by family. Demirag and Serter (2003) investigate ultimate ownership on the Istanbul Stock Exchange and find that most companies are owned by ultimate ownership and controlled by a family through a pyramid. Siregar (2006) investigates ultimate ownership in Indonesia and shows that most companies are controlled by a controlling shareholder. Based on a cut off of 10% control rights, 99% of public companies have ownership concentration on single controlling shareholder. Based on a cut off of 10%, Siregar (2006) finds 66% of companies are controlled through a pyramid.

There are consequences of concentrated ownership. Claessens, Djankov, Fan and Lang (1999) show higher cash flow rights increase firm value and higher control rights reduce firm value. A larger wedge between control rights and cash flow rights reduces firm value. Faccio, Lang and Young (2001) find that a higher O/C ratio implies increasing dividends. La Porta, Lopez-de-Silanes, Shleifer and Vishny (2002) and Claessens, Djankov, Fan and Lang (2002) show that higher cash flow rights increase firm value. However, Claessens, Djankov, Fan and Lang (2002) also show that higher control rights reduce firm value. Lins (2003) also finds that higher control rights reduce firm value. Lemmon and Lins (2003) show higher exceeding control rights and cash flow rights reduce firm value. Higher cash flow rights positively affect firm value. Siregar (2006) finds higher cash flow rights increase firm value and dividends and higher control rights negatively effects dividends. Cash Flow right leverage interacted with management of controlling shareholder to negatively affect dividends.

Schipper (1989) defines earnings management as a purposeful intervention in the external financial reporting process with the intent of obtaining some private gain. Healy and Wahlen (1999) define earnings management to occur when managers use judgment in financial reporting and in structuring transactions to alter financial reports for the purpose of either misleading some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers. Scott (2006) defines earnings management as the choice by a manager of accounting policies so as to achieve some specific objective.

According to Healy and Wahlen (1999) and Scott (2006), there are motivations to manage earnings. There are bonus motivations (Healy, 1985; Gaver, Gaver and Austin, 1995; Holthausen, Larcker and Sloan, 1995; and Guidry, Leone and Rock, 1999), contractual motivation (Sweeney, 1994; DeFond and Jiambalvo, 1994), political motivation (Jones, 1991; Cahan, 1992; Na'im and Hartono, 1996; Key, 1997; and Navissi, 1999), tax motivation (Dopuch and Pincus, 1988), changing of CEO motivation (DeFond and Park, 1997), capital market motivation ( Perry and Williams, 1994; Burgstahler and Dichev, 1997; Teoh, Welch and Wong, 1998a; Teoh, Welch and Wong, 1998b; Rangan; 1998; Erickson and Wang, 1999). Cash flow right leverage is the difference between the value of cash flow rights and control rights. The value of cash flow right leverage can be positive or zero because control rights are higher or equal to cash flow rights. Agency problems will be reflected at value of cash flow right leverage. The higher cash flow right leverage, the higher agency problems will be.

Higher cash flow right leverage is an incentive and opportunities for controlling shareholders to expropriate non controlling shareholders (Gugler and Yurtoglu, 2003). It is based on the argument of negative entrenchment effect (Yeh, 2005). It means that higher cash flow right leverage causes higher expropriation. Expropriation is conducted by controlling shareholder to increase the private benefit. Higher private benefits effects higher earnings management. Two empirical studies (Kim and Yi, 2006; and Haw, Hu, Hwang and Wu, 2004) showed that higher cash flow right leverage motivates controlling shareholder to manage earnings. This research estimates that the higher cash flow right leverage effects the higher earnings management. The estimation is based on the argument of negative entrenchment effect (NEE). NEE suggests that a controlling shareholder is interested in using his/her control rights to obtain private benefits by expropriating non controlling shareholders (Yeh, 2005). In this situation, the controlling shareholder manages earnings to avoid the non controlling shareholders observation. The following is hypothesis about cash flow right leverage and earnings management.

$H_1$: Cash flow right leverage of controlling shareholder positively influences earnings management.

## RESEARCH METHOD

The samples of this research are manufacturing industrial companies listed on the Indonesian Stock Exchange (IDX) from 2000 to 2007. The samples include large and small companies to avoid sample selection bias (Jogiyanto, 2010). Data Collected for this study was archival data. One of the forms of archival data is secondary data. The secondary data in this study was as follows. 1. Indonesian Stock Exchange for audited financial statements. 2. OSIRIS Database for the data of ultimate ownership. 3. The Data Centre of Indonesia Business for ultimate ownership. Table 1 shows process of collecting data.

Table 1: Process of Collecting Data

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | Firm Years |
|---|---|---|---|---|---|---|---|---|
| **Numbers of manufacturing companies listed at IDX** | 149 | 145 | 145 | 139 | 139 | 141 | 143 | 1,001 |
| **Incomplete financial statement** | (2) | (1) | (1) | - | (2) | (3) | (5) | (14) |
| **No data ownership** | (1) | - | (2) | (1) | - | - | (1) | (5) |
| **Unaudited report** | - | (2) | (2) | (1) | (1) | (2) | (1) | (9) |
| **Immediate ownership** | (5) | (5) | (6) | (6) | (6) | (5) | (5) | (38) |
| **Cut off less than 10%** | (2) | - | (1) | (1) | (1) | - | - | (5) |
| | | | | | | | | 930 |
| **Outlier** | | | | | | | | (144) |
| **Data can be processed at cut off 10% of control rights** | | | | | | | | 786 |

*The table shows the process of collecting data. The final samples can be processed are 786 observations at 10% cut off. When this research uses cut off 20%, the sum of observations are 739 and 640 firm years at cut off 30%. The samples of this research are all manufacturing companies listed at Indonesian Stock Exchange (IDX).*

Ownership of public companies is classified into dispersed and concentrated ownership. This study classifies dispersed and concentrated ownership at 10%, 20%, and 30% cut off control rights.

Variables of this research include independent variables, a dependent variable, and control variables. The independent variable is cash flow right leverage. The dependent variable is earnings management. Control variables include non-discretionary earnings, size, and leverage. Cash Flow right leverage is difference between control rights and cash flow rights. The cash flow right leverage value is calculated as control rights minus cash flow rights. Some researchers mention leverage as the ratio of cash flow right to control rights (Faccio, Lang and Young, 2001; Lemmon and Lins, 2003). Earnings management is proxied by discretionary accruals. This study uses model of Kang and Sivaramakrishnan (1995). The model is as follows:

$$Total\ accruals_{i,t}/Asset_{i,t-1}= \varphi_0+\varphi_1\left(\delta_1 Revenue_{it}/Asset_{i,t-1}\right)+\varphi_2\left(\delta_2 Expenses_{it}/Asset_{i,t-1}\right)+\varphi_3\left(\delta_3 Gross\ plant\ property\ and\ equipment_{it}/Asset_{i,t-1}\right)+\varepsilon_{it} \quad (1)$$

Where:

$\delta_1 = Account\ Receivable_{i,t-1}/Revenue_{i,t-1}$

$\delta_2 = Account\ balances\ related\ to\ expenses_{i,t-1}/Expenses_{i,t-1}$

$\delta_3 = Depreciation_{i,t-1}/Gross\ plant\ property\ and\ equipment_{i,t-1}$

$Total\ accruals_{i,t} = Net\ income_{i,t} - Operating\ cash\ flow_{i,t}$

$Net\ income_{i,t} =$ $Net\ income\ before\ extraordinary\ item, discountinued\ operation, and\ changes\ of\ accounting\ policies$

$Account\ balances\ related\ to\ expenses_{i,t-1} = Current\ asset - account\ receivable - cash - current\ liabilities$

Non discretionary accruals are obtained from the following equation:

$$Non\ discretionary\ accruals_{i,t}=\varphi_0+\varphi_1\left(\delta_1 Revenue_{it}/Asset_{i,t-1}\right)+\varphi_2\left(\delta_2 Expenses_{it}/Asset_{i,t-1}\right)+\varphi_3\left(\delta_3 Gross\ plant\ property\ and\ equipment_{it}/Asset_{i,t-1}\right) \quad (2)$$

Discretionary accruals are obtained from difference between total accruals minus non discretionary accruals. Discretionary accruals are obtained from residual of equation 3. The equation is as follows:

$$Discretionary\ accruals_{i,t} = Total\ accruals_{i,t}/Asset_{i,t-1} - \left[\varphi_0 + \varphi_1\left(\delta_1 Revenue_{it}/Asset_{i,t-1}\right) + \varphi_2\left(\delta_2 Expenses_{it}/Asset_{i,t-1}\right) + \varphi_3\left(\delta_3 Gross\ plant\ property\ and\ equipment_{it}/Asset_{i,t-1}\right)\right] \quad (3)$$

Earnings management is conducted for bonus motivation (Healy, 1985; Gaver, Gaver and Austin, 1995; Holthausen, Larcker and Sloan, 1995; and Guidry, Leone and Rock, 1999). According to Yang and Krishnan (2005) non-discretionary earnings are a proxy for bonus plan. The earnings are accounting earnings minus discretionary accruals. Leverage is total debt divided total assets. According to Sweeney (1994) and DeFond and Jiambalvo (1994), companies with large leverage tend to manage earnings. Companies might be sensitive to political problems. They tend to manage earnings to reduce political expense (Jones, 1991; Cahan, 1992). According to Johnson and Ramanam (1988), size of the firm negatively influences earnings management. Table 2 shows descriptive statistics.

The empirical model used to test $H_1$ is as follow:

$$Absolute\ discretionary\ accruals_{i,t}=\beta_0+\beta_1 Cash\ flow\ right\ leverage_{i,t}+\beta_2 Non\ discretionary\ earnings_{i,t}+\beta_3 Leverage_{i,t}+\beta_4 Size_{i,t}+\varepsilon_{i,t} \quad (4)$$

Table 2: Statistic Descreptive

| | N=786 | | | | N=739 | N=640 |
|---|---|---|---|---|---|---|
| | **Mean** | **Maximum** | **Minimum** | **Std. Dev.** | **Mean** | **Mean** |
| Absolute discretionary accruals | 0.0627 | 0.1992 | 0.0002 | 0.0467 | 0.0629 | 0.0634 |
| Cash flow right leverage | 0.0376 | 0.4251 | 0.0000 | 0.0786 | 0.0396 | 0.0429 |
| Non discretionary earnings | 0.0878 | 0.7496 | -0.3468 | 0.1457 | 0.0609 | 0.0932 |
| Leverage | 0.5755 | 2.982 | 0.0170 | 0.3364 | 0.5781 | 0.5860 |
| Size | 27.298 | 31.782 | 24.215 | 1.494 | 27.291 | 27.356 |
| Dummy | 0.1526 | 1.000 | 0.0000 | 0.3599 | 0.1515 | 0.0312 |

*The table shows sample description. The sample is collected from Jakarta Stock Exchange especially for manufacturing companies. The table also shows absolute discretionary accrual as proxy of earnings management and cash flow right leverage presenting agency conflict in Indonesia between controlling shareholder and non controlling shareholders.*

At a 10% cut off of control rights, the average of absolute discretionary accruals is 0.0627. The minimum value of absolute discretionary accruals is 0.0002. The value indicates all manufacturing companies do not manage earnings. Excess control rights to cash flow rights are shown on cash flow right leverage. Average of cash flow right leverage is 3.76%. The variable dummy is to control for heterocedasticity problems to test hypothesis. Before testing of hypothesis, this research tests the classical distributional assumption. The result shows normal distribution. There are not heterocedastity, autocorrelation, and multicoliniarity.

## EMPIRICAL RESULTS

This section presents the empirical results. The results in Table 3 show that the coefficient of cash flow right leverage is positive and significant at the 5% level. The results indicate that higher cash flow right leverage increases earnings management. The results show that for every 1% increase of cash flow right leverage earnings management increases 2.830% at a cut off of 10%. Based on these results, hypothesis $H_1$ is supported. Higher values of cash flow right leverage indicate larger agency problems.

According to Kim and Yi (2006), divergences between control rights and cash flow right are an incentive for controlling shareholders to expropriate the company's asset for private benefit and the expense of non controlling shareholders. To hide private benefits, controlling shareholders choose the method and accounting policies that hide expropriation. According to Gugler and Yurtoglu (2003), higher cash flow right leverage offers incentives and opportunities for controlling shareholder to expropriate non controlling shareholders. Therefore, the condition motivates controlling shareholders to manage earnings. The results of this research are consistent with the study of Haw, Hu, Hwang and Wu (2004) and Kim and Yi (2006).

Haw, Hu, Hwang and Wu (2004) document that earnings management is influenced by a wedge between control rights and cash flow rights in countries with low protection for non-controlling shareholders such as Indonesia. Kim and Yi (2006) also document that controlling shareholder tend to manage earnings when high control rights and low cash flow rights. Kim and Yi (2006) document controlling shareholders managing earnings to hide his/her self-serving behavior and to avoid the other consequences such as disciplinary judgments. This happens when the wedge between control rights and cash flow rights is large. With domination of control rights to cash flow rights, the controlling shareholder exploits the assets of the company for his/herself benefits. Decreasing company financial condition motivates controlling shareholders to manage earnings opportunistically through increasing earnings. The results are consistent at a cut off 20% in Panel B and 30% in Panel C on Table 3.

Table 3: Results

| Variable | Coefficient | t-statistic |
|---|---|---|
| **Panel A** | | |
| *Constant* | 0.1283 | 6.519*** |
| Cash flow right leverage | 0.0283 | 2.086** |
| Leverage | 0.0027 | 0.8154 |
| Non discretionary earnings | -0.0007 | -0.0987 |
| Size | -0.0030 | -4.173*** |
| Dummy | 0.0029 | 32.829*** |
| *Adjusted* $R^2$ | 0.591 | |
| F-Statistic | 228.57 | |
| Prob. F-Statistic | 0.0000 | |
| **Panel B** | | |
| *Constant* | 0.1232 | 6.175*** |
| Cash flow right leverage | 0.0275 | 2.008** |
| Leverage | 0.0020 | 0.5876 |
| Non discretionary earnings | -0.0011 | -0.1440 |
| Size | -0.0028 | -3.823*** |
| Dummy | 0.0987 | 31.803*** |
| *Adjusted* $R^2$ | 0.5906 | |
| F-Statistic | 213.96 | |
| Prob. F-Statistic | 0.0000 | |
| **Panel C** | | |
| *Constant* | 0.1291 | 6.044*** |
| Cash flow right leverage | 0.0260 | 1.845* |
| Leverage | 0.0024 | 0.6546 |
| Non discretionary earnings | 0.0031 | 0.3681 |
| Size | -0.0030 | -3.855*** |
| Dummy | 0.0991 | 29.296*** |
| *Adjusted* $R^2$ | 0.5868 | |
| F-Statistic | 182.51 | |
| Prob. F-Statistic | 0.0000 | |

*This table shows the influence of cash flow right leverage on earnings management. In panel a, number of* observation *are 786 firm years at cut off 10% of control rights. More increased cash flow right leverage indicates more increased agency problem between controlling shareholder and non controlling shareholders. Panel B shows the result of influence cash flow right to earnings management at cut off 20% of control rights. When this research uses the cut off, the sums of observation are smaller than 10%. The sums of observation in Panel B are 739 firm years. In Panel C, this research uses cut off 30% of control rights. Therefore in Panel C, the sums of observation are smaller than observation in Panel B.*
***, ** and * indicate significance at the 1, 5 and 10 percent level respectively.

## CONCLUSION

The objective of this research is to investigate whether cash flow right leverage influences earnings management. Data were collected from the Indonesian Stock Exchange. The study uses archival data and multiple regressions to test empirical hypotheses. The primary finding of this research is that cash flow right leverage positively influences earnings management. The conclusion implicates a entrenchment effect.

The private benefit is obtained by controlling shareholder through expropriation and is difficult to measure. This research does not measure the private benefit motivating controlling shareholder to manage earnings. The results of this research will be robust if private benefit is measured. If activity of expropriation is documented, private benefit will be easily measured. The limitation of this research is a low level of generalization. The sample used in this research is manufacturing firms. The results should not be generalized beyond this point. Future research can improve limitations of this research. Future research can measure private benefits. Future research can consider corporate governance in Indonesia. Good corporate governance is expected to prevent expropriation and opportunistic earnings management. Future researchers can research the role of an independent commissary to prevent

expropriation by controlling shareholders. Future researchers can also examine non-manufacturing companies.

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