GOVERNANCE ATTRIBUTES IN INDONESIA AND EARNINGS QUALITY

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Abstract

This research investigates the relationship between corporate governance structure and attributes and the quality of reported earnings in a sample of Indonesian firms. The findings of our research reveals that both concentrated and family ownership are associated with lower earnings quality. In addition we find that independent members of a board committee act as an effective monitoring mechanism to oversee the accounting and financial reports processes of a company.

Keywords: Earnings Quality, Indonesia, Ownership Structure, Audit Committees, Governance

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1 Introduction

This paper focuses on corporate governance monitoring mechanisms, especially the potential impact of ownership structures and board[1] and audit committee effectiveness on the quality of financial reporting. The effect of family ownership on firm value and earnings quality is controversial and is explained using two conflicting agency problems (Ali, Chen, and Radhakrishna, 2007): (1) the Type I agency problem representing the classic owner-manager conflict; and (2) the Type II agency problem describing conflicts between controlling shareholders and non-controlling shareholders. Family firms face a less severe Type I agency problem than other firms because of their ability to monitor managers closely. However, family firms face more severe Type II agency problems than their non-family counterparts because of the high levels of share ownership among families and their control over the board of directors. Further Type II agency problems may lead to earnings manipulation due to expropriation and the control exerted over board directors by controlling family owners (Andersen and Rebb, 2003).

Wang [2006] employs a sample of S&P 1500 firms to investigate the effect of founding family ownership on earnings quality, finding that earnings quality is higher in founding firms than in non-family firms. Wang's findings imply that founding families are less likely to engage in opportunistic earnings management for short-term gain as this may erode the family's reputation and wealth and dilute long-term performance. Similarly, Ali et al. [2007] document that family firms report better quality earnings and issue warnings for bad news, but disclose less information about corporate governance practices.

The setting of this study is Indonesia, a country where high family corporate ownership is prevalent and pervasive in most listed companies. Given the country's high level of concentrated ownership and weak legal protection of outside shareholders rights (Fan and Wong 2003), we address the following research questions. How earning quality is affected by ownership (family realted) structures? Is there an expropriation of wealth, for example, to the majority (family-related) shareholders whilst disadvantaging the minority (non-family) holders? Do the board and audit committee play an effective role in overseeing the financial reporting process?

1 Indonesian firms adapt a two-tier system in their board structure, supervisory board and management board. The supervisory board is called board of commissioners while the management board is called board of directors.

Earnings quality is an issue of growing international importance to investors, policy makers, market analysts and the general public. For their part, policy makers have sought to introduce various corporate governance reforms designed to constrain earnings manipulation. In addition, scholars have not been apathetic given the erosion of earnings quality resulting in major corporate collapses in recent years. Healy and Wahlen (1999), for example, in a review of the earnings quality literature, called for greater research of factors that limit earnings manipulation.

Some researchers (e.g., Morck, Shleifer, and Vishny 1988; Fan and Wong 2002; Wang 2006; Dechow, Sloan, and Sweeney 1996) suggest that the nature of a corporation's governance structure, specifically ownership and board characteristics provide an effective monitoring of management activities. Consequently, they are jointly able to oversee the company's financial reporting process. This study, in response to both the growing concern for earnings quality and calls for more empirical research in academic literature, investigates the effects of governance mechanisms on the quality of financial reporting. Consistent with previous research (e.g., Francis, LaFond, Olsson, and Shipper 2004; Velury and Jenkins 2006; Ball and Shivakumar 2008; Tong and Miao 2011), we use earnings management and accrual quality as proxies for quality of financial reporting while concentrated ownership, family ownership, board of commissioner and audit committee independence as measures for governance mechanisms (e.g., Dechow et al. 1996; Beasley 1996; Bedard, Chtourou, and Courteau 2004).

Our study differs from prior research on at least two main fronts. Firstly, it provides further evidence on the relation between a firm's internal governance mechanisms and the level of financial reporting quality using data from a unique institutional settings, namely Indonesia. Secondly, we enrich the literature by analyzing the joint effects of a range of governance (concentrated ownership, family ownership independent boards of commissioner, and independent audit committee) attributes, and earnings quality. As Vafeas and Theodorou (1998) remark, the study of key related corporate governance characteristics in isolation may hide key inferences, leading to misleading conslusions.

The remainder of the paper is organized as follows. In section 2 a review of the relevant literature is provided. Research methodology including sample selection, data sources, variable measurement and model specification is presented in section 3. The results of this study are discussed in section 4 followed by a brief conclusion in section 5.

2 Literature review

The majority of the literature seeking to explain the incentives to manage earnings draws on costly contracting theory. This study utilizes costly contracting theory which is characterized the corporation as a 'legal nexus of contractual relationship' and assumes that corporate reporting enables principals (shareholders) to monitor agents (managers) compliance with contractual obligations (Godfrey, Hodgson, and Holmes 2003). Jensen & Meckling (1976) identify the existence of two agency relationships: (1) the manager-shareholders (e.g, bonus plans) which the manager acts as an agent for the shareholders who are considered to be the owners; (2) the shareholder-debtholder (e.g., debt contracts) where the manager is assumed to act on behalf of the shareholders, thus the manager is an agent whereas the debtholder becomes the principal. Such situations impose agency costs, due to the existence of conflicts of interest between the agents and the principals. Bartov, Gul & Tsui (2001) note that agency costs include manager's incentive to manage earnings. Empirical evidence from agency theory also reports that management have a preference to manage earnings numbers in order to benefit from the contracting process (Holthausen, Larcker, and Sloan 1995).

Prior studies document that the higher transaction costs are manifested from the greater information asymmetry among market participants. When the markets or investors have less information and cannot observe a company's performance and prospects, they then require higher rates of return and lower current company's stock prices (Bartov and Bodnar 1996). Several studies also document evidence that the existence of information asymmetry between managers and shareholders is a necessary condition for earnings manipulation (Dye 1988). This is because shareholders have less information, thus corporate management can use its insider position to manage reported earnings (Lobo and Zhou 2001). Earnings manipulation reduces the reliability of earnings because reported earnings is biased, and misrepresents the true reporting earnings figure. Arthur Levitts, Jr., (1998) the former chairman of SEC, states that practice of earnings manipulation has negative effects on reliability and credibility of financial reporting.

2.1 Ownership structure and earnings quality

One important issue in the organization of firms is how to solve or mitigate the agency problem that emanates from asymmetric information. The nature of a corporation's ownership structure will affect the nature of the agency problems between managers and outside shareholders, and among shareholders. But the problems that occur when firm ownership is dispersed are different to those that arise when it is concentrated. When ownership is diffused, as is typical for US and UK corporations, conflicts of interest between managers and shareholders are a central problem (Jensen and Meckling 1976). However, when ownership is concentrated to the degree that one owner has effective control of the firm, as is typically the case for firms in Asia, conflicts of interest between controlling shareholders and minority shareholders becomes the main problem.

Claessens, Djankov and Lang (2000) investigated the separation of ownership in selected Asian countries. Their findings indicate that a controlling single shareholder is prevalent in more than two-thirds of the firms while the separation of management from ownership control was rare. Thus Asian countries' owners have significant power to pursue their own interests at the expense of minority shareholders, creditors and other stakeholders. As Shleifer and Vishny (1997) point out, controlling shareholders may not have a convergence of interests with minority shareholders. A greater degree of control by controlling shareholders implies a greater ability to expropriate wealth from minority shareholders.

Past studies document the relation between concentrated ownership structure and firm value. For example, Jensen and Meckling (1976) and Demsetz (1983) argue that managerial equity ownership will provide managers with incentives to maximize firm value. Stulz (1988), however, has provided a model of entrenched managers, where increased managerial ownership allows managers to pursue non-value maximizing agendas. Using US data, Morck, Shleifer and Vishny (1988) have empirically showed a non-linear relation between firm value and managerial ownership. They find that firm value increases up to a certain level of managerial ownership (i.e., 5%) and then decreases as management holdings raise further. Similar results were also reported by McConnell and Servaes (McConnel and Servaes 1995, 1990), Hermalin and Weisbach (2003) and Kole (1995).

Fan and Wong (2002) conduct a study on the relation between concentrated structure and informativeness of accounting earnings in seven Asian countries. They report that earnings informativeness decreases as holding of the controlling shareholders increase. They argue that there is an expropriation of minority shareholders by controlling shareholders. Gaining effective control of a corporation enables the controlling owner to determine not just how the company is run, but also how profits are shared among shareholders. Although minority shareholders are entitled to cash flow rights proportional to their share of equity ownership, they face the uncertainty that an entrenched controlling owner may opportunistically deprive them of their rights. This creates an 'entrenchment effect' (Morck et al. 1988). The entrenchment problem created by a controlling owner is similar to the managerial entrenchment problem. Higher managerial ownership might entrench managers, as they are increasingly less subject to governance mechanisms (Chang, Hillman, and Watson 2005).

Separation of ownership rights and control rights can worsen the entrenchment problems caused by concentrated ownership. Controlling owners could extract wealth from the firm but only bear a part of the cost through a lower valuation of their cash-flow ownership. There is considerable literature documenting the existence of private benefits from control (Zingales 1994; Zingales 1995 ; Nenova 2003; Dyck and Zingales 2004; Barclay and Holderness 1989).[2] In particular, Nenova (2003) and Dyck and Zingales (2004) show that higher private benefits from control are associated with: less developed capital markets; less protected minority shareholders; and more concentrated ownership.

In addition to the 'entrenchment effect', concentrated shareholdings might create an 'alignment effect'. Once the controlling owner obtains effective control of the firm, any increase in voting rights does not further entrench the controlling owner (Morck et al. 1988). Fan and Wong (2002) argue that higher cash

2 Private benefits, sometimes called control benefits, are benefits that accrue to managers or shareholders that have control of the corporation, but not to minority shareholders. They can be non-pecuniary, such as influence over who is elected on the board of directors or in CEO position, the power to build business empires (Nenova 2003), the ability to direct a company's resources to a cause one agrees (Demsetz and Lehn 1985), a preference for glamorous project (Jensen 1993).

flow ownership will cost the controlling shareholder more to divert the firm's cash flows for private gain. High cash-flow ownership can also serve as a signal that the controlling owner will not expropriate wealth from minority shareholders (Gomes 2000) because if minority shareholders know that the controlling owner unexpectedly extracts more private benefits, they will discount the stock price accordingly and the majority owner's share value will be reduced (Fan and Wong 2002). Fan and Wong (2002) argue further, in equilibrium, where a majority shareholder holds a large ownership stake this will result (other things being equal) in a higher stock price for the company. Thus, increasing a controlling owner's cash-flow rights improves the alignment of interests between the controlling owner and the minority shareholders and reduces the effects of entrenchment. In similar vein, Wang (2006) argues that family firms have incentives to report in good faith and thus to provide higher quality of earnings.

Concentration of ownership and extensive family control characterize corporate ownership in most Asian countries and it is particularly most severe in Indonesia (Claessens et al. 2000). Claessens *et al.* (2000) documented that around 67% of Indonesian listed companies are family controlled while only 0.6% are widely held. They further find that Indonesia has the highest ownership concentration of any East Asian Country and has the largest number of companies owned by a single family.

In an extension of the research on family businesses, Khalil, Cohen, and Trompeter [2010] investigate whether the likelihood of the auditor resigning and the resultant stock market reaction differ between family owned firms and non-family firms, and whether such market reaction is related to the identity of the CEO (founder, descendant, or non-family) managing a family firm. Of the three sets of results they report, the first indicates that the likelihood of the auditor resigning is significantly lower in family owned firms than in non-family owned firms. Second, auditor resignation in family firms managed by a founder or non-family CEO (descendant) is also less (more) frequent than in non-family firms. Third, abnormal market returns after the auditor resigns in a family owned firm or a family firm managed by a non-family CEO are higher (less negative) than in non-family firms.
Based on the above literature, concentration ownership (owner type) and family control ownership (owner identity) are examined as possible key predictors for the quality of financial reporting and we propose two separate hypotheses as follow:

H_1: There is an association between concentrated ownership and earnings quality.

H_2: There is an association between family ownership and earnings quality.

2.2 Board of director independence and earnings quality

Recently, the quality of board oversight has received considerable attention. Beasley (1996) and Dechow, Sloan and Sweeney (1996) suggest that the ability of the boards to act as an effective monitoring mechanism depends on their independence from management. The boards are considered to be independent if they do not have any relationship with the company beyond the role of director. Lipton and Lorsch (1992) define an independent director as a director who has no connection with the company, either as management, customer or supplier of goods or services. Thus, the independence board refer to a non-executive director who is not employed by the company and entirely independent from management. The non-executive directors are more likely to have incentives to guard shareholder interests well as they have invested their reputation in a firm (Vafeas and Theodorou 1998; Fama and Jensen 1983).

A number of previous studies report a positive association between board independence and actions that are in the best of interest of shareholders. For example, Beasley (1996) finds that the existence of independent directors associates with less financial statement fraud. Using a sample of U.S. and China firms, Klien (2002), Chang and Sun (2010) and Firth et al. (2007) respectively reports a negative relation between board independence and the magnitude of earnings management. Peasnell, Pope and Young (2000) show evidence supporting Klein's, Chang and Sun, and Firth *et al.* findings in U.K. context. In addition, Dechow et al. (1996) reveal that the more proportion of independent directors the less likely the firm is subjected to Securities and Exchange Commission (SEC) enforcement actions because of violating U.S. GAAP. Consequently, the third hypothesis is:

H_3: There is a positive association between commissioner independence and earnings quality.

2.3 Audit committee independence and earnings quality

Majority of previous studies concerning the relationship between board of directors' composition and firm value has concentrated on the role of the board at large; however, a great deal of board's decision-making occurs at the committee level (Ellstrand, Daily, and Johnson 1999). To oversee the accounting and financial reporting processes of a company as well as the audit of its financial statements, board of directors delegate their responsibility to an audit committee. Thus, it is expected that this committee provides shareholders with the greatest protection in maintaining the credibility of a company's financial statements (Bradbury 1990). A study of 142 U.K. firms conducted by Collier (1993) suggests that firms establish audit committee to alleviate their agency problem and reduce an information asymmetry between insiders and outsider. Evidence also shows that the formation of audit committee associates with more informativeness of reported earnings (Mitra, Hossain, and Deis 2007) and less financial fraud (McMullen and Raghunandan 1996; Dechow et al. 1996).

Prior literature indicates that the effectiveness of an audit committee is dependent on its objectivity or independence and its activity, especially, frequency of meeting (Bedard et al. 2004; Davidson, Goodwin-Stewart, and Kent 2005). Lynn (1996) argues that it is impossible for the audit committee to function effectively if they are also members of executives of the firm. Thus, an audit committee should comprise entirely of non-executive or independent directors (Menon and Williams 1994; Lipton and Lorch 1992). This argument is supported by Jiambalvo (1996) who finds that audit committee independence is associated with a higher degree of active oversight and a lower incidence of financial statements fraud. More recently, Chang and Sun (2010) find that audit committee independence improves the transparency of financial reporting quality. Thus, the fourth hypothesis is:

H_4: There is a positive association between audit committee independence and earnings quality.

3 Research DesignSample

To ensure data homogeneity and reduce industry bias, this study focuses solely on manufacturing companies identified by the Indonesian Capital Market Directory (ICMD). Another reason for choosing manufacturing firms is that these firms are dominant in Asian and particularly the Indonesian economy. As Dhawan, Mangaleswaran, Padhi, Sankhe, Schwan and Paresh (2000, , p. 42) noted: "Asia has become the workshop of the world: more than half of all manufacturing on Earth is estimated to take place there." Within the Indonesian context, Craig and Diga (Craig and Diga 1998, , p. 248) noted that "Indonesia was represented strongly by manufacturing-type entities."

The sample examined in this study comprises of all manufacturing companies listed on the Indonesia Stock Exchange (IDX) for the period 2003 to 2009. There are a total of 166 manufacturing firms listed on the IDX. However, due to missing data we are unable to construct a full set of proxy measures for all 166 entities; therefore, we are left with a final usable sample of 96 firms or 672 firm-years.

3.1 Data sources

The data sources used to trace the ultimate owner in this study originate from the ICMD publications issued by the Institute for Economic and Financial Research (2004, 2008). This data provides the firm's immediate owners. These owners are then traced and cross-checked through the Indonesian Business Data Centre (IBDC) (1997); Information Resource Development (2000); Information Resource Development (1998) and firm's prospectuses to determine a company's affiliation and, hence, its ultimate owner. A firm could have many ultimate owners but this study focuses on the largest ultimate owner.

To measure the degree of control, this study combines shareholdings registered in the name of the majority shareholder and other related shareholders (i.e. through shares held by individuals, family or companies that, in turn, are under his/her control). This procedure is justifiable since in Indonesia the majority of the companies listed on the capital market are family controlled. Following Claessens *et al.* (2000), this study does not distinguish individual family members and uses the family group as the unit of analysis. By identifying the name under which the shares are registered, this study delineates their family affiliation. Collective shares owned by individual family members are treated as a family ownership.

The data sources for measuring variables (dependent, independent and control variables) are hand collected from the IDX Monthly Statistics, March 2010, Volume 19, No. 3 issued by the IDX Research Division and published annual reports that are downloaded from the IDX website: http://www.idx.co.id/.

3.2 Estimation of dependent and independent variables

This study examines the earnings quality of manufacturing firms listed in IDX for the fiscal years 2003 to 2009 using the corporate governance monitoring mechanisms as the prime predictors. Following previous studies (e.g., Schipper and Vincent 2003; Ball and Shivakumar 2008; Velury and Jenkins 2006; Francis et al. 2004; Tong and Miao 2011) earnings quality is measured using two separate proxies: earnings management and accrual quality.

We use the magnitude of discretionary accruals to proxy earnings management. Prior to estimating discretionary accruals, total accruals (*TAC*) are calculated as:

$$TAC_{jt} = (\Delta CA_{jt} - \Delta Cash_{jt}) - (\Delta CL_{jt} - \Delta LTD_{jt} - \Delta ITP_{jt}) - DPA_{jt} \quad (1)$$

Where:

TAC_{jt} = total accruals for firm *j* in time period *t*; ΔCA_{jt} = change current assets for firm *j* from time period *t-1* to *t*;
$\Delta Cash_{jt}$ = change cash balance for firm *j* from time period *t-1* to *t*;
ΔCL_{jt} = change current liabilities for firm *j* from time period *t-1* to *t*;
ΔLTD_{jt} = change long-term debt included in current liabilities for firm *k* from time period *t-1* to *t*;
ΔITP_{jt} = change income tax payable for firm *j* from time period *t-1* to *t*;
DPA_{jt} = depreciation & amortization expense for firm *j* from time period to *t*.

TAC then is decomposed into normal accruals (*NAC*) and discretionary accruals (*DAC*) using the cross-sectional *modified* Jones (1991) model defined formally as:

$$TAC_{jk,t} / TA_{jk,t-1} = \alpha_{jt} [1/ TA_{jk,t-1}] + \beta_{jt} [(\Delta REV_{jk,t} - \Delta REC_{jk,t})/ TA_{jk,t-1}] + \gamma_{j,t} [PPE_{jk,t} / TA_{jk,t-1}] + \varepsilon_{jk,t} \quad (2)$$

Where:

$TAC_{jk,t}$ = total accruals for firm *j* in industry *k* in year *t;*
$TA_{jk,t-1}$ = are total assets for firm *j* in industry *k* at the end of year *t-1*;
$\Delta REV_{jk,t}$ = change net sales for firm *j* in industry *k* between years *t-1* and *t*;
$\Delta REC_{jk,t}$ = change in receivables for firm *j* in industry *k* between years *t-1* and *t*;
$PPE_{jk,t}$ = gross property, plant and equipment for firm *j* in industry *k* in the year *t*;
α_j, β_j, γ_j = industry specific estimated coefficients;
ε_j = error term.

NAC is defined as the fitted values from *Eq. 2* whilst *DAC* is the residual (*TAC* minus *NAC*). Consistent with Klien (2002) and Frankel, Johnson and Nelson (2002), we use the absolute value of discretionary accruals to proxy earnings management. A higher value discretionary accruals means a greater level of earnings management or lower earnings quality.

Our measure of accrual quality is based on Dechow and Dichev's (2002) model. It is defined as the standard deviation of the residuals of the following regression of total current accruals to lagged, current and future cash flows from operations:

$$TAC_{i,t} = \square + \beta_1 CFO_{i,t-1} + \beta_2 CFO_{i,t} + \beta_3 CFO_{i,t+1} + \varepsilon_{i,t} \quad (3)$$

Where:

TAC is firm *i'*s total current accruals in year *t*,
CFO is firm *i'*s cash flow from operations in year *t. All variables are* divided by total assets at the beginning of period *t*.

Large (small) value of accrual quality relates to poor (good) earnings quality.

This study examines the effect of corporate governance monitoring mechanisms: specifically ownership structures and the effectiveness of board of commissioner and audit committee oversight on earnings quality.

Ownership structure refers to the identities of a firm's equity holders and the size of their holdings (Denis and McConnel 2003). Thus, there are two key dimensions of ownership structure that are analyzed: ownership concentration (ownership type) and the identity of owners (ownership identity) (Boubakri, Cosset, and Guedhami 2005).

Murali and Welch (1989) categorized ownership type into closely held and widely held firms and noted that "Effective control is assumed to exist when ownership by an individual or a small group is greater than fifty percent" (p.390). Holderness and Sheehan (Holderness and Sheehan 1988) classified ownership type as either majority held or diffusely held and argued that "A shareholder whose primary objective is expropriation might hold more than 50% of the stock" (p.326). Following Murali and Welch (1989) and Holderness and Sheehan (1988), this study dichotomously categorizes ownership concentration as either: majority ownership; or non-majority ownership. Majority Ownership is defined if one owner (person, family, family's company), the government (local or national), or a foreign multinational owning more than 50% of the shares in a company. A dummy variable is used to categorize firms, set equal to one if a firm has a majority ownership structure and zero otherwise.

Most prior studies of ownership structure emphasize immediate ownership; that is, common shares directly owned by individuals or institutions. Fan and Wong (2002) argued that immediate ownership is not sufficient for characterizing the ownership and control of Asian firms because these firms are generally associated with complicated indirect ownership structures. Therefore, this study focuses on the ultimate ownership of companies. The ultimate owner is defined as the shareholder who has the determining voting rights of the company and who is not controlled by anybody else (Fan and Wong 2002).

The ultimate ownership structures were computed by following existing studies (Faccio, Lang, and Young 2001; Faccio and Lang 2002; Claessens, Djankov, Fan, and Lang 2002; Claessens et al. 2000) that carefully traced the chain of ownership and identified the ultimate owner(s) that controlled the most voting rights (the controlling shareholder(s) by summing their direct and indirect ownership (voting rights) in a company[3]. In many cases, the immediate shareholders of a firm are themselves corporate entities, or investment companies and other legal entities (Yeh 2005). This study then identifies their owners, the owners of their owners, etc[4]. Following Fan and Wong (2002), to economize on the data collection, the ultimate owner's voting rights level is set at 50% and not traced any further once that majority level is reached. Claessens *et al.* (2000) who studied ownership structure and control in nine East Asian countries including Indonesia, documented that in most cases the ultimate owner was an individual or a family.

This study then further classifies significant minority ownership where an individual, or group of family members, holds more than 20% of a firm's shares (voting rights) and is the largest controlling block in the company.[5] The use of the 20% cut-off point has also been adopted by prior researchers such as La Porta *et al. (1999)* who studied corporate ownership in 27 countries and Claessens *et al.* (2000) who investigated company ownership in nine East Asian countries including Indonesia. La Porta *et al.* (1999), for example, argued that the idea behind using a 20% cut-off is "this is usually enough to have effective control of a firm" (p.477). Moreover, according to the Indonesian Capital Market Law (Article (1) 1995) a person that directly or indirectly holds at least 20% of the voting rights of a company is called a 'substantial shareholder'. Similar to La Porta *et al.* (1999) and Claessens *et al. (2002)*, this study does not consider ownership by individual family members separately, but uses the family as the unit of analysis. Family ownership also covers the ownership interests of family members beyond their surnames (i.e. it

3 Direct ownership occurs through shares registered in the name of the ultimate owner. Indirect ownership occurs through shares held by entities that are controlled by the ultimate owner.

4 In many cases, the ownership of these immediate companies can be collected from the prospectus of each company in the sample.

5 There are several definitions of family firms, for example, see Villalonga and Amit (2004) . They include different combinations of family ownership, management, and control. This study is based on ownership.

includes blood and marriage ties) and families are assumed to own and vote collectively.[6] A company is then classified according to data extracted from the ICMD, IBDC, and INFORDEV publications, and firm's prospectuses. A dummy variable is used to identify the firms and is set equal to one if a firm is considered to be family owned (controlled) and zero otherwise.

The ability of the board and its committee to act as an effective monitoring mechanism depends on their independence from management (Beasley 1996; Dechow et al. 1996; Bedard et al. 2004). Thus, we measure the effectiveness of board of commissioner (audit committee) as percentage of the board of commissioners (audit committee) that is independent (Klein 1998, 2002; Han and Wang 1998; Bedard et al. 2004; Davidson et al. 2005).

3.3 Control variables

To control for compounding influences of cross-sectional factors, this study includes size, leverage, firm performance and absolute value of total accruals as control variables in the regression analysis. Consistent with much prior literature (e.g., Becker et al., 1998; Reynolds and Francis, 2000; Frankel et al., 2002) we include firm size as prior studies indicate that litigation risk is greater for larger size clients (Lys and Watts 1994; Heninger 2001). Also, large companies are less likely to engage in earnings management due to more scrutiny from financial analysts and investors (Zhou and Elder 2001). Size is calculated as the natural logarithm of the total sales.

Prior studies show firms with a higher likelihood of violating debt agreements are more likely to have an incentive to engage in earnings management to increase earnings (e.g., Watts and Zimmerman 1986; Press and Weintrop 1990; Healy and Palepu 1990; DeFond and Jiambalvo 1994; Sweeney 1994). Leverage is included to control for this possible compounding factor. We define Leverage as ratio of total liabilities to total assets. Previous research (e.g., Dechow et al., 1995; Frankel et al., 2002; Kothari et al., 2002) reports discretionary accruals is dependent on a firm's financial performance. This is because a firm's financial performance may affect corporate management opportunistic window and the incentives for managing earnings. Furthermore, financial performance may have a bearing on a firm's audit risk (e.g., Gul et al., 2003; Krishnan, 2003). Return on assets (ROA) is included to control for the possible compounding influences of a firm's financial performance. We also include absolute value of total accruals (ABSTAccruals) to control for a firm's 'accrual-generating potential' (Becker et al., 1998). This control in also included as firms with higher absolute values of total accruals are likely to have greater discretionary accruals (Krishnan, 2003).

3.4 Empirical model equations

We use OLS multiple regression as the main statistical technique to test the hypotheses. The main regression model is defined in the following equation:

$$EarningsQuality_i = a_i + \gamma_{i1}\, OwnerType_i + + \gamma_{i2}\, OwnerIdentity_i + \gamma_{i3}\, IndBoc_i + \gamma_{i4}\, IndAudCom_i + \alpha_{i1} Size_i + \alpha_{i2}\, ABSTAccurals_i + \alpha_{i3}\, Leverage_i + \alpha_{i4} ROA_i + \varepsilon_i \quad (4)$$

4 Descriptive and statistical analyses

Table 1, Panels A and B, provides the descriptive statistics for the dependent, independent and control variables. Panel A shows the descriptive statistics for the continuous variables in the regression model. Panel B reports details of the dummy regression variables. Table 1, Panel A indicates that average discretionary accruals (a proxy for earnings management) is 0.0050 (ranging from -2.1030 to 1.8253) of the beginning balance of total assets. Accrual Quality measure has a mean (median) value of 0.0019 (0.0012) and a standard deviation of 0.0685.

The percentage of independent commissioner has an average of 39.35% with a median of 33.33%. On average, only 23.78% of audit committee members are independence. This is consistent with many other developing countries that the percentage of independent commissioners and independent members of the audit committee are under 50%. Size of the companies that are included in the sample has a wide range.

6 Indonesian Capital Market Law (Article 1, 1995) defines 'family affiliation' as a 'family relationship by marriage' and 'family relationship by descent' both to the second degree, horizontally as well as vertically.

Panel A shows that the size of the Indonesian companies has a mean of IDR2,031,443 million, ranging from IDR96 to IDR25,636,995 million. Average total liabilities to total assets ratio (*Leverage*) of the sample firms is 68.00%, demonstrating that Indonesian companies are heavily financed by third party funds rather than self-financing. On the other hand, most of the sample firms earn relatively lower profits during 2003 to 2009 financial years. As presented in Panel A, the sample firms' net profit to total assets, on average, is 3.97% ranging from losses 21.42% to profit 37.27%. The natural logarithm of the absolute value of total accruals has a mean (median) of 16.33 (16.89).

In relation to the ownership structure observed across the sample firms, Panel B of the table indicated that 60.42% of firms are controlled by the owners who have a majority ownership (more than 50% of a company's outstanding share). Panel B also shows that 64.58% of firms are owned by an individual or group of family members. This is consistent with Claessens *et al.* (2000) finding that Indonesian ownership concentration is higher than most other countries, with the major shareholders controlling 61.70% of all corporations.

Table 1. Descriptive statistics

Panel A – Continuous variables

	Mean	*Median*	*Std Dev*	*Minimum*	*Maximum*
Earnings	0.0050	0.0128	0.5030	-2.0130	1.8253
Management	-0.0019	-0.0012	0.0685	-0.1625	0.1882
Accrual Quality	39.35	33.33	11.09	0	0.8000
IndBoc (%)					
IndAudCom (%)	23.78	33.33	16.31	0	0.6667
ROA (%)	3.97	3.45	8.97	-21.42	37.27
Leverage (%)	68.00	58.38	61.35	10.91	152.99
Sales (million IDR)	2,031,443	503.960	4,750,877	96	25,636,995
ABSTAccruals (ln)	16.33	16.89	2.85	5.16	21.47

Panel B – Dummy regression variables

	Frequency	*Percentage*
Owner Type		
Majority	58	60.42
Non-majority	38	39.58
Owner Identity		
Family	62	64.58
Non-family	34	35.42

Legend:
Earnings Management: the earnings quality measure computed based on Jones (1991).
Accrual quality: the earnings quality measure computed based on Lipe (1990).
IndBoc: The proportion of independent Board of Commissioner.
IndAudCom: The proportion of independent Audit Committee.
ROA: Ratio of net income to total assets.
Size: Total assets of firm.
Leverage: Ratio of total liabilities to total assets.
ABSTAccruals: Absolute value of total accruals deflated by total assets.
Owner Type: Indicator variable with firm i scored one (1) if one owner (person, family, family's company), the government (local or national), or a foreign multinational has a majority ownership (more than 50% of the shares in a company); otherwise scored zero (0)
Owner Identity: Indicator variable with firm i scored one (1) if an individual or group of family members, holds more than 20% of a firm's shares (voting rights) and is the largest controlling block in the company; otherwise scored zero (0)

The correlations of the variables are presented in Table 2. The Pearson correlation coefficients provide some evidence of the direction of the results. Both of the ownership structure measures, Owner Type and Owner Identity, are positively (negatively) correlated with Earnings Management (Accrual Quality). These positive (negative) coefficients imply that both concentrated and family ownership are associated with lower (higher) earnings quality. Consistent with predictions, Independent Board Commissioner (IndBoc) is negatively associated with both earnings quality measures (Earnings Management and Accrual Quality), inferring that independent commissioner members act as an effective monitoring mechanism in overseeing the financial reporting process thus higher earnings quality. However, those relationships are statistically not significant. In addition, there are some significant correlation amongst the independent variables, however the highest correlation is below the critical limit of 0.80 (Hair, Anderson, Tatham, and Black 1995; Greene 1999; Cooper and Schindler 2003). In respect to correlations between independent and control variables, and amongst control variables themselves, the highest correlations are between *Size* and *ABSTAccruals* with a coefficient of 0.647 ($p<0.01$). This value is, below the critical limit of 0.80.[7] Variance inflation factors calculated for the regression reported in Table 3 for all independent and control variables provide further indications that multicollinearity is not a problem in the model estimations (Hair, Anderson, Tatham, and Black 1995; Greene 1999; Cooper and Schindler 2003).

Table 2. Pearson correlation matrix

	Earnings Manage-ment	Accrual Quality	Owner Type	Owner Identity	IndBoc	IndAud Com	ROA	Leverage	Size	ABSTA-ccrual
Earnings Management		0.614*	0.013	0.109	-0.148	-0.047	0.161	-0.138	-0.099	-0.259*
Accrual Quality			-0.073	-0.076	-0.041	-0.013	0.568*	-0.194**	0.029	-0.198**
Owner Type				0.024	0.214**	-0.279*	0.070	-0.057	0.098	0.035
Owner Identity					-0.119	0.034	-0.259*	0.004	-0.150	-0.053
IndBoc						0.086	0.228**	0.065	0.048	-0.002
IndAudCom							0.081	-0.195***	0.069	0.010
ROA								-0.235**	0.201**	0.036
Leverage									-0.059	-0.006
Size										0.647*

Legend

: * and ** indicate significance at $p<0.01$ and $p<0.05$ (based on two-tailed tests).

Earnings Management: the earnings quality measure computed based on Jones (1991).

Accrual quality: the earnings quality measure computed based on Lipe (1990).

IndBoc: The proportion of independent Board of Commissioner.

IndAudCom: The proportion of independent Audit Committee.

ROA: Ratio of net income to total assets.

Size: Total assets of firm.

Leverage: Ratio of total liabilities to total assets.

ABSTAccruals: Absolute value of total accruals deflated by total assets.

Owner Type: Indicator variable with firm i scored one (1) if one owner (person, family, family's company), the government (local or national), or a foreign multinational has a majority ownership (more than 50% of the shares in a company); otherwise scored zero (0)

Owner Identity: Indicator variable with firm i scored one (1) if an individual or group of family members, holds more than 20% of a firm's shares (voting rights) and is the largest controlling block in the company; otherwise scored zero (0)

7 As a further check for multicollinearity this study performs the model estimations reported in Table 3 again after first excluding Size and then ABSTAccruals. The independent exclusion of each respective control variable does not significantly alter the findings reported in the main result.

The main result for testing the impact of corporate governance monitoring mechanisms on earnings quality is reported in Table 3. Panels A and B present the results of regression using earnings management and accrual quality respectively. Regression model estimates reported in Table 3, Panels A and B are all statistically significant (F-statistic p<0.001) with explanatory power of 20% (Panel A) and 47% (Panel B). The coefficients on Owner Type are negative but statistically insignificant in both earnings quality measurements. Thus, the evidence does not support the notion that a higher level of ownership concentration influences the quality of financial information and therefore, our H_1 is rejected. This finding is inconsistent with previous studies, for example Fan and Wang (2002) and Morck et al. (1988), who document that earnings quality decreases as holding of the controlling shareholders increase. The finding also fails to confirm that highly concentrated ownership firms might create an 'alignment effect' (Morck et a. 1988).

The coefficients on Owner Identity are positive and significant (at p<0.05 and p<0.10) in Earnings Management and Accrual Quality measures respectively. Thus, our H_2 is accepted. These results suggest that the presence of high concentrated shareholdings by family members might higher earnings management and accrual quality, thus lower earnings quality. Our findings support the notion that family control may harm firm performance (Faccio et al. 2001; Claessens et al. 2002; Barth, Gulbrandsen, and Schonea 2005; Saito 2008). However, the results are inconsistent with Wang (2006) who find that founding family ownership is related with higher earnings quality.

With regard to board of commissioner and its audit committee, as predicted, we find that the coefficients on IndBoc and IndAudCom are negative in both earnings quality measurements. However, the only IndBoc is statistically significant (at the bottom level of p<0.10) associated with earnings management. Thus, H_3 is accepted. This implies that independent members of a board of commissioners do act in the best of interest of shareholders. They act as an effective monitoring mechanism to oversee the accounting and financial reporting processes of a company. This finding support previous studies (e.g., Bealey 1996, Klien 2002, Firth et al. 2007, Chang and Sun 2010).

Table 3. Multiple regression results

	Panel A–*Earnings Management*		**Panel B–*Accrual Quality***	
	Beta	***t*-statistic**	**Beta**	***t*-statistic**
(Constant)		0.536		0.609
Owner Type	-0.037	-0.362	-0.109	-1.319
Owner Identity	0.190	1.965**	0.136	1.733***
IndBoc	-0.183	-1.845***	-0.125	-1.557
IndAudCom	-0.055	-0.549	-0.113	-1.381
ROA	0.192	1.841***	0.643	7.598*
Leverage	-0.088	-0.899	-0.114	-1.432
Size	0.524	2.799*	0.294	1.933**
AbSTAccrual	-0.736	-4.066*	-0.431	-2.930*
Model Summary				
R-Squared	0.268		0.517	
Adj. R-Squared	0.200		0.472	
F-Statistic	3.977*		11.621*	
Sample Size	96		96	

Legend:
*, **, and *** indicate significance at p<0.01, p<0.05 and p<0.10, respectively (based on two-tailed tests).
Earnings Management: the earnings quality measure computed based on Jones (1991).
Accrual quality: the earnings quality measure computed based on Lipe (1990).
IndBoc: The proportion of independent Board of Commissioner.
IndAudCom: The proportion of independent Audit Committee.
ROA: Ratio of net income to total assets.
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Owner Type: Indicator variable with firm i scored one (1) if one owner (person, family, family's company), the government (local or national), or a foreign multinational has a majority ownership (more than 50% of the shares in a company); otherwise scored zero (0)
Owner Identity: Indicator variable with firm i scored one (1) if an individual or group of family members, holds more than 20% of a firm's shares (voting rights) and is the largest controlling block in the company; otherwise scored zero (0)

5 Conclusions

Corporate governance can be defined as the set of institutional arrangements effecting corporate decision-making (Ball, 1998). It describes, for example, rules governing board structure, manager's and boards' incentive composition, decision rights by the board and CEO, shareholding voting, debt/ equity finance decisions as well as disclosure during takeovers. Given the existence of agency problems inherent in the corporate form, corporate performance will be a function of the quality of the corporate governance structures of the company (Weisbach, 1993). In an efficient capital market, investors will discount the price they are willing to pay for a company's shares by the expected level of managerial agency costs. It is therefore assumed that for a company to prosper, it will choose a corporate governance structure that is efficient in minimizing agency costs.

The purpose of this study was to examine the relationship between family oriented ultimate owners, board and audit committee monitoring and earnings quality in Indonesian firms. Using a sample 96 firms we find a negative association between ultimate owners and earnings quality. The findings of our research reveals that both concentrated and family ownership are associated with lower earnings quality. In addition we find that independent members of a board committee act as an effective monitoring mechanism to oversee the accounting and financial reports processes of a company.

This study is subject to several limitations. First, working with an indonesian sample increases the probability of omitted correlated variable problem. Further, the theoretical relations among institutional factors and differences in corporate governance, ownership concentration and business structures are still not well understood. Third, selection criteria for the sample and the small sample size may limit the generalizability of the results. Finally, the endogeneity issue between governance and financial reporting quality is not fully addressed in this study due to a lack of theoretical instruments that affect governance but not earnings quality. In spite of these caveats, our work contributes to a growing literature on the association between firm characteristics and financial reporting quality (earnings).

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