

The Influence of Family Control and Institutional Ownership of Profit Management

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This study was conducted to examine the effect of family control and institutional ownership on earnings management. The population in this study consists of all the manufacturing companies listed on the Indonesia Stock Exchange (BEI) in 2012-2016. The sample used is 665 company data collected by purposive sampling. The analysis technique used in this research is multiple linear regression. The data collection method used is documentation, while the data type is secondary data processed with data processing software SPSS 20.0. The results found that family control had a positive effect on earnings management while institutional ownership had a negative effect on earnings management.

Key words: *Family control, institutional ownership, earnings management*

Introduction

Financial statements are a form of management accountability for shareholders and the community in general. Lamora et al. (2014) revealed that earnings information, which is part of financial statements, is often manipulated by management to maximize their personal interests. This can be detrimental to shareholders or investors. These opportunistic actions are carried out by selecting certain accounting policies so they can change the amount of profit disclosed in the financial statements. This is a practise often referred to as earnings management (Agustia, 2013). The earnings management managerially increase or reduce reported profits from its responsibility unit that have no relationship with increases or decreases in long-term corporate profitability (Mahrani & Soewarno, 2018).

In accordance with agency theory, earnings management can arise because there is a conflict of interest between the principal and the agent (Jensen & Meckling, 1976). The conflict of interest can occur because the agent tends to prioritize his welfare, while the agent expects a high rate of return or return on shares. One example of an earnings management case occurred at the Toshiba company in 2015. Toshiba shocked the whole world when it stated that the company was investigating an internal accounting scandal and had to revise earnings calculations over the last three years. After the investigation, it is known that Toshiba has been struggling to achieve business profit targets since the 2008 global crisis, prompting the company to commit an accounting fraud worth 1.22 billion US dollars. As a result, Toshiba lost 8 billion US dollars.

Scott (2003) revealed that earnings management is the manager's decision in choosing the accounting policies that affect earnings to achieve certain goals. Earnings management is also conceptualized as a management intervention in the external financial reporting process, with the aim of obtaining some personal benefits that can occur at any stage of external disclosure (Schipper, 1989; Healy & Wahlen, 1999). There are factors, like family control, which can pressure the management to implement earnings management practices. Family control is a condition where the family members are either commissioners or directors who participate in the operation of the company (Villalonga & Amit, 2006). According to Sánchez-Marín et al., (2016), direct pressure exerted by commissioners or directors from family members aims to increase financial success to the fullest, and family members will actively provide ideas related to the company's operational activities.

Another factor that can influence management to take actions relating to earnings management is institutional ownership. Hapsari (2016) stated that institutional ownership is ownership of shares by other institutions, particularly ownership by companies or other institutions like insurance companies, banks, and investment companies. The existence of institutional ownership in a company positions increased supervision as optimal for management performance, because the ownership of shares represents a source of power that can be used towards management performance (Malady, 2016). Institutional investors can carry out monitoring and act as a restraint on opportunistic behaviour by managers, which can help reduce the cost of corporate agencies and also be a substitute for debt if the institution can monitor managerial activities at low cost (Mahadwarta & Ismiyanti, 2008). Institutional ownership generally consists of active and passive investors (Salehi & Sehat, 2018).

This research specifically examines the relationship between family control and institutional ownership and earnings management. This research used a sample of manufacturing companies listed on the Indonesia Stock Exchange (IDX) in the 2012-2016 period. The sample used was 665 company data collected by purposive sampling. The results showed that

family control had a positive effect on earnings management, while institutional ownership had a negative effect.

This research will continue with the following arrangement: a literature review; an explanation of the variables and samples as well as research models; empirical analysis results and hypothesis testing results; and a summary or conclusion of the study, which will include suggestions for further research.

Literature Review

Family Control and Earnings Management

Family control is a situation where all family members are directly involved both in top management and director positions (Dyreng et al., 2010; Taruvinga, et.al 2017). Companies with family control tend to have higher flexibility when compared to those without family control. Short hierarchy and bureaucracy make companies faster in the decision-making process and more adaptable to the developments of the business world. On the other hand, companies with family control have higher complexity.

The existence of a family in the top management chair gives the family greater opportunity to carry out opportunistic practices, and to make decisions that will provide benefits for only certain parties, specifically the family. Gama and Galvao (2012) revealed that in companies where the majority of shareholders are family members who will control decisions within the company through their control rights, these decisions are often based only on the interests of the majority shareholders and not on behalf of all shareholders.

Earnings management refers to actions taken by company management to influence reported earnings which can provide information about economic advantages that are actually not experienced by the company. In the long run these actions can harm the company (Merchant, 1989). Scott (2014) showed that earnings management is an intervention carried out by managers in the process of preparing financial statements for specific purposes.

Almeida-Santos et al. (2014) and Ishak et al. (2011) provided empirical evidence that family control has a positive impact on the occurrence of earnings management actions. The results of the study provided empirical evidence that the greater the family control in the family company, the greater the number of earnings management actions taken. On the other hand, the research done by Jiraporn and Dadalt (2009) and Martin et al. (2013) provided empirical evidence that family control has a negative effect on earnings management, which indicates that greater family control within the company will reduce the practise of earnings management.

The greater the family's control of the company, the greater the possibility of earnings management. The existence of a family that serves on the management, namely on the position of the board of commissioners and the board of directors, will make it easy for the family members to meet their expectations in generating personal profit by managing corporate profits. Almeida-Santos et al. (2014) found that family control had a positive impact on earnings management actions. The research provided empirical evidence that high family control in a company results in high earnings management actions.

H1: Family control influences earnings management

Institutional Ownership and Profit Management

Institutional ownership is the ownership of company shares by companies, institutions, or other institutions. Hapsari (2016) stated that institutional ownership is the ownership of shares by parties in the form of institutions, such as insurance companies, banks, investment companies, and other institutional ownership.

Institutional ownership plays a very important role in minimizing agency conflicts that occur between managers and shareholders (Jensen & Meckling, 1976). Institutional ownership has special importance in monitoring management because having institutional ownership will encourage increased oversight. Such monitoring will certainly guarantee prosperity for the shareholders. The effect of institutional ownership as a supervisory agent is suppressed through its sizable investment in the capital market. A high level of institutional ownership will lead to greater oversight efforts by institutional investors, limiting the manager's opportunistic behaviour.

Bao and Lewellyn (2015) and Agustia (2013) provided empirical evidence that institutional ownership has no effect on earnings management. This shows that institutional ownership does not have the ability to control management and, by extension, reduce earnings management. This is in contrast to Malady (2016), who provided empirical evidence that institutional ownership had a significant negative effect on earnings management. These results indicate that the greater the ownership of shares by institutions, the smaller the earnings management actions. On the other hand, Hapsari (2016) found that institutional ownership had a significant positive effect on earnings management, which means that companies with a high level of institutional ownership had a higher level of earnings management by management.

Institutional investors are considered more experienced at detecting errors than individual investors. Malady (2016) concluded that institutional investors acting as sophisticated investors had the power to pressure management to focus more on company performance and

reduce opportunistic behaviour that benefits only certain parties. Alzoubi (2016) found that institutional ownership had a negative influence on earnings management. This shows that the greater the institutional ownership in a company, the smaller the level of earnings management that occurs in these companies. Institutional investors will more actively monitor the activities of companies they invest in as a consequence of the amount of wealth they have invested in the company.

H2: Institutional ownership influences earnings management

Research Methodology

Samples and Data Sources

The sample in this study includes all manufacturing companies listed on the Indonesia Stock Exchange in 2012 - 2016. The sample selection method was carried out using the purposive sampling method based on the following criteria:

Table 1: Sample Selection Criteria

No.	Criteria	Amount				
		2012	2013	2014	2015	2016
1.	Manufacturing companies listed on the Indonesia Stock Exchange	132	135	141	143	144
2.	Manufacturing companies that do not report annual reports on the Indonesia Stock Exchange	(2)	(1)	(2)	(1)	(5)
3.	Manufacturing companies with a financial reporting period other than December 31	(3)	(4)	(5)	(4)	(2)
4.	Manufacturing companies that do not provide the data needed for research.	(1)	0	0	0	0
Total Sample		126	130	134	138	137

Definition of Variable Operations

Earnings management

Earnings management is an intervention carried out by managers in the process of preparing financial statements for specific purposes (Scott, 2014). Earnings management is measured using discretionary accruals with the Modified Jones model.

The steps in measuring earnings management with the Modified Jones Model are:

1. Determine the total value of accruals, which is the difference between net income and operating cash flow

$$TA_{it} = NI_{it} - CFO_{it}$$

2. Determine the parameter value using Jones Model (1991)

$$TA_{it} = \alpha_I + \beta_1 \Delta REV_{it} + \beta_2 PPE_{it} + e_{it}$$

To scale the data, all the variables above are divided by the assets of the previous year, so the formula becomes

$$\frac{TA_{it}}{A_{it-1}} = \alpha \left(\frac{1}{A_{it-1}} \right) + \beta_1 \left(\frac{\Delta REV_{it}}{\Delta REC_{it}} \right) / A_{it-1} + \beta_2 \left(\frac{PPE_{it}}{A_{it-1}} \right) + e_{it}$$

Parameter values 1, 2, and 3 are estimated using the Ordinary Least Square (OLS) regression equation

3. Using parameter values 1, 2, and 3, the nondiscretionary accrual value can be calculated by the formula

$$NDA_{it} = \alpha \left(\frac{1}{A_{it-1}} \right) + \beta_1 (\Delta REV_{it} - \Delta REC_{it}) / A_{it-1} + \beta_2 \left(\frac{PPE_{it}}{A_{it-1}} \right) + e_{it}$$

4. Total accruals are also the sum of discretionary accruals and nondiscretionary accruals. To calculate the value of discretionary accruals, which is an indicator of accrual earnings management, is done by deducing nondiscretionary accruals from total accruals

$$DA_{it} = TA_{it} / A_{it-1} - NDA_{it}$$

Information:

TA	: total accruals
NI	: net income
CFO	: operating cash flow
NDA	: non-discretionary accruals
DA	: discretionary accrual
A-1	: total assets -1
ΔREV	: changes in net sales
ΔREC	: change in receivables
PPE	: property, plant, and equipment

it	: company i , in t
$\alpha_1, \beta_1, \beta_2$: parameters obtained from the regression equation
e	: residual error

Family Control

Family control is a situation where all family members are directly involved both in top management and directors' positions (Dyrenge et al., 2010). Family control is measured by a dummy variable, given a value of 1 if there are family members in the company's top management, and a value of 0 if not.

Institutional Ownership

Institutional ownership is ownership of shares by other institutions, namely ownership by companies or other institutions, such as insurance companies, banks, investment companies, and other institutions ownership (Hapsari, 2016). It is measured using a percentage of the company's shares owned by another company.

$$\text{INSTOWN} = \frac{\text{Numbers of shares owned by institutionals}}{\text{Numbers of outstanding shares}}$$

Control Variables

Loss

Loss is a proxy of a troubled company's financial condition (Peni & Vahamaa, 2010). The loss variable is measured by a dummy variable, given a value of 1 if the company suffers a loss, and a value of 0 if not.

Leverage

Leverage is a ratio that measures a company's ability to meet its long-term obligations (Frank et al., 2009). Gaaya et al. (2017) formulated the leverage ratio as follows:

$$\text{Leverage} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

Analysis Techniques and Research Models

The analysis technique used in this study is multiple linear regression analysis because the technique aims to measure the effect of more than one independent variable with one dependent variable. The regression model in this study was formulated as follows:

$$DA = a + \beta_1 FCON + \beta_2 INST + \beta_3 LEV + \beta_4 LOSS + \varepsilon$$

DA represents earnings management measured using the Modified Jones Model. FCON represents family control as measured by the presence of family elements in the top management of the company. INST represents institutional ownership as measured by the percentage of share ownership by institutional investors over the number of outstanding shares. LEV represents leverage as measured by the ratio of total debt to total assets. LOSS represents the loss measured by the loss experienced by the company.

Result and Discussion

Descriptive Statistics

Table 2: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
DA	665	0	04	879	1336
FCON	665	0	00	782	9990
LOSS	665	0	00	346	2406
LEV	665	4	06	522	8233
INST	665	0	00	917	1467

The DA proxy used to explain earnings management has a minimum value of 0.000000000000022, a maximum of 1.04, and an average of 0.0879, with a standard deviation of 0.11336. The FCON proxy which explains family control has a minimum value of 0, a maximum of 1, and an average of 0.4782 with a standard deviation of 0.4999. The LOSS proxy which explains loss has a minimum value of 0, a maximum of 1, and an average of 0.2346 with a standard deviation of 0.42406. The LEV proxy explaining leverage has a minimum value of 0.04, a maximum of 5.06, and an average of 0.5522 with a standard deviation of 0.48233. The INST proxy explaining institutional ownership has a minimum value of 0, a maximum of 1, and an average of 0.6917 with a standard deviation of 0.21467.

The Normality Test

The normality test is carried out using the Kolmogorov-Smirnov method. Residuals will be normally distributed if the probability value of significance > 0.05. If not, the residuals will not be normally distributed. Based on the normality test, the significance value of 0,000 < 0.05 means the data is not normally distributed. Therefore, it is necessary to normalize the data by removing the data that has the highest residual value by deleting 305 outlier data. The

significance value after normalizing the data is $0.064 > 0.05$, which means the data has been normally distributed.

The Multicollinearity Test

Multicollinearity occurs when the tolerance value ≤ 0.10 or VIF ≥ 10 . The multicollinearity test results show that there is no multicollinearity among the independent variables in this study because the tolerance value ≤ 0.10 and the VIF value ≥ 10 .

The Heteroscedasticity Test

This study uses the Glejser test to prove the absence of heteroscedasticity. If the calculated significance value for each variable in the Glejser test is greater than 0.05, the regression model does not experience heteroscedasticity problems. The heteroscedasticity test results showed that there were no heteroscedasticity problems as the significance value calculated for each variable > 0.05 .

The T-Test

Table 3: Statistical T-Test Results

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	.047	.006		8.176	.000
FCON	.005	.002	.110	2.050	.041
INST	-.016	.007	-.134	-2.483	.013
LEV	.002	.007	.019	.338	.735
LOSS	-.002	.003	-.031	-.544	.587

Based on the results in Table 3, it can be seen that the family control variable (FCON) has a significance level of 0.041 on earnings management (DA) with a regression coefficient of 0.005 and a t-value of 2.050. This value indicates that the family control variable has a significant influence on the earnings management variable.

Institutional ownership (INST) has a significance level of 0.013 on earnings management (DA) with a regression coefficient of -0.016 and a t-value of 2.483. This value indicates that the variable institutional ownership has a significant influence on earnings management variables. Leverage (LEV) has a significance level of 0.735 on earnings management (DA) with a regression coefficient of 0.002 and a t-value of 0.338. This value indicates that the leverage variable has no significant effect on earnings management variables. Loss (LOSS)

has a significance level of 0.587 to earnings management (DA) with a regression coefficient of -0.002 and a value of -0.544. This value indicates that the loss variable has no significant effect on earnings management variables.

Multiple Linear Regression

Table 4: Multiple Linear Regression Test Results

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	.047	.006		8.176	.000
	FCON	.005	.002	.110	2.050	.041
	INST	-.016	.007	-.134	-2.483	.013
	LEV	.002	.007	.019	.338	.735
	LOSS	-.002	.003	-.031	-.544	.587

The Effect of Family Control on Earnings Management

Based on the results of multiple linear regression analysis, a significance value of 0.041 < 0.05 means that family control has a significant influence on earnings management. The coefficient value of 0.005 indicates that family control has a positive influence on earnings management. The results of this study indicate that the first hypothesis of this study was accepted, which is that family control has a significant positive effect on earnings management. This shows that the greater the family control in the company, the greater the tendency of management to take earnings management actions.

The existence of a family who serves in the top management chair allows the family to have a greater opportunity to carry out opportunistic practices to make decisions that aim to provide benefits only for certain parties, especially the family. This statement is in accordance with Ishak et al. (2011) who show that the existence of a family serving in the management, specifically in the position of the board of commissioners or board of directors, will make it easy for family members to meet their expectations in generating personal profit by reducing corporate profits.

Management will overcome efforts to manage earnings for the benefit of the family by certain accounting treatments that improve the existing profit position, namely earnings management. This is in accordance with the research done by Jara-Bertin and Sepulveda (2016) who found that the level of earnings management is higher in companies with family control than in those without it. These results are in line with the research performed by

Almeida-Santos et al. (2014) which provided empirical evidence that family control had a positive impact on earnings management actions.

The Effect of Institutional Ownership on Earnings Management

Based on the results of the multiple linear regression analysis, significance value of $0.013 < 0.05$ means that institutional ownership has a significant effect on earnings management. The coefficient value of -0.016 indicates that institutional ownership has a negative influence on earnings management. The results of this study indicate that the second hypothesis of this study is accepted, namely institutional ownership has a significant negative effect on earnings management. This shows greater institutional ownership in a company will reduce the tendency of management to do earnings management.

Institutional investors are considered more experienced in detecting errors than individual investors. Institutional investors have the ability to control management through effective monitoring processes so they can oversee the company's operational activities by management. This statement is in accordance with Alzoubi (2016), who stated that institutional investors would more actively monitor the activities of the companies where they invest due to the amount of wealth they invest in these companies.

Through their role as sophisticated investors, institutional investors have the power to pressure management to focus more on company performance and reduce opportunistic behaviour that will benefit only certain parties. Sophisticated investors are investors who are sophisticated in receiving, analysing, and interpreting the information available. Institutional investors participate in overseeing all management activities, especially earnings management. These results are consistent with the research of Malady (2016) and Wijayanti (2018) who found empirical evidence that institutional ownership has a significant negative effect on earnings management. Based on the results in Table 4, the significant variables on the ethical perceptions of earnings management are relativism, idealism, ethical climate organization and moral reasoning. This happens because the significance of the variable is less than 0.05. On the other hand, age, sex and years of service do not have a significant effect on the ethical perceptions of earnings management.

Conclusion

This research shows that family control in the company has a positive effect on the practise of earnings management. The existence of family control in a company will increase the information asymmetry that enables the family to control the company in accordance with their interests and, through such means as earnings management, against the interests of non-family parties. In addition, institutional ownership negatively affects earnings management.



The existence of institutional investors will increase the monitoring of management activities and will pressure management to focus more on company performance, reducing the opportunistic behaviour of management which benefits only certain parties, and thereby decreasing earnings management.

This study has several limitations. It only covers manufacturing sector companies, so this research cannot be used as a general reference for all public companies listed on the IDX. Further research can expand the research sample to all public companies listed on the Stock Exchange to confirm the results of this study's analysis.

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