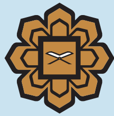

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

6th ASEAN UNIVERSITIES INTERNATIONAL CONFERENCE ON ISLAMIC FINANCE (6th AICIF)

14th - 15th November 2018
New World Makati City, Manila, Philippine

CONFERENCE PROCEEDING

SUB THEMES

1. CORPORATE GOVERNANCE
2. ISLAMIC BANKING AND CAPITAL MARKET
3. MONEY PAYMENT SYSTEM & FINANCIAL INNOVATION
4. TAKAFUL & RISK MANAGEMENT
5. ISLAMIC SOCIAL FINANCE
6. ARABIC PAPERS

CORPORATE
GOVERNANCE

Sub Theme	Corporate Governance			
No	**Paper ID**	**Paper Title**	**Author(s)**	**Affiliation**
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12	6th AICIF: 101-125	Earnings Management of Family Generation Company in Indonesia: Socio Emotional Wealth (SEW) Theory Perspective	Edy Suprianto, Y Anni Aryani, Doddy Setiawan, Rahmawati	Universitas Islam Sultan Agung (UNISSULA), Indonesia

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Earnings Management of Family Generation Company in Indonesia: Socio Emotional Wealth (SEW) Theory Perspective

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Abstract

This study tries to test whether the controlling generation (founder vs. descendant) of family companies in Indonesia affects earnings management. To prove this, this study took samples from manufacturing group companies listed on the Indonesian stock exchanges from 2012 to 2015. The total sample we used in this study was 172 observations. Modified Jones model is used as a proxy for earnings management. Based on the results of the analysis it can be concluded that the controlling generation has a negative effect on earnings management. Trend analysis results also show that family companys owned and managed by first-generation earnings management tend to be stable for 4 consecutive years compared to family group companies owned and managed by the second generation.

Keywords: Accrual Earnings Management, family & controller generation companies

1. Introduction

Much research has been done on family companies in Indonesia such as Prabowo (2013), Suyono (2016) and Diyanty (2017). Some of these studies compare more on family companies rather than non-family companies, while research that discusses different types of family companies is rarely done (Paiva *et al*., 2016). Family companies are companies that are managed by a family with a view for forming and pursuing a business vision that is held by all family members so that it can grow across generations of families (Chua *et al.*, 1999). This is consistent with the characteristics of family companies in Indonesia which tend to involve family members within the company (PWC, 2014).

Maintaining a generation to work within the company has its positive and negative sides. On the other hand, family companies try to maintain the next generation and able to maintain good family names such as Family owner of *Djarum Group* and family owner of *Sinar Mas Group*. Beside that, many family companies that maintain the next generation of the family often a family conflict that resulted in the company destroyed like *PT. Nyonya Meneer*. This research tries to analyze whether there is the difference of earnings quality of family company controlled by first generation (founder) with a company which dominated by next generation (descendant) which still not got the attention of researcher in Indonesia. Connecting family companies with earnings quality is still an interesting topic to be re-examined.

In the Socio-emotional Wealth Theory (SEW), it is stated that family companies tend to prioritize SEW rather than other interests. Gomez-Mejia et al. (2007) stated that business owners tend to not take risks to look after SEW, but company owners will take risks if the priority SEW becomes threatened. Family companys controlled by the first generation tend to prioritize family interests rather than other interests, such as maintaining the good name of the family. To maintain this, they tend to not take risky actions that could damage their reputations such as earnings management. It is assumed that the first generation or family founders have high family ties and tend to assume that family priorities are more important than business objectives (Westhead, 2003). Gils et al. (2004) also found that when the second or third generation who took controls of the company then the priority of the family will be decreased.

2. Literature Review

2.1 Family Ownership & Earnings Management in Indonesia

Based on Law No. 40 of 2007 on Limited Liability Companies, the Company's organs consist of General Meeting of Shareholders, Board of Directors and Board of Commissioners. General Meeting of Shareholders (GMS) is company organ that has authority not given to the Board of Directors or Board of Commissioners within the limits specified in this Law and/or the articles of association. The Board of Directors shall be the competent corporate body and fully responsible for the maintenance of the Company for the interest of the Company, in accordance with the purposes and objectives of the Company and to represent the Company, both inside and outside the court in accordance with the provisions of the articles of association. While the Board of Commissioners is the Company's organs that perform the supervision in general and/or specifically in accordance with the articles of association and give advice to the Board of Directors.

This corporate organ in Indonesia follows the "two-tier board system" company management system where there is a separation between the parties that run the company and those who oversee the running of the company. This is different from "one-tier system" as applied in the US and UK countries, where company managers and company supervisors are located in one organ called the "board of directors" (Wulandari, 2004). The position of a manager or director within a company that follows a one-tier system is usually called as CEO (Chief Executive Officer), whereas in Indonesia based on Law No. 40 of 2007 known as the Director who holds the highest managerial position commonly referred to as the President Director.

Porta *et al*., (2002), Claessens *et al*., (2000) and Carney dan Child (2013) state that corporate ownership in Indonesia is largely controlled by families. This result is supported by Habib *et al*. (2017) who concluded that the pattern of ownership structure in Indonesia is more concentrated than spread and Mulyani *et al*. (2016) also added that companies listed on the BEI are more controlled by the family. This is supported by the results of a survey conducted by the PWC in 2014 which stated that more than 95% of businesses in Indonesia are family owned and 60% of public companies (*Tbk.)* in Southeast Asia are family companies.

When linked to earnings management, there are still many cases of earnings management in Indonesia that have been published by the Capital Market Supervisory Agency. For example in the case of *PT. Ades Alfindo, Tbk,* which is inconsistently recorded sales for 4 years from 2001 to 2004. Sulistiawan *et al*. (2009) stated that the reported amount of *PT. Ades* sales was higher than production. Another case is the *PT. Indofarma, Tbk*, which overstates the presentation of inventory value in the process in the 2001 financial statements. The result is that the value of production costs is lower so that earnings will be higher. On this matter, the Capital Market Supervisory Agency provides sanctions of Rp. 500 million to the Directors of *PT. Indofarma, Tbk.* The case of *PT. Perusahaan Gas Negara* which conceals information about the decline in gas volume can mislead investors. The company's stock price dropped from Rp 9,650 to Rp 7,400 per share. The case of *PT. Bank Lippo, Tbk* issued double financial statements in 2002. Both financial statements have very significant differences, especially on the value of the foreclosed collateral, earnings and loss, asset values and minimum capital liability ratio. The case of *PT. Kimia Farma, Tbk* overstated earnings by increasing the value of finished goods inventory and sales value for 2002 financial report. For this cases, the Capital Market Supervisory Agency also gives sanction to the Board of Directors of *PT. Kimia Farma, Tbk* and KAP auditing company Sulistiawan *et al*. (2009).

Several studies about the effect of family ownership on earnings quality using the basic theory of agencies still show mixed results. On the other hand, some researches such as Wang (2006), Jung and Young (2002), Warfieid, Wild, Biggs and Watts (1991) and Chen and Chen (2008) suggest that family companys show higher earnings quality. This is because family companies have the advantage of disciplining and monitoring managers

(Anderson dan Reeb, 2003) so managers will act in accordance with interest of shareholders (alignment). Beside that, some researchers also suggest that family-controlled companys tend to have lower earnings qualities such as Yeo, Gillian, Tan, Patricia, Ho, Kim and Sheng (2002), Beuselinck dan Manigart (2007) and Firth, Fung and Rui (2007). The existence of family controller ownerships tends to lead to opportunistic behavior of majority shareholders who can harm the expropriate shareholders such as tunneling (Fan dan Wong, 2002), to hide this opportunistic behavior, the controller shareholder will report the lower quality of accounting information (Beuselinck and Manigart, 2007, Firth *et al*., 2007 and Aharony, Wang and Yuan, 2010). Prabowo (2013), Suyono (2016) and Diyanty (2017) also found several family companys in Indonesia who do earnings management.

Indonesia has in common with continental European countries (Germany, Netherlands, and Italy) of the legal system, but Indonesia has a different culture. Hofstede (2001) explains that Indonesians tend to like to cooperate, maintain good relationships with others, are not willing to take risks and are very conservative but do not close themselves to change. Another characteristic of family companies in Indonesia is that they tend to choose the composition of the board of commissioners and directors of family members (Wirawan dan Diyanty, 2014). The PWC study (2014) also explains that the characteristics of family companies in Indonesia are always maintaining family identity and prioritizing the company's long-term goals (maintaining family control and good family name) compared to business goals (obtaining company earnings). This is consistent with the SEW dimensions introduced by Berrone, Cruz, and Gomez-Mejia, (2012), namely maintaining family control (through share ownership and placement of family members in the directors and board of commissioners of the company) and maintaining family generations.

2.2 Socio Emosional Wealth (SEW) Theory

Gomez-Mejia et al. (2007) tried to develop the SEW theory. This theory predicts that the owner of the family is 'loss averse' and attached importance to SEW. They will take a risky decision to earn the SEW although it will reduce its economic wealth. At the same time, they will avoid risky decisions that might increase their economic wealth but can reduce SEW (Cennamo et al., 2012). According to Gomez-Mejia et al. (2007), an important aspect of the socio-emotional wealth of a family business is the fulfillment of needs related to family identification such as family control and good family name.

Research on family companies in Indonesia has also been carried out by several previous researchers based on agency theory. For example, Masripah et al. (1999) examined tax avoidance behavior carried out by family companies, but no tax evasion was found by companies controlled by family ownership. Unlike the research conducted by Wirawan dan Diyanty (2014) and Muawanah (2014) evaluating the governance of family companies compared to non-family companies, they concluded that there were differences in the level of corporate governance used by the two groups of companies.

The previous research that analyzed the earnings quality of family companies based on the SEW theory since it was introduced by Gomez-mejia *et al.* (2007), only done by three researchers namely Stockmans et al. (2010); Achleitner et al. (2014) and Pazzaglia et al. (2013). In this theory, Gomez-mejia *et al.* (2007) explained that there are non-economic goals that motivate family companies to make earnings management, namely family control and influence, family identity, closeness to social relations, emotional linkages and maintaining family ties within the company through dynastic succession. Losing SEW means loss of spirit and status and even failure to meet family expectations.

2.3 Hypothesis Development

Berrone *et al*. (2012) explain that one dimension of SEW is a succession of dynasties (generation) with the aim of maintaining family ties within the company. Research that has analyzed the motivation of family companies to maintain the generation that will be responsible for the company has been done by Westhead (2003). Assuming that the first generation or family founders have high family ties, Westhead (2003) finds that the first generation of corporate control tends to assume that family priorities are more important than business objectives. Gils et al. (2004) also found that when the second or third generation who took controls of the company then the priority of the family will decrease.

In accordance with the SEW theory, family companies tend to prioritize SEW rather than business interests. Gomez-Mejia et al. (2007) stated that business owners tend not to take risks to keep SEW, but company owners will take risks if the priority SEW becomes threatened. Family companys controlled by the first generation tend to

prioritize family interests rather than other interests, such as maintaining a good family name. To maintain this, they tend not to take risky actions that can damage it, for example, earnings management.

However, the conditions will be different if the control of the family company has changed hands to the second generation and so on. Arregle et al. (2007); Gómez-Mejía et al., (2007) states that family attachment to organization and family social capital tends to decrease when entering the next generation. In this condition, the SEW which becomes the priority of the family will become weak when the family company has entered the next generation stage, as a result, they will focus more on business objectives so that the risk preferences are same as the non-family investors (Schulze et al., 2003). Thus family companies tend to be earnings management although it will damage the good name of the family. So family companies that are controlled by the first generation tend to not do earnings management to maintain family control and vice versa when it is controlled by the next generation it tends to do earnings management to maintain the company's business. Based on the explanation above, it can be formulated the second hypothesis as follows:

H1: The first generation of family companies in Indonesia has a negative effect on earnings management.

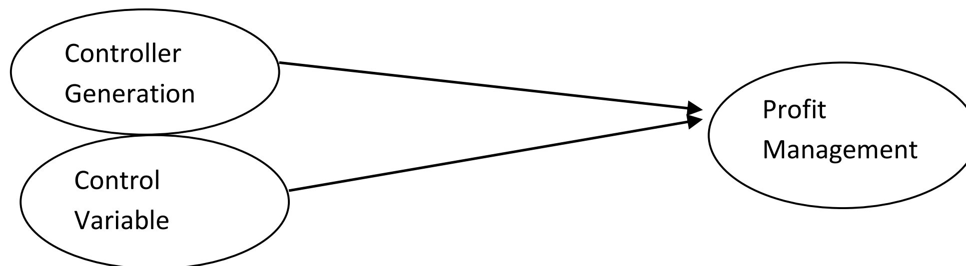


Figure 1. Research Model

3. Research Method

The population of this study is all manufacturing companies on the IDX because this type of industry is sufficient to contribute significantly to the economy in Indonesia. The selection of family companies in this study used the approach that was used by Chua et al., (1999) which defines a family company is a company that has a minimum 25% shareholding by the family and there are family members who hold positions as directors and have a business vision held by all family members. Based on these criteria, 43 manufacturing companies were included in the category of family companies. Financial report data used on 2012 to 2015, so the sample of this study obtained 172 samples (43 companies for 4 years).

3.1 Operational Variable Definition

Controller generation is the generation of families who participate and influence the company in decision making. This research on the controller generation can be through shareholding ownership (Family Ownership) and puts family members in top management positions (Family Directors). This study adopted the controller generation proxy used by Stockman *et al*. (2010) that use a dummy variable 1 for the first generation and 0 for the next generation. To determine the first or the next generation, they still use the approach that was used by Prabowo dan Simpson (2011) that is the first thing should be found is the immediate owner's of the annual report and then search the immediate owner's to the company profile and various media sources to find the generation to some family owners in the company.

The variable of earnings management in this research use modified Jones model. To measure the amount of earnings management using the value of discretionary accruals (DAC) is defined as the residual value of the equation below.

$$\frac{TA_{it}}{A_{it-1}} = \alpha_i \left[\frac{1}{A_{it-1}}\right] + \beta_{1i} \left[\frac{\Delta REV_{it} - \Delta REC_{it}}{A_{it-1}}\right] + \beta_{2i} \left[\frac{PPE_{it}}{A_{it-1}}\right] + \varepsilon_{it}$$

Note:

TA	= total accruals in t year for i company
TA	= $NI_{it} - CFO_{it}$
NI_{it}	= net incomes in t year to i company
CFO_{it}	= cash flows in t year to i company
ΔREV_{it}	= revenues in t year to be diminished revenues of the previous year to i company
PPE_{it}	= gross property, plat, and equipment in t year to i company
ΔREC_{it}	= accounts receivables in t year to be diminished accounts receivables of the previous year to i company
A_{it-1}	= total asets of the previous year to i company

This study uses several control variables that will control the influence of the main variable to the dependent variable i.e. company size as measured by total assets Ln, leverage is measured by using leverage ratio or debt to equity ratio and profitability is measured by using net income. The model of this research is as follows:

$$\text{DAC} = \alpha + \beta1\text{Kep_Keluarga} + \beta1\text{Direksi_Keluarga} + \beta2\text{VarKontrol} + \varepsilon$$

Table 1
Descriptive Statistics

	Mean	Min	Max	Standard Deviation
Family Ownership	0,814	0	1	0,390
Family Directors	0,140	0	1	0,347
DAC	-0,026	0,016	0,681	0,154
Size	13655	132	103162	25606,1
Earnings	218,541	0,012	5217.95	815,45
Leverage	1,504	0.013	31.781	2,910

Size and Earning in billion rupiah.

3.2 Descriptive statistics

Table 1 shows descriptive statistical data for each variable. For the family ownership variable for 4 years show an average of 0.814. It means that 81.4% of family companies are still controlled by first-generation owners, while for Family Directors variables for 4 years show the average of 0.140. It means that 14% of family companies are still controlled by first-generation directors. Variable earnings management (DAC) is -0.026 so it can be concluded that on average family companies in Indonesia that enter the manufacturing industry tend to lower earnings. For an average variable size is Rp. 13,655 billion, the average of profitability is Rp. 218.5 billion and 1,501 for leverage.

3.3 The Effect of Controller Genaration on Earnings Management

Based on the result of regression test in table 2, it is found that the coefficient of Family Ownership variable is -0.09 with the significant level at 0.03, while the Family Directors variable also shows the coefficient value of -0.10 with the significant level equal to the 0.03 level. So it can be concluded that the controller generation through ownership and directors has a negative effect on earnings management, **the hypothesis is accepted**. The results of this study support previous research conducted by Stockmans et al. (2010) who suggest that the first generation in family companys tends to report a quality earnings compared to the next generation. This is because family attachment to organization and family social capital tends to decline when entering in the next generation consequently they will focus more on business objectives so that the same risk preference with non-family investors (Schulze et al., 2003) tends to be the larger possibility of earnings management.

Table 2
Regression between independent variables of the Controllers Generation and Earnings Management

Independent Variabel	Predict Sign	Variabel Dependen (DAC)	
		(β)	(Prob)
Constant	?	0.28	0.00
Family Ownership	-	-0.09	0.03
Family Directors	-	-0.10	0,03
Var Control :			
Size	-	1,00	0.86
Profitability	+	-0.00	0.14
Leverage	+	-0.00	0.67
Commond Effect :			
Total Obs		172	
Udjusted R2		0.05	
Probability		0.01	

4. Discussion

The results of this study are consistent with predictions from the view of the SEW theory that family companies tend to not take risks to maintain SEW (Gomez-Mejia et al., 2007). Family companys controlled by the first generation tend to prioritize family interests rather than other interests, such as maintaining the good name of the family. To maintain this so they tend to not take risky actions that can damage it, for example, earnings management.

To support this result, we conduct robustness testing by using trend analysis of earnings management behavior for each family company group. In this analysis, family companies are divided into 4 groups. Group 1 is a family company group owned by the first generation and has a second-generation president director. Figure 2 shows that this group of companies individually performs varying earnings management but when viewed from the linear trend line looks stable from point 0 to point -0.01. So it can be concluded that the existence of first-generation owners tends to control the second generation of managers not to make earnings management. The same condition is also shown in Figure 3 (group 2 is a group of family company owned and managed by the first generation) and figure 5 (group 3 is a group of family company owned by the second generation but it is managed by the first generation), it shows that a linear trend line has seen stable from point 0 to point 0.01.

Group 4 is a group of family companies owned and managed by the second generation. In Figure 4, it can be seen that this group of companies individually varies earnings management as shown in Figures 2 and 3, but when it is seen from the linear line the trend seems to decrease significantly between the points 0.2 to -0.2. So it can be concluded that the existence of owners and managers of the second generation tends to do earnings management. The results of this analysis support the hypothesis that has been tested previously.

Figure 2
Earnings Management of Family Company
Owner (1st generation) dan President Director (2nd generation)

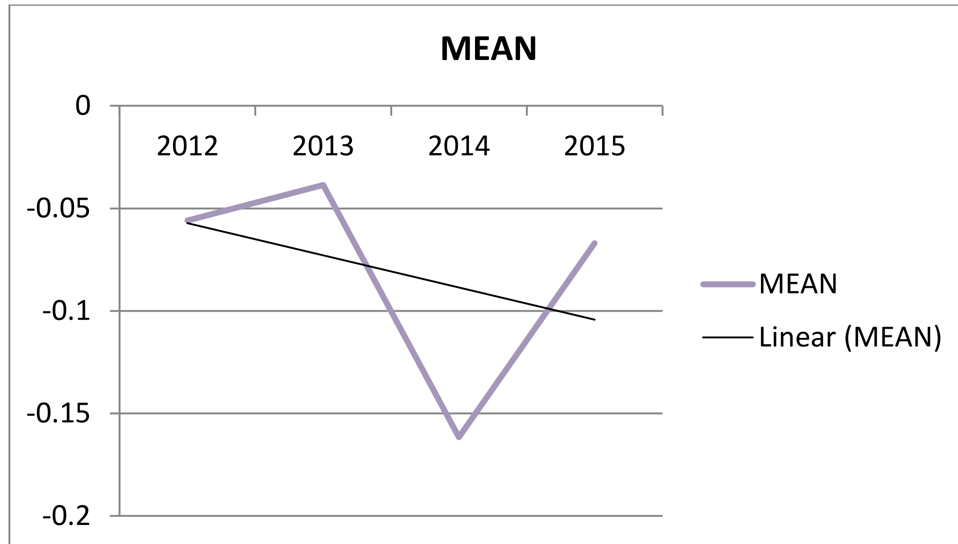


Figure 3
Earnings Management of Family Company
Owner and President Director (1st generation)

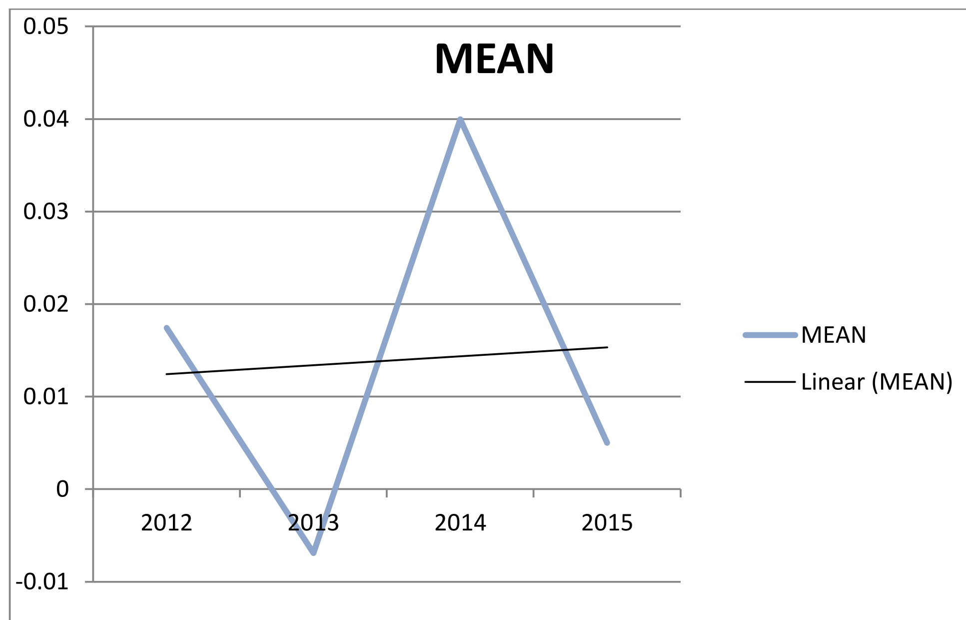


Figure 4
Earnings Management of Family Company
Owner and President Director (2nd generation)

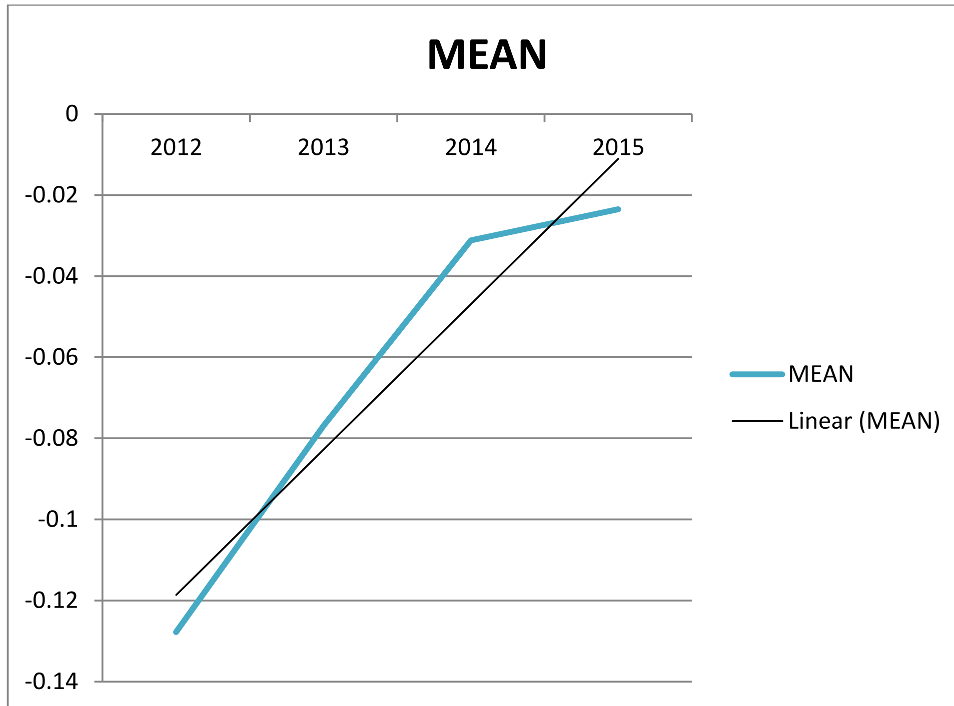
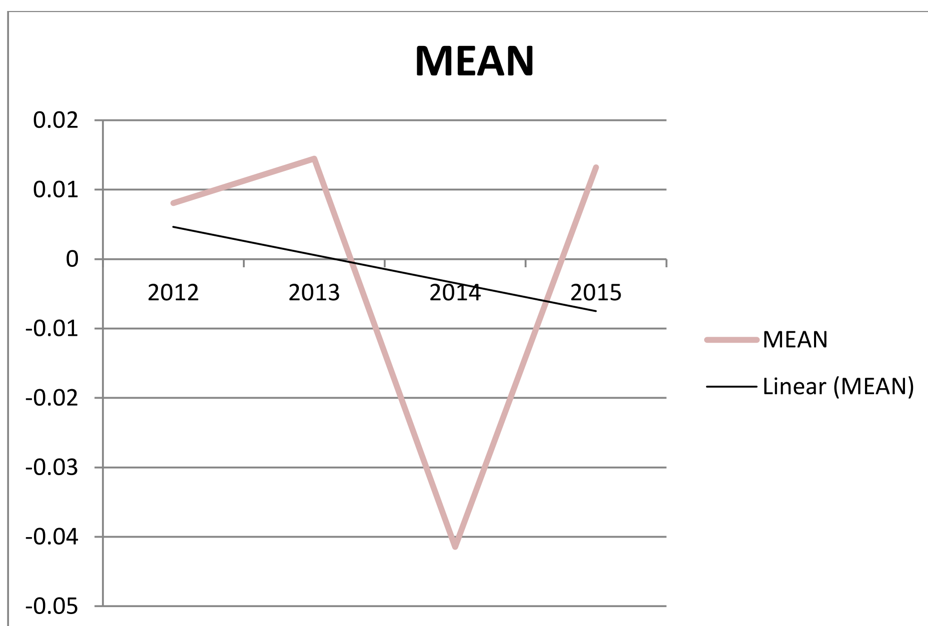


Figure 5
Earnings Management and Family Company
Owner (2st generation) dan President Director (1nd generation)



5. Conclusion

Based on the results of the analysis, it can be concluded that the controller generation has a negative effect on earnings management, the hypothesis is accepted. The results of this study reject previous studies conducted by Schulze et al. (2003), Stockmans et al. (2010) and Gómez-Mejía et al., (2007). This result is supported by trend analysis in group 1 (the group of family-owned by the first generation and have second generation director) and group 2 (the group of family company owned and managed by the first generation) it is seen that linear trend line looks stable from point 0 up to 0.01 point. While group 3 is the group of family company owned and managed by second-generation linear trend line tends to drop significantly between points 0.2 until a point -0.2. The limitations of this study are *first*, the sample of this study is limited to manufacturing industry, so this result can only be generalized to this industry, further research to be able to analyze in other industries. *Second,* earnings management measures are only from the accrual approach, further research can analyze real earnings management to get better results.

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