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Type of earnings management and the effect of ownership structure, firm size, and corporate-governance practices: Evidence from Indonesia

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Abstract

The purpose of this study is to investigate whether companies listed on the Jakarta Stock Exchange (JSE) conduct efficient or opportunistic earnings management and to examine the effect of ownership structure, firm size, and corporate-governance practices on it.

Using multiple regressions, we find evidence that the type of earnings management selected by JSE listed firms tends toward efficient earnings management. This evidence is inconsistent with the common view that earnings management in Indonesia is opportunistic. Family ownership has a significant influence on the type of earnings management selected. Firms with a high proportion of family ownership and non-business groups are more inclined to choose efficient earnings management than other types of firms. We find inconsistent evidence with regard to the impact of institutional ownership, firm size, and corporate-governance practices on type of earnings management.

Keywords: Type of earnings management; Ownership structure; Firm size; Corporate governance

1. Introduction

This study examines whether earnings management in public firms in Indonesia is motivated by opportunistic behavior or efficient contracting. This study is motivated by the

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common perception that earnings management by Indonesian public firms is opportunistic. This study also investigates whether ownership structure, corporate-governance practices, and firm size influence the type of earnings management selected.

There are two types of earnings management: efficient earnings management (i.e., to improve earnings informativeness in communicating private information) and opportunistic earnings management (i.e., management reports earnings opportunistically to maximize his/her utility) (Scott, 2000). Burgstahler and Dichev (1997) and Balsam, Bartov, and Marquardt (2002) present evidence that is consistent with the opportunistic perspective. On the other hand, Subramanyam (1996), Gul, Lung, and Srinidhi (2000), and Krishnan (2003) conclude that the behavior of discretionary accruals (a proxy for earnings management) is consistent with the efficient perspective, because discretionary accruals have a significant positive relationship with future profitability.

There has been extensive research on earnings management; however, literature concerning factors that influence the selection of a particular type of earnings management is quite rare. Krishnan (2003) finds that external auditing is often used as a proxy for corporate-governance practices and plays an important role in constraining opportunistic earnings management. Other proxies are the proportion of an independent board and the existence of an audit committee. Hence, these corporate-governance mechanisms could also influence the type of earnings management uses. In addition, firm size and ownership structure could also play important roles in restraining opportunistic earnings management. However, the extant literature has not examined these possibilities.

Company size is used as a proxy for information asymmetry in the predisclosure information environments, as managers of small companies are able to retain their private information more successfully than their counterparts in large companies (Lee & Choi, 2002). Information on large firms usually is more publicly available and could be obtained with lower costs than information on small firms (Bhattacharya, 2001). Because larger firms are more easily scrutinized by investors or regulators than smaller firms, the former type is expected to engage in less opportunistic earnings management than the latter.

Ownership structure influences the monitoring mechanism a company uses, including the monitoring of earnings-management activity. Balsam et al. (2002) state that institutional investors, who are sophisticated investors, are more capable of detecting earnings management than non-institutional investors because they have more access to timely and relevant information. Existing literature only examines the effect of institutional investors on earnings-management *magnitude*, while our study will examine the effect of institutional investors on the *type* of earnings management.

Institutional investors have a greater monitoring role if the company's ownership structure is widely dispersed. Wide-spread ownership structure only takes place in Anglo-Saxon countries, such as the United States and the United Kingdom. In other developed and developing countries, firms usually are controlled by founding families. La Porta, Lopez-de-Silanes, and Shleifer (1999), report that 85% of Spanish firms have controlling shareholders, compared to United States and the United Kingdom, which have only 10% and 20%, respectively. Arifin (2003) also finds that the majority of public firms in Indonesia is controlled by families. He suggests that agency problems in family-controlled firms are not as serious as that in publicly-controlled firms or firms without