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Corporate Governance, Audit Quality, Family Ownership and Earnings Management

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Abstract

This study aimed to obtain empirical evidence regarding the influence of corporate governance and audit quality on earnings management measures, as well as their relationship with the effect of family ownership. Research on earnings management has been widely conducted, but research in family firms is still limited, while based on previous observational data, 95% of companies in Indonesia are family firms. In addition, the difference in the concept of corporate governance in developing countries compared to developed countries is crucial in relation to company supervision patterns. Earnings management practices carried out by company management can be caused by the occurrence of information asymmetry in which management as an agent has more information related to the company than the company owner. This information asymmetry is used by managers to mislead other parties with the aim of increasing their managerial career or compensation. Implementing the corporate governance mechanism is a way to reduce earnings management. Another factor affecting earnings quality is audit quality. This study took a sample of manufacturing companies listed on the Indonesian Stock Exchange during the 2017- 2018 period. 152 sample data were tested. This study used secondary data obtained from annual reports of companies listed on the Indonesian Stock Exchange. Moderated regression analysis (MRA) was used. Corporate governance had no effect on earnings management and audit quality had a significant effect on earnings management behavior. Family ownership was able to strengthen the effect of audit quality in determining earnings management actions.

Keywords: corporate governance, audit quality, earnings management, family ownership.

1. Introduction

This study aims to obtain empirical evidence of the effect of corporate governance and audit quality on earnings management measures, as well as its relationship to the effect of family ownership, that the family ownership is synonymous with family firm. Research

on earnings management has been widely conducted, but research on accounting behavior in family firms is still very limited [45]. This is the reason for researchers to make observations on family firms, because based on data from the Indonesian Institute for Corporate and Directorship (IICD, 2010) more than 95% of businesses in Indonesia are companies owned or controlled by families [53]. Family firms have a major contribution to the economy [24], so that their existence is considered a good signal in the economy [25]. This condition indicates that family firms tend to have strong implications in terms of accounting practices, including earnings management.

The concept of corporate governance referred to by Indonesia is a concept that has been applied in developed countries, which are market-based with widespread ownership. The main control over a market-based corporate governance system, is based on market mechanisms and has internal mechanisms that function effectively [34]. This is different from the application in developing countries which is based on networks and concentrated family ownership, so that the control function by the market and internal instruments does not yet have an effective power to discipline companies. Given these differences, this study can provide further insight into the effectiveness of corporate governance in limiting earnings management in developing countries, where Indonesia is one of the developing countries.

Financial reports are, in fact the result of an accounting process that can be used as a tool to communicate financial data or company activities to interested parties [24]. The information contained in the financial statements can show the performance of a company, so that the information can be used in high quality. One of the important information in the report is financial information on earnings. because the profit figure is an indicator of the company's operations. The statement of [14] explains that high-quality earnings are earnings that accurately reflect the company's current performance. From this explanation, it can be seen that earnings quality can decrease when companies manipulate earnings because reported earnings do not reflect the actual performance of the company [14]. Several cases of earnings manipulation where there were weak earnings quality were reported by the company. The existence of profit manipulation practices carried out by management will result in reduced reported profit and loss, thus decreasing investor confidence in the reported financial statements.

Earnings manipulation can be done through earnings management actions. Earnings management occurs when managers use judgments in financial reporting and in structuring transactions to modify financial statements to mislead some stakeholders about the underlying economic performance of a company, or to influence contract outcomes that depend on reported accounting figures [22]. Earnings management

practices carried out by company management can be caused by the occurrence of information asymmetry in which management as an agent has more information related to the company than the company owner as of the principal. The existence of this information asymmetry is used by managers to mislead other parties with the aim of increasing their managerial career or compensation [40].

Previous research has been conducted on determinants of earnings management such as corporate governance and audit quality. The main objective of the company is to improve the quality of company earnings so that the implementation of corporate governance becomes one of the key elements in increasing economic efficiency, which includes a series of relationships between company management, the Board of Commissioners, independent board, audit committee, shareholders and other stakeholders. Corporate governance also provides a structure that makes it easier to determine company goals, and as a means of determining performance monitoring techniques [16]. The implementation of corporate governance is a form of protection of the interests of shareholders (public) as company owners and creditors as external funders. A good corporate governance system will provide effective protection to shareholders and creditors to get returns on investment fairly, precisely and efficiently as possible, in addition to ensuring that management works as well as possible for the benefit of the company. Corporate governance mechanism will provide protection to shareholders and directors to get returns on investment fairly, precisely and efficiently as possible and to ensure that management works as best as possible for the benefit of the company [29].

Corporate governance mechanisms as a way to reduce earnings management. There are quite a number of studies being conducted with samples from various-countries. Research with a sample of US countries conducted, among others, by [9], [10], [27], [32], [33], [54], while research with a sample of the UK was conducted, among others, by [5], [41],and research in Asian countries by [6], [43], [44, 48]. These various studies document that the effectiveness of corporate governance mechanisms affects the earnings management practices of widely owned public companies, while there are also some that link to concentrated ownership in the hands of families [42], [26].

Another factor affecting earnings quality is audit quality. Auditor quality is not something that can be observed directly. Perceptions of audit quality are always linked to the auditor's name. In this case the company's reputation is the most important picture. Theoretically and empirically, quality is often measured using the size of the Public Accounting Firm. A good auditor's reputation is one of the factors that can reduce the occurrence of earnings management actions, because with a bad reputation managers

have the opportunity to carry out earnings management. Auditing is a valuable control mechanism in controlling company managerial policies, so this value is expected to be different from the quality of the Public Accounting Firm [29]. External auditors are considered to be able to reduce information asymmetry, because they are expected to be able to detect manipulation of financial statements by comparing the information reported by the company in its financial statements with the actual information that occurs within the company. Research by [15] explains that the higher the quality of the audit will provide greater credibility to financial reports because it is assumed that auditors provide useful services desired by users of financial statements. Previous studies also often measure audit firm size as a proxy for audit quality. The company is considered to choose a public accounting firm that has a good reputation because it is considered to have high audit quality. [51] research found evidence that companies audited by large accounting firms generate more precise earnings.

Concentration of ownership can be an internal mechanism for disciplining management, and is one mechanism that can be used to improve the effectiveness of supervision, because with large ownership, shareholders have significant access to information to offset the benefits of information owned by management. If this can be realized, then management's moral hazard action will be in the form of a reduction in earnings management [3]. Statement of [36] argue that the main conflict in a company owned by a relatively few shareholders is between majority and minority shareholders. In a developing market such as Indonesia where ownership is largely in the hands of the family and therefore market control mechanisms are weak, corporate governance has to do more than solve agency problems between executives and shareholders. On the contrary, it is important to resolve conflicts between majority shareholders who take an active role in the company (generally families) and minority shareholders and creditors.

The research of [39] have reviewed earnings management in family firms based on agency theory, concluding that Type II agency problems provide a better explanation for earnings management in family firms than Type I. Type II agency problems in family firms have a larger motive. to take over minority interests compared to non-family firms. Meanwhile, Type I agency problems are more likely to arise in non-family firms due to differences between management and owner interests. Thus, family firms, which are usually characterized by significant controlling owners, may experience higher Type II agency problems, resulting in lower reported quality of earnings. This is in line with the concept of entrenchment effect that occurs in companies that are owned and controlled by families.

Companies with a higher level of ownership concentration in the family can further worsen the quality of earnings. This is because family owners and managers can operate with the sole objective of increasing their own wealth at the expense of minority shareholders [45]. On the other hand, the alignment effect states that higher family involvement in corporate governance will result in higher earnings quality. The reason is that the higher the involvement of family members in governance, the stronger the management monitoring activities by the family and the greater the “alignment effect” that will be obtained, thereby reducing the opportunistic actions of management in carrying out earnings management. Thus, ownership that is concentrated on family ownership can be a determining factor for earnings management practices and are thought to moderate the influence of corporate governance and audit quality on earnings management.

The discussion in this study consists of 3 parts. The first part, this study discusses the background of the research and literature review and the development of hypotheses, the influence of corporate governance and audit quality on ernings management, and the role of family ownership in these relationships. The second part discusses the research methodology which includes model of the research and the measurement of the variables used, the results of the research and their discussion. The third part is the final part of the research, is a conclusion that includes the limitations of the study, as well as suggestions for further research

2. The Effect of Corporate Governance on Earnings Management

Earnings management action is an action that is usually associated with agency theory, which explains the relationship between the agent (manager) and the principal (investor), where the investor wants to maximize wealth with a high return while the company's management wants to gain trust in investors. The difference in interests that occurs between managers and investors encourages managers to convey information that is not in accordance with the actual conditions. This condition shows that managers have full control over company information, or in other words, there is an information gap between company managers and investors.

Information asymmetry that arises can encourage management to behave opportunistically so that it has an impact on earnings management actions. The negative impact of opportunistic earnings management is low reported earnings quality [52], decreased relevance of accounting information [23], decreased stock liquidity [18]. It is

hoped that the negative impact of earning management actions can be minimized by implementing good corporate governance.

Corporate governance is a system that functions to direct and control the company [8], with the aim of ensuring that company management acts in line with the interests of shareholders [40], [47]. Broadly speaking, it can be concluded that corporate governance is a system to minimize information asymmetry problems. The implementation of corporate governance can run well if it is carried out using the right mechanism, so that it is effective in achieving the expected goals.

The corporate governance mechanism is divided into two: first, in the form of an internal mechanism, such as the composition of the Board of Commissioners, managerial ownership, and executive composition, and second, external mechanisms, such as market control and level of debt financing [4]. Research on this mechanism, among others, was proposed by [31], which measures the quality of corporate governance through the structure of the Board of Commissioners, ownership structure and independence of the audit committee. The same thing was stated by [11], [49]. Thus, the hypothesis proposed is:

H1: corporate governance has the effect of reducing earnings management actions

3. Effect of Auditor Quality on Earnings Management

Auditor is one of the capital market supporting professions whose function is to examine the financial statements of companies that are going to go public. The objective of the financial statement audit is to provide assurance to users of financial statements that the reports prepared are in accordance with generally accepted accounting principles [28].

Companies that use quality auditors indicate that the information produced by the issuer can be used to see prospects in the future. This shows that the financial reports audited by a highly reputable public accounting firm provide a signal to investors that the reports produced by the company are accountable reports, quality auditors will produce better audit quality, which is related to the level of manipulation produced. The audit quality in this study will use a proxy for the Public Accounting Firm which is included in the Big 4 category. The relationship between audit quality and earnings management usually uses Big N and non-Big N measures as a surrogate measure for audit quality

Auditors who are in the Big N category provide higher audit quality than non-Big N companies, because when the auditors have large clients, when they lose their

reputation, the losses incurred are also very high [7]. Various studies have found that Big N auditors have better audit quality and can minimize the occurrence of audit failures [35], [20], and auditors who are in the Big N category are more aggressive in limiting discretionary accruals [19], [30]. Thus, it can be concluded that auditors who are in the Big 4 category are expected to minimize earnings management. Thus, the hypothesis proposed is:

H2: auditor quality has the effect of reducing earnings management action

4. Corporate Governance, Audit Quality and Family Ownership

Concentrated share ownership is a condition in which most shares are owned by a small number of individuals or groups [12]. The composition of share ownership can come from various parties such as: family ownership, management ownership, government ownership, or also ownership of other private companies. This study will focus on family ownership. This is because most companies in Indonesia, company shares are concentrated on family ownership, as stated in the research of [46].

The large share ownership in the company will certainly affect how the implementation of corporate governance and the determination of auditors in the company, and this will also affect earnings management practices. In relation to this condition, this study provides empirical evidence regarding the application of corporate governance and the appointment of auditors in family companies to earnings management actions. Thus, the hypothesis proposed is:

H3a: family ownership strengthens the influence of corporate governance in reducing earnings management

H3b: family ownership strengthens the effect of audit quality in reducing earnings management

5. Research Methodology

This study tooked a sample of 83 manufacturing companies listed on the Indonesia Stock Exchange during the 2017-2018 period, so that a sample of 166 data was obtained. However, in testing there were 14 outier data, so the sample data tested in this study were 152 sample data. This study used secondary data obtained from annual reports of companies listed on the Indonesia Stock Exchange.

The analytical tool in this study was moderated regression analysis (MRA), which is an analysis that explains the effect of the independent and moderating variables on the dependent variable. The dependent variable in this research is earnings management, which is measured by Kothari's development model. The independent variables of this study are corporate governance and auditor quality. Corporate governance is measured by using a system of assessments carried out on the characteristics of the Board of Commisioners and the Board of Directors, namely: the size of the Board of Commissioners, level of independence, number of meetings, and business economic education background. Meanwhile, audit quality is measured by giving Big-4 and Non-Big-4 categories. This study uses the moderating variable of family ownership, which is measured by the percentage of shares owned by the family.

Hypothesis testing is done to analyze the significance of the model, which includes testing the values: adjusted R-Square, F-Test, and t-test. Hypothesis testing in this study was conducted to determine the effect of corporate governance and audit quality on management earnings, and the effect of family ownership in this relationship. Hypothesis testing is done using moderated regression analysis (MRA), with the following equation model.

$$EM = \alpha + \beta 1CG + \beta 2AQ + e \quad (1)$$

$$EM = \alpha + \beta 1CG + \beta 2AQ + \beta 3FO + e \quad (2)$$

$$EM = \alpha + \beta 1CG + \beta 2AQ + \beta 3FO + \beta 4CG * FO + \beta 5AQ * FO + e \quad (3)$$

notasi:

EM = Earnings management

CG = Corporate governance

AQ = Audit quality

FO = Family ownership

There are four hypotheses in this research. Equation (1) is used to answer hypothesis 1 and hypothesis 2. Hypothesis 1 examines the effect of corporate governance on earnings management, while hypothesis 2 examines the effect of audit quality on earnings management. Equation (3) is used to answer hypothesis 3, which focuses on the interaction variable between corporate governance and family ownership; and between audit quality and family ownership. This hypothesis examines how family ownership is able to strengthen the influence of corporate governance and auditor quality in reducing earnings management.

6. Result

Data testing was carried out on 152 data samples. Table 1 was a statistical description of the data of this study, which includes the minimum, maximum, average, and standard deviation values. These statistical descriptions consist of statistical descriptions of the dependent, independent, and moderating variables. This data was a description of the distribution of data used in testing the research hypothesis.

Table 1: Descriptive

Variable	N	Minimum	Maxsimum	Mean	Deviation Std.
EM	52	-0.13	0.13	0.00	0.05
CG	52	10.00	21.00	16.84	2.18
BIG4	52	0.00	1.00	0.36	0.48
FAM OWNERSHP	52	10.19	95.38	59.93	22.95
ROE	52	-0.45	0.33	0.04	0.13
LNASET	152	11.40	18.65	14.78	1.58
EM	=	Earnings management			
CG	=	Corporate govrnance			
BIG4	=	Audit quality			
FAM_OWNERSHP	=	Family ownership			
ROE	=	Return of equity			
LNASET	=	size			

Testing the influence of corporate governance and audit quality on earnings management and the effect of family ownership in it is presented in Table 2. Based on the test results, the coefficient of determination (adjusted R2) was obtained from the research equation model which explains the effect of the independent variables studied on the dependent variable. In addition, the value of goodness of fit in the 3 equation models in this study showed a significance value below 5%, which indicates that the model meets the testing criteria.

This study used moderated regression analysis (MRA), which is carried out using three similarity models, namely equation model (1) is the equation model before entering the moderating variable, equation model (2) is the equation model by including the moderating variable as the independent variable, and equation model (3) is the model after interaction. between the independent variable and the moderating variable. Table 2 is the result of hypothesis testing using these three equation models.

The results of testing the effect of corporate governance and quality of equity on family ownership, showed an adjusted R2 value of 0.101 and a significance value of F value of 0.001. This implies that the equation model meets the goodness of fit criteria. The t-test result for the corporate governance variable shows -0.496 with a significance level of 0.620. Based on these results, this study rejects hypothesis 1 (H1). Meanwhile, the t test results for the audit quality variable showed -2.269 with a significance level of 0.025. Based on these results, this study accepts hypothesis 2 (H2).

Table 2: Hypothesis Testing Results

R^2	*Adjusted* R^2	R^2 *Change*	F_{hitung}	*Sig. F*	*F Change*	*Sig. F Change.*
0.125	0.101	0.125	5.232	0.001	5.232	0.001
0.136	0.107	0.012	4.613	0.001	1.993	0.160
0.162	0.122	0.026	3.984	0.001	2.221	0.112

Variable	Exp Sign	Coeff.	t_{hitung}	Sig
(Constant)		-0.018	-0.331	0.741
CG	-	-0.001	-0.496	0.620
BIG4	-	-0.022	-2.269	0.025 **
ROE	+	0.137	3.972	0.000 ***
LNASET	+	0.002	0.815	0.416
(Constant)		-0.039	-0.714	0.476
CG	-	-0.001	-0.400	0.689
BIG4	-	-0.020	-2.019	0.045 **
ROE	+	0.137	4.001	0.000 ***
LNASET	+	0.003	0.870	0.386
FAM_OWNERSHP	-	0.000	1.412	0.160
(Constant)		0.010	0.093	0.926
CG	-	-0.005	-0.833	0.406
BIG4	-	0.026	1.077	0.283
ROE	+	0.144	4.199	0.000 ***
LNASET	+	0.002	0.805	0.422
FAM_OWNERSHP	-	0.000	-0.262	0.793
CG*FO	-	5.834E-5	0.655	0.514
BIG4*FO	-	-0.001	-2.085	0.039 **

Dependent: earnings management
*** = *sig 1%*, ** = *sig 5%*, * = *sig 10%*

Equation model (2) is the development of testing equation model (1), by including the moderating variable as the independent variable. The test results show that the adjusted R2 value is 0.107 and the significance of the F value is 0.001, which means that the equation model meets the goodness of fit criteria. However, seen from the value of R2 change 0.012 and the F value of change 1.993 with a significance of 0.160, it shows that the inclusion of the family ownership factor into the model does not change the effect significantly. Likewise, the t test results show the coefficient value of 1.412 with a significance level of 0.160. This shows that family ownership has no effect on earnings management actions.

Equation model (3) is the development of the test for equation model (2), which is carried out by interacting between corporate governance and audit quality and family ownership. The test results show an adjusted R2 value of 0.122 and a significance of F 0.001, indicating that the equation model meets the criteria of goodness of fit. The value of R2 change is 0.026 and the F value of change is 2.221 with a significance of 0.112 indicating that the inclusion of the interaction variable into the regression is not able to increase the effect significantly, where the test results show that only one variable has a significant effect. This can be seen from the results of the t test on the interaction variable of corporate governance with family ownership which shows a value of 0.655 with a significance level of 0.514. This shows that family ownership does

not moderate the effect of corporate governance on earnings management. Based on these results, this study rejects hypothesis 3a (H3a). Meanwhile, the t test results for the interaction variable of audit quality and family ownership show the value of -2.085 with a significance level of 0.039. Based on these results, this study accepts hypothesis 3b (H3b).

7. Discussion

Table 2 shows that corporate governance has no effect on earnings management. This does not support the monitoring concept of the implementation of corporate governance. The consistent application of corporate governance mechanisms is expected to improve the quality of financial reports and also inhibit earnings management, so as to illustrate a good company's fundamental performance. The results of this test indicate that the implementation of corporate governance in Indonesian companies has not been effective.

The results of this study indicate that audit quality has a significant effect on earnings management. Effective audit implementation can suppress earnings management [7]. Audit quality is one of the factors that investors often use in assessing companies. This study uses Big 4 and Non Big 4 proxies in measuring audit quality. The audit quality produced by the Big 4 category of Public Accounting Firm is able to suppress earnings management [38]. This shows that the size of Public Accounting Firm (The Big- 4) is an indication of the high quality of the resulting audit. Research conducted in Iran also shows that the size of Public Accounting Firm reduces earnings management actions [21]. This shows that the size of Public Accounting Firm (The Big- 4) is an indication of the high quality of the resulting audit.

If it is related to agency theory, the existence of family control can reduce agency costs, because in family firms the ownership function and the control function can work in harmony [26]. This indicates that the control function in family firms is more efficient. Research conducted by Anderson, Mansi, and Reeb (2003) with a sample of companies in the US, shows that although the ownership of the founding family does not lead to an increase in the wealth of minority shareholders, these minority shareholders actually take advantage of the founding family's existence in management. This shows that family ownership is considered to ensure the continuity of the company

Companies that are controlled by family have better performance than non-family firms [1]. This strengthens what [17] stated that family companies are more efficient in monitoring companies. This indicates that family ownership can reduce earnings

management actions. The test results of the interaction between corporate governance and family ownership show that family ownership is not able to strengthen corporate governance in reducing earnings management actions. The results of this test are consistent with the results of testing prior to interaction, where the implementation of corporate governance in Indonesia has not been effective, even though in family companies that usually maintain the sustainability of the company. Meanwhile, the results of the interaction test between audit quality and family ownership show that family ownership can strengthen audit quality in minimizing earnings management. Thus it can be concluded that audit quality and family ownership can be used to minimize earnings management.

The results of this study reinforce the statement about the difference in the concept of implementing corporate governance between developing countries and developed countries. The concept of corporate governance, which is a form of internal oversight mechanism, has not been able to oversee the running of the company, so other mechanisms outside the company are needed, one of which is an independent auditor. The results of auditing financial statements conducted by reputable auditors are able to provide strength in suppressing unexpected actions.

8. Conclusion

This study aims to obtain empirical evidence regarding the influence of corporate governance and audit quality on earnings management measures, as well as their relationship with the effect of family ownership. This study has 4 hypotheses. The test shows that hypothesis 1 and hypothesis 3a are rejected, while hypothesis 2 and hypothesis 3b show that the hypothesis is accepted.

The test results show that corporate governance has no effect on earnings management, likewise when it is interacted with family ownership, the test results show that there is no supervisor. The next test results show that audit quality has a significant effect on earnings management behavior. Meanwhile, when interacting with family ownership, the test results also show that family ownership is able to strengthen the effect of audit quality in determining earnings management.

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