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Controlling generation of family firms and earnings management in Indonesia: The role of accounting experts of audit committees

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Abstract. This study aims to identify whether the controlling generation (founder vs. descendant) of family companies in Indonesia affects earnings management and analyze the role of accounting experts of audit committees in minimizing the implementation of earnings management. A total of 258 samples are collected from manufacturing group companies listed in the 2012-2017 Indonesian stock exchange. A modified Jones model is used as a proxy for earnings management. Results reveal that controlling by the first generation negatively affects earnings management. Trend analysis results also show that family companies owned and managed by the first generation via earnings management remain stable for 6 consecutive years compared with that of family group companies owned and managed by the second generation. Accounting experts of audit committees negatively influence earnings management in family firms.

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1. INTRODUCTION

Family companies in Indonesia have been investigated by numerous researchers, such as Prabowo (2013), Suyono (2016), and Diyanty (2017). Some of these studies have focused more on comparisons among family companies rather than non-family companies, but studies on different types of family companies have been rarely performed (Paiva *et al.*, 2016).

Family companies are managed by a family with the goal of forming and pursuing a business vision held by all family members so that it can grow across generations of families (Chua *et al.*, 1999). This description is consistent with the characteristics of family companies in Indonesia, that is, family members are involved in their company (PWC, 2014).

Maintaining a generation to work within a company has positive and negative effects. Some family companies try to sustain their business until the next generation and maintain good family names, such as the family owners of *Djarum Group* and *Sinar Mas Group*. Conversely, other family companies, such as *PT Nyonya Meneer*, maintain their business for succeeding generations but often encounter family conflicts that result in their destruction.

This research aims to analyze whether the earnings quality of a family company controlled by the first generation (founder) differs from that of a company dominated by the next generation (descendant). Further research has yet to be performed to show the relationship of family companies with earnings quality in Indonesia.

According to socio-emotional wealth (SEW) theory, family companies prioritize SEW rather than other interests. Gomez-Mejia et al. (2007) stated that business owners avoid risks to monitor their SEW, but other company owners take risks if the priority SEW becomes threatened. Family companies controlled by the first generation prioritize family interests, such as maintaining the good name of their family, over other interests by avoiding risky actions, such as earnings management, which can damage their reputations. The first generation or family founders have high family ties and 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 take control over a company, family priorities decrease.

The Capital Market Supervisory Agency (BAPEPAM) issued a Decree of the Chairman of BAPEPAM. Kep-29/PM/2004 to oblige companies listed on BEI to have an audit committee. According to agency theory, the role of an audit committee as a controlling party in preventing the opportunistic acts of management varies considerably. Abbott et al. (2004) indicated that an audit committee can increase the quality of financial statement restatement. Chandar et al. (2014) and Chen et al. (2007) showed that an audit committee can reduce earnings management. This research aims to examine whether an audit committee can minimize the implementation of earnings management in family firms based on SEW theory.

2. LITERATURE REVIEW

2.1. Socio-emotional wealth (SEW) theory

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

Family companies in Indonesia have been investigated on the basis of agency theory. Masripah et al. (1999) examined tax avoidance behavior carried out by family companies and found no tax evasion cases from companies controlled by family ownership. In contrast to the findings of Wirawan dan Diyanty (2014) and Muawanah (2014) who evaluated the governance of family companies compared with nonfamily companies, they concluded that the level of corporate governance used by the two groups of companies differs.

Since Gomez-Mejia et al. (2007) introduced SEW theory, three researchers, namely, Stockmans et al. (2010), Achleitner et al. (2014), and Pazzaglia et al. (2013), have analyzed the earnings quality of family companies based on SEW theory. In this theory, Gomez-Mejia et al. (2007) explained that family companies are motivated to implement earnings management because of non-economic goals, including 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.

2.2. Family ownership and earnings management in Indonesia

According to Law No. 40 of 2007 on Limited Liability Companies, alimited liability company's ("Company") organs consist of a general meeting of shareholders (GMS), a board of directors, and a board of commissioners. GMS has authority not given to the board of directors or the board of commissioners within the limits specified in this law and/or the articles of association. The board of directors should be a competent corporate body fully responsible for the maintenance of the Company for its interest 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. The board of commissioners is the Company's organ that performs the general and/or specific supervision in accordance with the articles of association and gives advice to the board of directors (Widyaningsih et al., 2017).

This corporate organ in Indonesia follows a "two-tier board system," which is a company management system where parties that run a company are separated from those who oversee the running of the company. This system varies from a "one-tier system" applied to countries in the US and the UK, where company managers and supervisors work under one organ, that is, the board of directors (Wulandari, 2004). The position of a manager or a director within a company that follows a one-tier system is usually calleda chief executive officer. In Indonesia, according to Law No. 40 of 2007,a director, commonly referred to as president director, holds the highest managerial position.

Porta et al. (2002), Claessens et al. (2000), and Carney and Child (2013) stated 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 wide spread. Mulyani et al. (2016) added that companies listed on BEI are more controlled by families. A survey conducted by the PWC in 2014 supported this finding and stated that more than 95% of businesses in Indonesia are family owned, and 60% of public companies (Tbk) in Southeast Asia are family companies.

Many cases of earnings management in Indonesia have been published by the Capital Market Supervisory Agency. For example, sales were inconsistently recorded by PT. Ades Alfindo, Tbk for 4 years from 2001 to 2004. Sulistiawan et al. (2009) stated that the reported amount of PT. Ades's sales was higher than the cost of production. In PT. Indofarma, Tbk, the presentation of inventory value was overstated in its 2001 financial statements. The result shows that the cost of production is low, so earnings are high. As such, the Capital Market Supervisory Agency implemented a sanction of Rp500 million to the directors of PT. Indofarma, Tbk. In the case of PT. Perusahaan Gas Negara, information about the decline in gas volume was concealed, thereby misleading investors. As a consequence, the company's stock price dropped from Rp9,650 to Rp7,400 per share. PT. Bank Lippo, Tbk issued two considerably different financial statements in 2002 especially in terms of the value of the foreclosed collateral, earnings and losses, asset values, and minimum capital liability ratio. PT. Kimia Farma, Tbk overstated earnings by increasing the value of finished goods inventory and sales value for their 2002 financial report. In these cases, the Capital Market Supervisory Agency also gave sanctions to the board of directors of PT. Kimia Farma, Tbk and KAP auditing company (Sulistiawan et al., 2009).

Earnings quality is considered high if it contains minimum to zero perception interference and is able to reflect the true performance of a firm (Gideon et al., 2018). Several studies on the effect of family ownership on earnings quality in accordance with the basic theory of agencies have shown mixed results. Wang (2006), Jung and Young (2002), Warfieid, Wild, Biggs, and Watts (1991), and Chen and Chen (2008) suggested that family companies show higher earnings quality because family companies have the advantage of disciplining and monitoring managers (Anderson dan Reeb, 2003), so managers act in accordance with the interest of shareholders (alignment). Yeo, Gillian, Tan, Patricia, Ho, Kim, and Sheng (2002), Beuselinck dan Manigart (2007), and Firth, Fung, and Rui (2007) implied that family-controlled companies have lower earnings quality. The existence of family-controlled ownerships likely promotes opportunistic behaviors, such as tunneling, of a majority of shareholders who can harm expropriate shareholders (Fan dan Wong, 2002).To hide this opportunistic behavior, a controller shareholder reports 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) found that several family companies in Indonesia implement earnings management.

Indonesia shares some common legal systems with continental European countries, such as Germany, Netherlands, and Italy. However, Indonesia has a different culture. Hofstede (2001) explained that Indonesians cooperate, maintain good relationships with others, show unwillingness to take risks, and exhibit conservativeness but remain open to changes. Another characteristic of family companies in Indonesia is that they tend to choose family members as part of the board of commissioners and directors (Wirawan dan Diyanty, 2014). The PWC study (2014) also indicated that the characteristics of family companies in Indonesia include maintaining family identity and prioritizing the company's long-term goals (i.e., maintaining family control and good family name) over business goals (obtaining company earning). This observation is consistent with the following SEW dimensions introduced by Berrone, Cruz, and Gomez-Mejia (2012): maintaining family control through shared ownership and placement of family members as directors and commissioners of the company and maintaining family generations.

2.3. Hypothesis development

Berrone et al. (2012) explained that one dimension of SEW is a succession of dynasties or generation to maintain family ties within a company. Westhead (2003) analyzed the motivation of family companies to maintain generations responsible for a given company. Assuming that the first generation or family founders have high family ties, Westhead (2003) found that the first generation of corporate control assumes that family priorities are more important than business objectives. Gils et al. (2004) also found that when the second or third generation takes control of the company, family priorities decrease.

In accordance with SEW theory, family companies prioritize SEW rather than business interests. Gomez-Mejia et al. (2007) stated that business owners unlikely take risks to keep SEW, but company owners take risks if SEW becomes threatened. Family companies controlled by the first generation prioritize family interests over other interests, such as maintaining a good family name. To achieve this initiative, they avoid taking risky actions that can damage it; for example, earnings management.

Conditions differ if the control of a family company has changed in succeeding generations. Arregle et al. (2007) and Gómez-Mejía et al., (2007) stated that the attachment of a family to its organization and family social capital likely decreases in the next generation. Under this condition, SEW, which has been a family's priority, becomes weak when its company has entered the next generation stage. As a result, next-generation families focus on business objectives so that risk preferences are the same as those of non-family investors (Schulze et al., 2003). Thus, family companies implement earnings management, although this technique possibly damages a family's good name. As such, family companies controlled by the first generation avoid earnings management to maintain family control, whereas the succeeding generations apply earnings management to maintain the company's business. Based on this explanation, the first hypothesis can be formulated as follows:

H1: The first generation of family companies in Indonesia negatively affects earnings management.

The role of BAPEPAM no. 29/PM/2004 explained that the members of the audit committee must have expertise or experience expertise in accounting and finance. A financial expert has knowledge of GAAP and financial statements, can access the accounting application of a firm, understands audit committee's tasks and functions, and has experience in auditing, preparing, analyzing, and evaluating financial reports. This position is in accordance with agency theory, which states that an owner or a shareholder cannot supervise the management behavior within a firm that tends to be opportunistic (Jensen & Meckling, 1976). Therefore, monitoring mechanisms should be established to inform stakeholders that a firm's financial statements are correct (Defond et al., 2005). Krishnan & Visvanathan (2008) argued that audit committee directors with expertise have the best ability to distinguish some accounting policies as conservative or aggressive and have more incentives than other directors.

In SEW theory, audit committees in family firms aim to compel the management to save the families' good name. Audit committees, which comprise experts in accounting, serve as a good corporate governance mechanism that minimizes the practice of earnings management by a family agent. Sherliza and Devi (2013) stated that audit committee is negatively correlated with earnings management. Inaam & Khamoussi (2016)confirmed that audit committee negatively affects earnings management. Based on this explanation, the second hypothesis can be formulated as follows:
H2: An accounting expert of an audit committee negatively affects earnings management in family firms.

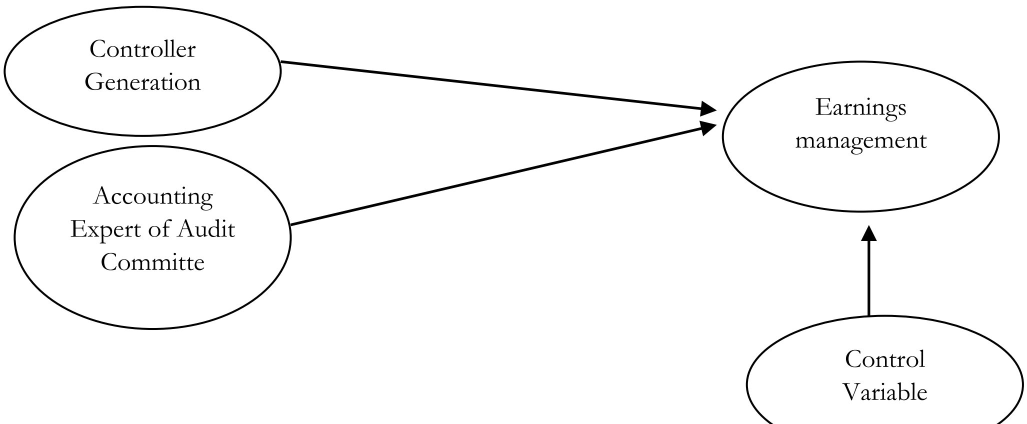

Figure 1. Research model

3. METHODOLOGY

The population explored in this study consists of all manufacturing companies on the IDX because this type of industry is sufficient to contribute remarkably to the economy in Indonesia (Isniawati et al., 2018). The selection of family companies in this study used the same approach applied by Chua et al., (1999), who defined that a family company has a minimum of 25% shareholding by the family, has family members who hold positions as directors, and has a business vision held by all family members. On the basis of these criteria, we include 43 manufacturing companies in the category of family companies. We use the financial report data of 2012–2017 and obtain a total of 258 samples (i.e., 43 companies for 6 years).

Controller generation is defined as the generation of families who participate and influence the company in decision-making. Controller generation can be achieved through shareholding ownership (family ownership) and places family members in top management positions (family directors). This study adopts the controller generation proxy used by Stockman *et al.* (2010),who used dummy variable 1 for the first generation and 0 for the next generation. To determine the first generation or the next generation, they used the approach proposed by Prabowo dan Simpson (2011). In particular, the immediate owner's annual report should be initially presented, and company profile and various media sources should be subsequently searched to determine the generation of some family owners in a company. The accounting experts of the audit committee variable (AE) utilize the sum of the audit committee members who are experts in accounting divided by the total number of audit committee members.

The variable of earnings management in this research constitute the modified Jones model. The amount of earnings management measured 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 income 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 assets of the previous year to i company

This study uses several control variables that regulates the influence of the main variable on the dependent variable, that is, company size as measured by the total assets Ln, leverage as measured by the leverage ratio or the debt-to-equity ratio, and earning ability as measured by net income. The model of this research is expressed as follows:

DAC= $\alpha + \beta 1\text{Fam\_Own} + \beta 2\text{Fam\_Dir} + \beta 3\text{Control\_Var} + \varepsilon$ ... model 1

DAC= $\alpha + \beta 1\text{Fam\_Own} + \beta 2\text{Fam\_Dir} + \beta 2\text{AE} + \beta 3\text{Control\_Var} + \varepsilon$ ... model2

4. EMPIRICAL RESULTS AND DISCUSSION

Descriptive statistics

Table 1 shows the descriptive statistical data of each variable. The family ownership variable for 6 years has an average of 0.65, indicating that 65% of family companies are still controlled by first-generation owners. The family director variable for 4 years has an average of 0.35, indicating that 35% of family companies are still controlled by first-generation directors. The AE variable has a mean of0.67, suggesting that the audit committee has good experience in accounting. The variable of earnings management (DAC) is −0.06.Thus,on average, family companies that enter the manufacturing industry in Indonesia have low earnings. For an average variable size of Rp487,221 billion, the averages of earning ability and leverage are Rp442,912 billion and 1.504,respectively.

Table 1

Descriptive Statistics

	Mean	Min	Max	Standard Deviation
Family Ownership	0.65	0	1	0.390
Family Directors	0.35	0	1	0.347
AE	0.67	0.33	0.75	0.250
DAC	-0.06	0.01	2.68	0.154
Size	28,779	132	487,221	256,06.1
Earning	442,912	0.012	751,295	88,545
Leverage	1.504	0.013	31.781	2.910

Size and Earning in billion rupiah.

Findings

The results of the regression test in Table 2 indicate that the coefficient of family ownership variable is −0.01 with a significant level of 0.01, and the coefficient of family director variable is −0.47 with a significant level equal to 0.04. Therefore, the controller generation through ownership and directors negatively affects earnings management. Thus, the first hypothesis is accepted. The results of this study support previous findings obtained by Stockmans et al. (2010), who suggested that the first generation in family companies reports quality earnings compared with the next generation because family attachment to organization and family social capital decline with the next generations. Consequently, succeeding generations focus on business objectives so that the same risk preference with nonfamily investors (Schulze et al., 2003) provides a high possibility of earnings management.

In Table 2, the coefficient of the AE variable is−0.11 with a probability level of 0.06.Considering that the significance level is less than 10%, we can suggest that the accounting expert of the audit committee has a significantly negative effect on earnings management. Thus, the second hypothesis is accepted at the significance level of 10%. This result supports previous findings obtained by Sherliza and Devi (2013) andInaam & Khamoussi (2016), who stated that accounting experts of audit committees negatively influence earnings management. This finding is also supported by agency and SEW theories stating that the existence of an audit committee who has accounting skills reduces the possibility of an opportunistic manager in a firm to conduct earnings management. Therefore, an accounting expert of audit committees is important in businesses as a good corporate governance mechanism (Suprianto et al., 2017). We also examine whether the moderation variable AE*Fam_Own and AE*Fam_Dir affect earnings management. In Table 2, the moderation variable AE*Fam_Own significantly and negatively affects earnings management, whereas the moderation variable AE*Fam_Own and AE*Fam_Dir positively influences earnings management, but this effect is not significant.

Table 2

Regression between independent variables of the Controllers Generation and Earnings Management

Independent Variable	Predict Sign	Dependent Variable (DAC)		Dependent Variable (DAC)		Dependent Variable (DAC)	
		(β)	(Prob)	(β)	(Prob)	(β)	(Prob)
Constant	?	2.53	0.05	1.90	0.25	1.33	0.07
FamOwn	-	-0.01	0.01	-0.07	0.02	-0.12	0.05
Fam_Dir	-	-0.47	0.04	-0.30	0.03	-0.21	0.05
AE	-			-0.11	0.06	-0.07	0.01
AE*Fam_Own	-					-0.58	0.01
AE*Fam_Dir	-					-0.32	0.07
Control Variable:							
Size	-	-0.59	0.06	0.86	0,00	0,03	0.05
Profitability	+	0.13	0.00	0.20	0.04	0.10	0.00
Leverage	+	0.65	0.00	0.70	0.00	0.06	0.07
Random Effect:							
Total Obs.		258		258		258	
R-Square		0.03		0.04		0.09	
Wald Chi^2 Probability		16.33 0.00		20.02 0.00		25.01 0.00	

Discussion

Our results are consistent with the predictions of SEW theory stating that family companies unlikely take risks to maintain SEW (Gomez-Mejia et al., 2007). Family companies controlled by the first generation prioritize family interests over other interests, such as maintaining the good name of their family. As such, they avoid risky actions that can damage their family name. For example, earnings management.

To support this result, we conduct robustness testing by subjecting the earnings management behavior of each group of family companies to trend analysis. In this analysis, family companies are divided into four 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 individually performs varying earnings management but appears stable from −0.04 to −0.06as indicated by the linear trend. Therefore, the existence of first-generation owners likely prevents the second-generation managers from implementing earnings management. The same condition is also illustrated in Figure 3 that is, Group 2 comprises family companies owned and managed by the first generation. Its linear trend is stable from 0.01 to 0.02.

Group 4 includes family companies owned and managed by the second generation. In Figure 4, this group individually varies in earnings management (Figures 2 and 3).Conversely, its linear trend decreases significantly between −0.14 and −0.02. Thus, second-generation owners and managers likely perform earnings management. These results support a previously tested hypothesis.

5. CONCLUSION

On the basis of the results of our analysis, we conclude that the controller generation negatively affects earnings management. Thus, the hypothesis is accepted. The results of this study disagree with previous findings obtained by Schulze et al. (2003), Stockmans et al. (2010), and Gómez-Mejía et al., (2007) and are supported by the trend analysis in Group 1,which is owned by the first-generation family and includes the second-generation director, and Group 2,which comprises the family company owned and managed by the first generation. The linear trend appears stable from 0 to 0.01. In Group 3, which consists of the family company owned and managed by the second generation, the linear trend drops significantly between 0.2 and −0.2. Accounting experts of the audit committee also negatively affect earnings management. This study has several limitations. First, the sample of this study is limited to the manufacturing industry, so this result can be generalized to this industry only. Further research should be performed to analyze other industries. Second, earnings management measures are derived from an accrual approach. Further research should be conducted to examine real earnings management and obtain accurate results.

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APPENDIXES

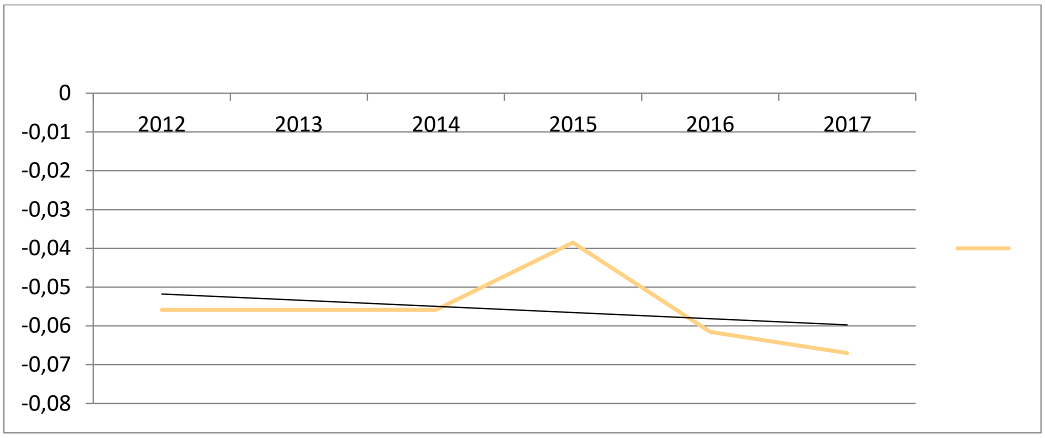

Figure 2. Earnings management of the Family Company
Owner (first generation) and the President Director (second generation)

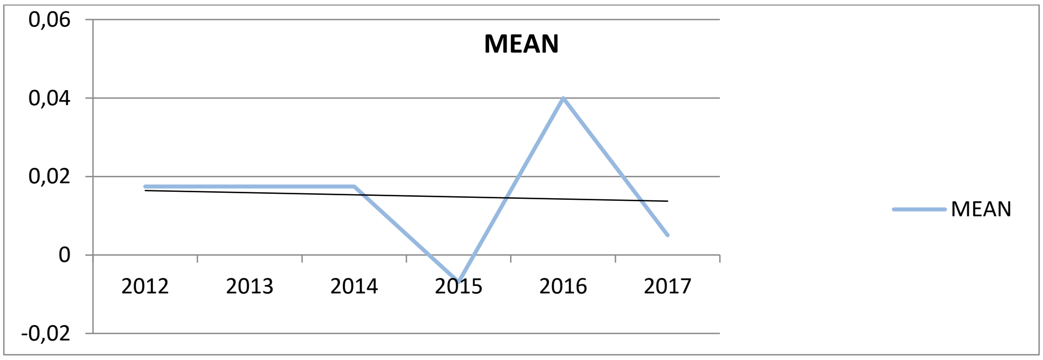

Figure 3. Earnings Management of the Family Company
Owner and President Director (first generation)

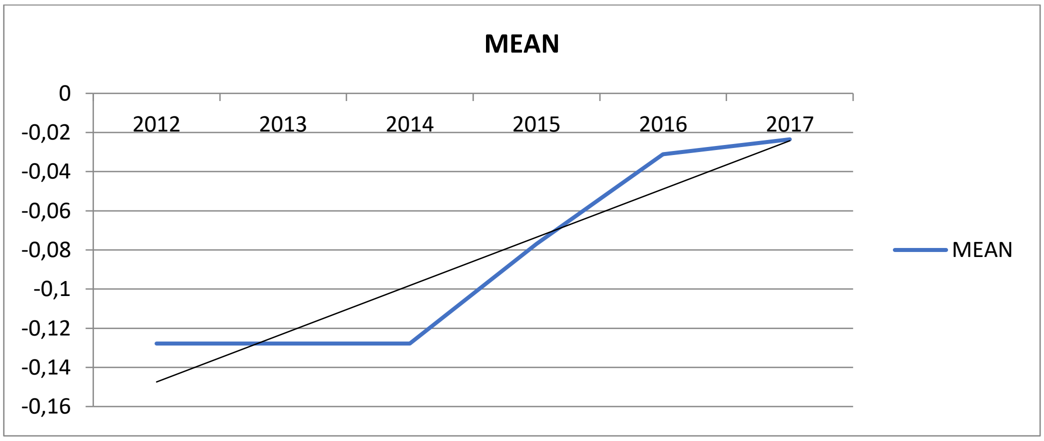

Figure 4. Earnings Management of the Family Company
Owner and President Director (second generation)