

The Effect of Controlling Shareholders on Earnings Management

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The purpose of this study is to analyse how controlling shareholders affects earnings management. This study uses observations from 865 firms listed on the Indonesia Stock Exchange during the 2015-2017 period. This study uses the Ordinary Least Square Regression analysis model with STATA 14.0 software. The results found that the entrenchment effect and alignment effect did not have a significant effect on the level of earnings management. This finding shows that controlling shareholders in both the entrenchment effect and alignment effect are not the main factors in determining earnings management.

Keywords: *Controlling shareholders, Entrenchment effect, Alignment effect, Earnings management.*

Introduction

According to agency theory, principals and agents are assumed to be economic individuals who have rational minds and are only motivated by individual interests. From this issue, conflicts of interest arise (Nasution, 2019), because principals and agents have different interests and desires in terms of maximising utility (Putra et al., 2018). Agency conflict that occurs between shareholders and management is conflict that often occurs in scattered ownership structures. In companies, management decisions in improving financial statements can be influenced by institutional shareholders or individual shareholders (Madyan and Arianto, 2019). These matters concern the variety of ownership that is spread in a company. A scattered ownership structure will usually be found in a common-law country that has reliable legal protection for the rights of its shareholders. Civil law countries with weak investor protection have made many companies with concentrated ownership structures. This phenomenon occurs in Indonesia, which is a civil law country. Significant power over many companies is only in the hands of the majority shareholders. This can lead to conflicts

between majority and minority shareholders. This is consistent with research conducted by Claessens et al. (2000) on 2,980 companies in Asia, including 132 companies in Indonesia. The results show that corporate ownership in Asia tends to be concentrated ownership.

When the ownership of a company is concentrated among only a few shareholders, controlling shareholders can determine the rules and policies of the firm's operations. A concentrated ownership structure where a controlling shareholder has control rights that exceed their cash flow rights is an example of the entrenchment effect. The entrenchment effect does not always harm a company and does not always lead to agency conflict. Still, if a controlling shareholder determines a company's policies based on their interests with the power they have, then this can threaten the interests of non-controlling shareholders. This phenomenon is said to be a negative entrenchment effect (Claessens et al., 2002).

A negative entrenchment effect occurs when a company is owned by a controlling shareholder in a pyramid ownership structure. The concept used in the pyramid ownership structure is the concept of ultimate ownership. The idea of ultimate ownership is ownership that is both directly and indirectly traceable through a chain of ownership. The existence of the ultimate ownership concept makes a person's ownership chain in a public company traceable until the ultimate owner can be identified. The ownership structure of the pyramid results in the controlling rights of the controlling shareholder exceeding the rights of their cash flow. Consequently, the controlling shareholder takes over the company's wealth without being willing to bear the costs incurred if there is a financial loss or decline in the value of the company.

When the controlling shareholder has substantial cash flow rights, the controlling shareholder also has a strong incentive to oversee managers and increase cash dividend payments. This shows the commitment of controlling shareholders not to carry out expropriation according to their personal interests. The substantial increase in cash flow rights marked by the rise in the percentage of ownership is an implication of the alignment effect (Fan and Wong, 2002).

According to Claessens et al. (2000), expropriation is the process of using controls to maximise personal welfare through the distribution of wealth from other parties, minority shareholders, and the company. Expropriation is carried out by a controlling shareholder to obtain private benefits over the control they have. Expropriation can be carried out by controlling shareholders through more control rights that they have. Private benefit control is a benefit obtained by controlling shareholders through dominant control rights (financial, and non-financial) (Gilson and Gordon, 2003). In other words, expropriation is the behaviour of controlling shareholders who take private benefits by taking the rights of minority shareholders.

When the cash flow rights of a controlling shareholder are higher or their percentage of ownership increases (alignment effect), it will reduce the possibility of the controlling shareholder performing expropriation. Controlling and non-controlling shareholders who are concerned with a company rather than personal interests will reduce agency conflicts between controlling and non-controlling shareholders.

Concentrated ownership has a relationship with earnings management practices (Kim and An, 2018). Earnings management can occur when controlling shareholders cover up their frauds or for their interests by manipulating the area of company management through more control rights they have. Earnings management can be in the form of acts of manipulation of accounting records, intentional omissions, or misuse of accounting principles (Bukit and Iskandar, 2009). Earnings management can also be done by manipulating a company's actual actions. This action is defined as a management action that is not appropriate in general business practices with primary objectives to reach certain amounts of income (Christiawan and Rahmiati, 2017). Previous research states that controlling shareholders tend to do earnings management in the accrual area (Kim and An, 2018). However, Zhu et al. (2012) state that controlling shareholders do not always want to carry out expropriation. If controlling shareholders pursue maximising firm value, they use their control rights to improve company performance by monitoring more transparent management and accounting practices. Achievement of a company's current performance is a basis for management or company managers to improve performance in the next period (Mahrani and Soewarno, 2018). Companies with good performance describe good company profitability so that earnings management can be avoided.

Controlling shareholders may want to maximise firm performance and monitor management to avoid earnings management. The increase in cash flow rights of controlling shareholders, referred to as the occurrence of the alignment effect, will also motivate controlling shareholders to reduce earnings management. This is because the involvement of controlling shareholders in earnings management can have a significant loss on them and will also reduce the quality of financial statements. The latter also have an impact on the welfare of controlling shareholders.

This study aims to determine whether controlling shareholders, based on the entrenchment effect and alignment effect, affect earnings management. The analysis of this study uses 865 samples of companies in all non-financial industry sectors listed on the Indonesia Stock Exchange from 2015-2017. The analytical method used is multiple linear regression analysis using STATA 14.0 software. The results of this study prove that the entrenchment effect and alignment effect do not affect earnings management. This result indicates that despite the level of concentration of controlling shareholders, the presence or absence of earnings management will remain the same.

Furthermore, this research will continue with the following structure: Section 2 contains the literature review and hypothesis development. Section 3 includes explanations for variables and samples as well as research models. Section 4 contains empirical analysis and the results of hypothesis testing and the results of sensitivity tests. Section 5 summarises or concludes the research, including suggestions for further research.

Literature Review

Conflicts that occur between controlling shareholders and non-controlling shareholders fall under Agency Problem Type II (Bozec and Laurin, 2008). An instance of Agency Problem Type II will get worse if it occurs in a concentrated ownership structure, where company ownership is only concentrated among several shareholders who are controlling shareholders. These controlling shareholders can determine the operational policies of a company through their control rights (Coffee, 2001). Control rights can become conflicts of interest between a controlling shareholder and non-controlling shareholder if the controlling shareholder uses their control rights to expropriate the other shareholder's rights. They may do so through various policies that only benefit themselves (Bozec and Laurin, 2008). Concentrated ownership raises two arguments regarding a company's shareholders (consisting of controlling shareholders and non-controlling shareholders). The two arguments involve the entrenchment effect and the alignment effect.

The entrenchment effect is the controlling right of controlling shareholders that exceeds their cash flow rights, often referred to as the divergence between control rights and cash flow rights (Fan and Wong, 2002). The entrenchment effect can be traced through the concept of ultimate ownership, where the concept can trace the chain of ownership until the ultimate owner can be identified. If a controlling shareholders determines a company's policies based on their personal interests with the power they have, this event can threaten the interests of non-controlling shareholders. A negative entrenchment effect will harm a company because controlling shareholders do not want to bear losses due to their expropriation behaviour. A negative entrenchment effect will worsen if it occurs within the ownership structure of a pyramid (Claessens et al., 2000).

Some methods can be used to reduce acts of expropriation of non-controlling shareholders. One way is to increase the cash flow rights of the controlling shareholders, as reflected in the increasing percentage of ownership of the controlling shareholders (Fan and Wong, 2002). An increase in cash flow rights is an implication of the alignment effect. Alignment effects can reduce acts of expropriation due to the increased cash flow rights of controlling shareholders. Consequently, if the controlling shareholders expropriate and there are

significant losses to the company, controlling shareholders will bear higher losses in line with their increased incentive rights (Claessens et al., 2002 and Sanjaya, 2010).

In the entrenchment effect, controlling shareholders can expropriate through their control rights so that they are involved in earnings management to cover up their fraudulent behaviour (LaPorta et al., 1999; Claessens et al., 2000; and Diyanti et al., 2013). However, controlling shareholders in the entrenchment effect who have a desire to improve company performance will monitor management to increase the transparency of financial statements where such actions can reduce the level of earnings management (Zhu et al., 2012). The alignment effect will motivate holders controlling shares to monitor management so as not to conduct earnings management because controlling shareholders do not want to bear significant losses (Sanjaya, 2010).

The Entrenchment Effect on Earnings Management

Negative entrenchment effects that occur in companies with concentrated ownership structures encourage controlling shareholders to exercise excessive control rights for personal interests. One of these is to surrender top management positions to the family of the controlling shareholder, or a person appointed to fulfil the personal interests of the controlling shareholder rather than being left to capable management (Caselli and Gennaioli, 2013). Research conducted by Kim and Yi (2006) states that controlling shareholders who are in companies with high control-ownership disparity structures tend to be involved in earnings management practices. A controlling shareholder will engage in earnings management actions by encouraging the management of a company to take opportunistic actions of earnings management to hide the bad behaviour of the controlling shareholder and the resulting losses. The information held by a manager can be used to deceive other shareholders to obtain financial incentives (Narsa and Supriyadi, 2019). However, Zhu et al., (2012) and Kim and An (2018) state that controlling shareholders do not always want to carry out expropriation. Controlling shareholders that pursue maximising the value of a company will use their control rights to improve company performance by monitoring more transparent management and accounting practices. Companies with good performance describe good profitability so that earnings management can be avoided.

H1: The entrenchment effect from controlling shareholders affects profit management.

The Alignment Effect on Earnings Management

An agency can achieve its expected vision and goals if the organisation can determine the level and priority of aspects of the company's activities (Sumardi and Fernandes, 2018). The existence of expropriation for personal interests will cause problems for companies, especially controlling shareholders. Of issues that arise and must be borne by a controlling shareholder, one of which is the high risk of loss to a company, which is also a loss for the

controlling shareholder. With the high risk to be borne, it encourages controlling shareholders to increase the value of companies and not to carry out expropriation. Awareness of the negative entrenchment effect makes controlling shareholders supervise management actions in making decisions that affect a company (Claessens et al., 2002). Aligning the interests of controlling shareholders to increase the value of a company and oversee management so they do not carry out opportunistic actions in earnings management and maintain transparency are the implications of the alignment effect. Some previous studies, such as research conducted by Claessens et al., (2000), La Porta et al., (1999), Claessens et al., (2002), Lemmon and Lins (2003), and Siregar and Utama (2008), state that there is a positive relationship between an increase in cash flow rights and the value of a company. High company value reflects a low level of earnings management, so this study suspects that the existence of high cash flow rights will align the interests of controlling shareholders and non-controlling shareholders. This causes a negative alignment effect with earnings management.

H2: The alignment effect from controlling shareholders has a negative effect on earnings management.

Research Methodology

Sampling and Data

The sample used in this study consists of all industrial sectors of companies listed on the Indonesia Stock Exchange. The industrial sector with code SIC number 6 is excluded because the industry is engaged in financial services and insurance, where the industry has financial statement disclosures that are different from other industries. The population in this study includes all industrial sectors to obtain more accurate and clearer measurement results. Furthermore, the population was sampled using the purposive sampling method with several criteria, namely excluding companies engaged in financial services, insurance, and companies engaged in real estate (companies with SIC code 6) for the 2015-2017 period. The companies that met the research criteria based on the purposive sampling method were 865 samples. Table 1 shows the results of sample selection in this study.

Table 1: Sample Selection

Description	Total
Total population	1248
Exclude:	
Incomplete data	383
Total sample	865

Dependent Variable

Earnings Management

Earnings management in companies occurs when managers use their decisions in financial statements and in preparing transactions to make changes to financial statements. The objective is to create incorrect perceptions for stakeholders about a company's economic performance or to influence contracts that depend on accounting numbers in financial statements (Muda et al., 2018).

Earnings management is measured as follows:

$$DAC_{it} = TA_{it}/AT_{it-1} - [\beta_0 + \beta_1 (1/AT_{it-1}) + \beta_2 (\Delta REV_{it} - \Delta REC_{it}) + \beta_3 PPE_{it}]$$

$$TA_{it}/AT_{it-1} = \beta_0 + \beta_1 (1/AT_{it-1}) + \beta_2 (\Delta REV_{it} - \Delta REC_{it}) + \beta_3 PPE_{it} + \varepsilon_{it}$$

where:

TA_{it} = Total accruals for company i in period t , calculated from the difference in net income in the current year with cash from operating activities for the current year

AT_{it-1} = Total assets of company i in period $t-1$

ΔREV_{it} = Changes in income of company i in period t

ΔREC_{it} = Changes in receivable of company i in period t

PPE_{it} = Net Property, Plant, Equipment of company i in period t

ε = Error

Independent Variables

Controlling Shareholders

An ownership structure only concentrated among several shareholders, where the shareholders determine the rules and operational policies of a company through their increased control rights, is the implication of the entrenchment effect. However, increasing cash flow rights can increase the commitment of controlling shareholders not to misuse company assets and not expropriate minority shareholders. This condition is called the alignment effect.

Entrenchment Effect

The Entrenchment effect occurs when controlling shareholders have strong control rights in determining a company's operating policies (Coffee, 2001). In a pyramid ownership structure, controlling shareholders tend to exercise their control according to their desires. The worsening entrenchment effect is called the negative entrenchment effect. Bozec and Laurin (2008) state that ownership structures become problematic if controlling shareholders determine their control rights to exceed the voting rights of a company. Based on research by LaPorta et al., (1999), Claessens et al., (2000), and Diyanti et al., (2013), this study measures

the alignment effect of controlling shareholders using cash flow leverage (CFL). CFL is the ratio between control rights (CR) and cash flow rights (CFR). It measures the incentive for expropriation by controlling shareholders. CFLs can be formulated as follows:

$$CFL = \frac{CR_{it}}{CFR_{it}}$$

CR_{it} is the value of a control right calculated using the weakest link in the ownership control chain (Claessens et al., 2000).

Alignment Effect

Fan and Wong (2002) argue that shareholders who have substantial cash flow rights will reduce expropriation by controlling shareholders. This is because the controlling shareholder bears a higher risk burden in the company's failure. The high risk encourages the controlling shareholder to increase firm value, reduce the possibility of expropriation, and oversee management actions in decision making (Claessens et al., 2002). Thus, reduced expropriation and increased corporate value imply an alignment effect (Fan and Wong, 2002).

In this study, the alignment effect of controlling shareholders is measured using cash flow rights (CFR). Cash flow rights are the addition of multiplications of the percentage of share ownership for each share ownership chain. Diyanti et al. (2013) stated that CFR is the biggest cash flow right.

Control Variable

To overcome the endogeneity problem, in the form of omitted variables, this study uses several control variables, namely leverage, size, profitability, and age of company. Leverage (LEV) is proxied by the debt to asset ratio obtained by dividing total debt by total assets (DeFond and Jiambalvo, 1994). The size of the company is related to the total assets of the company, which explain the company's resources (Nasih et al., 2019). Company size (SIZE) is measured through the natural logarithm of total company assets i for fiscal year t . Profitability is proxied by return on assets (ROA) obtained by dividing profit after tax by total assets (Dechow et al., 2012). Company age (AGE) was measured when each company first went public until the sample year used in this study.

Methodology

This research used STATA 14.0 software. The analysis technique used included a descriptive statistical analysis test, Pearson correlation test, and multiple linear regression analysis tests. Regression analysis was done if two variables had a causal relationship or functional relationship based on theories and concepts related to the variable. Regression analysis was

used to find out how the dependent variable influenced the independent variable (Anshori and Iswati, 2009: 127). The regression model used to test the hypothesis in this study was as follows:

$$EM_MJ_{it} = \alpha + \beta_1 CFR_{it} + \beta_2 CFL_{it} + \beta_3 LEV_{it} + \beta_4 SIZE_{it} + \beta_5 ROA_{it} + \beta_6 AGE_{it} + \varepsilon_{it}$$

Description:

α = Constanta

β_1 - β_6 = Regression Coefficient

CFR = Cash Flow Rights

CFL = Cash Flow Leverage

LEV = Leverage

$SIZE$ = Firm Size

ROA = Return on Asset

AGE = Firm Age

Results and Discussion

Sample Distribution

Table 2: Sample Distribution

SIC Code	Frequency	Percentage
0	38	4,39%
1	137	15,84%
2	243	28,09%
3	159	18,38%
4	124	14,34%
5	84	9,71%
7	69	7,98%
8	11	1,27%
Total	865	100%

Table 2 shows the distribution of the research sample. The results show that of the 865 companies sampled in this study, as many as 38 or 4.39% belonged to SIC 0 code (agriculture, forestry, engagement), 137 or 15.84% to SIC 1 code (mining and construction industry), 243 or 28.09% to SIC 2 code (manufacturing industry), 159 or 18.38% to SIC 3 code (manufacturing industry), 124 or 14.34% to SIC 4 code (industry transportation, communication, utilities, and sanitation), 84 or 9.71% to SIC 5 code (trade, wholesale and retail industries), 69 or 7.98% to SIC 7 code (service industries), and 11 or 1.27% to SIC 8 code (service industry).

Descriptive Statistics

Table 3: Descriptive Statistics

Variables	Mean	Median	Minimum	Maximum
EM_MJ	0,076	0,053	0,000	0,991
CFR	0,472	0,468	0,001	0,972
CFL	1,080	1,000	1,000	3,708
LEV	0,542	0,493	0,000	5,771
SIZE	21,772	21,726	16,857	26,291
ROA	0,029	0,025	-0,706	0,580
AGE	18,388	18,000	2,000	68,000

Table 3 shows the results of the descriptive statistical analysis of the variables used in this study. The average value for earnings management is 0.076, with a median of 0.053. The alignment effect (CFR) has an average value of 0.472 and a median value of 0.468. The entrenchment effect (CFL) has an average value of 1,080 and a median value of 1,000. The average LEV value is 0.542, and the median LEV value is 0.493. The average value of SIZE is 21.777, and the median LEV value is 21.726. The average value of ROA is 0.029, and the median value of ROA is 0.025. The average AGE value is 18,388, and the median AGE value is 18,000.

Pearson Correlation

Table 4: Pearson Correlation Model

	AUDQUAL	EM_MJ	CFR	CFL	LEV	SIZE	ROA	AGE
AUDQUAL	1.000							
EM_MJ	-0.144*** (0.000)	1.000						
CFR	0.111*** (0.001)	0.015 (0.653)	1.000					
CFL	0.165*** (0.000)	-0.036 (0.297)	-0.315*** (0.000)	1.000				
LEV	-0.120*** (0.000)	0.182*** (0.000)	-0.007 (0.845)	-0.076** (0.025)	1.000			
SIZE	0.313*** (0.000)	-0.239*** (0.000)	0.016 (0.648)	0.090*** (0.008)	0.013 (0.698)	1.000		
ROA	0.242*** (0.000)	-0.220*** (0.000)	0.069* (0.043)	0.129*** (0.000)	-0.355*** (0.000)	0.141*** (0.000)	1.000	
AGE	0.140*** (0.000)	0.020 (0.548)	0.056 (0.102)	-0.068** (0.047)	-0.001 (0.974)	-0.068** (0.046)	0.133*** (0.000)	1.000

p-values in parentheses * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

The Pearson correlation test shown in Table 4 shows that the relationship between CFR and EM (Earnings Management) has a positive and insignificant value. Likewise, CFL also has a negative and insignificant relationship to EM_MJ. The LEV variable has a significant positive relationship with EM_MJ. ROA and SIZE variables have a negative and significant relationship to EM_MJ. Meanwhile, the AGE variable has no significant positive relationship with EM_MJ.

Ordinary Least Square Test

Table 5: OLS Test

Variable	Predicted Sign	EM_MJ	
		OLS	OLS robust
CFR	+	0,017 (0,16)	0,017 (0,17)
CFL	+/-	0,005 (0,50)	0,005 (0,30)
LEV	+	0,032*** (0,00)	0,032*** (0,00)
SIZE	-	-0,012*** (0,00)	-0,012*** (0,00)
ROA	-	-0,082*** (0,00)	-0,082** (0,02)
AGE	-	0,001** (0,02)	0,001** (0,01)
_cons		0,282*** (0,00)	0,282*** (0,00)
r2		0,141	0,141
N		865	865

p-values in parentheses * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Based on the multiple linear regression test results above, it can be explained that the entrenchment effect variable (CFL) with OLS does not have a significant effect on earnings management (EM_MJ). Its *p*-value of 0.50 is greater than the significant level of 0.1. OLS Robust shows insignificant results between CFL and EM_MJ, with a *p*-value of 0.30, which is greater than the significant level of 0.1. The alignment effect (CFR) variable in OLS shows insignificant results between CFR and EM_MJ, with a *p*-value of 0.16, which is greater than the significant level of 0.1. In contrast, OLS Robust shows insignificant results between CFR and EM_MJ, with a *p*-value of 0.17, which is greater than the significant level of 0.1. The value of *r*² in the EM_MJ is 0.141. This value indicates that the earnings management regression model is explained by 14.1% of all independent and control variables tested. This means there are other variables not examined in this study that are also determinants of

earnings management.

The Entrenchment Effect on Earnings Management

This research is consistent with the work of Francoeur et al. (2012), which states that the insignificant relationship between controlling shareholders and earnings management is due to legal and extra-legal protections that protect the interests of minority shareholders. This research is consistent with a study conducted by Francoeur et al. (2012), which states that the insignificant relationship between controlling shareholders and earnings management is due to legal and extra-legal protections that protect the interests of minority shareholders. This legal protection is considered quite strong and plays an important role in limiting the personal benefits available to controlling shareholders (Dyck and Zingales, 2004). With adequate legal protection, the existence of controlling shareholders does not have a role in earnings management because of the existence of the law as a regulator with certainty.

This research is also consistent with that of Fatmawati and Sabeni (2013). They indicate controlling shareholders are not determinants for the management of opportunistic practices. Managers of companies that carry out earnings management actions do not consider controlling shareholders their primary consideration. Besides, the personal characteristics of controlling shareholders determine their behaviour. If a controlling shareholder has characteristics that obey the rules of law or has good intentions towards the progress of a company, when they experience a deviation of control rights and cash flow rights being greater through a pyramid ownership structure and cross-holdings, they will continue to carry out their same function in the company. They will not use more control rights for expropriation in earnings management and vice versa. Thus, it can be concluded that the entrenchment effect contained in concentrated ownership does not affect the presence or absence of earnings management. Higher levels of the entrenchment effect do not affect levels of earnings management.

The Alignment Effect on Earnings Management

This research is consistent with the work of Perwitasari (2014), which states that companies with concentrated and distributed share ownership have the same roles and functions in the presence or absence of earnings management. In other words, a controlling shareholder focuses on their duties and functions as a controlling shareholder separate from the company's management function. This research is consistent with the research of Joseph Ason and Wee Ching Pok (2010), which states that ownership concentration has no effect on earnings management when a company has a good governance mechanism.

The alignment effect is an indication of alignment between controlling and non-controlling shareholders in companies that are considered to have good governance mechanisms. Companies that already have good organisational supervision systems enable controlling

shareholders not to mix their authority in management duties. Controlling shareholders who do not interfere in earnings management indicate the existence and absence of earnings management practices is not due to the influence of controlling shareholders. Thus, it can be concluded that the alignment effect contained in concentrated ownership does not affect the presence or absence of earnings management so that a higher level of the alignment effect does not affect the level of earnings management.

Conclusion

This study aims to analyse the effect of controlling shareholders on earnings management. The results of this study indicate that controlling shareholders, both in the entrenchment effect and the alignment effect, do not have a significant effect on earnings management. This implicates that despite both high and low levels of concentration of controlling shareholders, the presence or absence of earnings management will remain the same. The function and role of controlling shareholders is not a significant factor in the opportunistic actions of earnings management because of legal protection as a definitive regulator. Consequently, controlling shareholders do not have a role in the opportunistic behaviour of earnings management. In addition, the alignment effect, which is an indication of good corporate governance, shows a company has a good separation of functions so that controlling shareholders do not mix their authority in earnings management.

The limitation of this study is that it only uses companies listed on the Indonesia Stock Exchange, and no measurement measures the expropriation value of controlling shareholders for personal gain directly. A suggestion for further research is to broaden the scope of research into other sectors so that results can be more generalised and can use different proxies to assess variables.

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