

# The Characteristics Board of Directors, Family Ownership and Accounting Conservatism: Evidence from Family Public Firms in Indonesia

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## Abstract

This study attempt to identify whether family ownership can strengthen the relationship between board of directors on conservatism. Our main hypothesis are tested on a sample of 99 Indonesia firms that list on Indonesian Stock Exchange (IDX). The result show that there is positive relationship between audit comitee on conservatism. This study also show that there is no relationship between proportion of independent directors on conservatism. Our result also suggest the existence of family ownership weaken the impact between the proportion of independent directors and conservatism; while family ownership does not weaken or strengthen the audit committee relationship to conservatism. The evidence deepen the emperical evidence of Agency Coflict Type II and entrenchment effect among indonesian firms that owned by family. Accounting Conservatism in concentrated ownership is under control of family ownership through the hand of board of directors.

**Keywords:** Agency conflict Type II, Characteristics of Board of Directors, Family Ownership, Accounting Conservatism

## 1. Introduction

A financial report based on the accounting standard provided flexibility for the management in choosing method and accounting estimation. Flexibility in choosing method and estimation emerge due to grey area in standard. Methods that can be chosen as well as the accounting estimates that are not constrained also the fact that the condition of uncertain business could potentially lead management in a state of hesitation in the decision making. Under conditions of doubt, management must apply conservatism.

Conservatism is one of the principles which can be defined as the tendency of accountants who require a higher level of verification to recognize the advantages compared to a loss (Basu, 1997). Accounting conservatism can be interpreted as an attitude of pessimism that is not anticipated profit earned, but anticipate all potential losses that occurred (Watts, 2003a). Under conditions of pessimism, conservatism is useful to prevent opportunistic behavior from managers (Watts, 2003b).

Pros and cons of the existence of conservatism in accounting is often debated related to the economic consequences occured. Researchers who agree with the existence of conservatism stated that by presenting financial report in understatement, the company tried to protect creditors and owners from management as well as reduce the possibility of agency conflicts (Watts, 2003a). Conservatism cause manager can not act opportunistically as to make the financial statements as a media contract then use these contracts to enrich themselves (Claessens *et al.*, 2002).

Conservatism is determined by good corporate governance mechanisms relating to the characteristics board of directors (Ahmed and Duellman 2007; Indrayati 2010; Wardhani 2007). The board of directors require financial statements presented in conservative number with consideration of the ease of obtaining loans from financial institutions and the benefit obtained by the company. The Company seeks to protect creditors by presenting financial statements with a conservative figure (Sari *et al.* 2014). The implications of conservatism is the company's reported earnings lower than it should, causing allocation dividend to shareholders low. Lower dividend payments resulted in the company cause sufficient cash to pay debts (Ratnadi *et al.*, 2013). Meanwhile, another benefit of conservatism according to (Ball *et al.*, 2013), with the presence of conservatism companies can avoid investments that have a negative NPV.

According to Lins and Warnock (2004), a mechanism that can control the behavior of the commissioners can be classified into two groups: the company's internal mechanism and external mechanisms. The internal mechanism of the company is the ownership structure and management structure, while the external mechanism is regulation in which the company operate. This study used the company's internal mechanism which is ownership structure as moderating variables.

The ownership structure of the company determine the application of conservatism (Chen *et al.*, 2009; Limantauw, 2012; Ratnadi *et al.*, 2013; Zureigat *et al.*, 2014). In the context of conservatism, the findings about the effect of the ownership structure to conservatism still inconsistence caused by the two different views (Porta *et al.*, 1999; Ratnadi *et al.*, 2013; Zureigat *et al.*, 2014). In point of view agency theory, family ownership can

mitigate (alignment effect) or even sharpen (entrenchment effect) agency problems that occur in the company (Setia *et al.*, 2011).

The ownership structure used in this study is family ownership with the thought of the ownership structure in the ASEAN countries, especially in Indonesia is different from other countries where the ownership structure is dominated by family ownership in large numbers (Alijoyo *et al.*, 2004). Family ownership in large numbers is a significant aspect that can influence the direction of policy related companies as well as reflect the culture of the management companies in Indonesia.

Previous researchers such as Ahmed and Duellman (2007); Indrayati (2010); and Wardhani (2007), have not considered the existence of family ownership on their model.

### *1.1 Aim of Study*

This study aims to examine whether family ownership can strengthen the relationship between board of directors and conservatism. Conservatism is proxied by market approach by Beaver and Ryan (2005).

### *1.2 Significance of Study*

This study contributes in enhance the empirical studies on Agency Conflicts Type II which is still limited in Indonesia public firms. The remaining of this paper is organized as follows. Section 2 discusses study of literature and hypothesis development. Section 3 describes research methodology, Section 4 explain the results of study and continued by section 5 with conclusion and recommendations.

## **2. Literature Review and Hypothesis Development**

### *2.1 Agency Problem II*

Agency theory explains the relationship separation of ownership and control over the company (Jensen and Meckling 1976). In a situation that management controls companies and principal as the owner of capital, the conflict that occurred is between management and shareholders. Agency conflict between shareholders and management can be minimized by concentrated ownership. Concentration of ownership may supervise management decisions, but it raises another problem. The agency problem between the agent and the principal can be overcome but the problem of conflicts between minority shareholders and majority shareholders began to emerge (Villalonga and Amit 2004).

The main theory used in this research is the agency theory which the agency problem type II. Concentrated ownership structure owned by the majority shareholder, in this study is the family ownership, may cause differences in agency conflicts and can affect financial reporting (Watts, 2003a).

Agency Theory Type II describes the agency problem occurred because the majority shareholder has a controlling interest in the company to influence management in determining the direction of the company's decision. Majority shareholder control rights can be used to maximize its interests by way of expropriation of minority shareholders in the form of misallocation of assets redistribution. Agency theory type II lead to two views which are entrenchment effect and alignment effect. Entrenchment effect happened when majority shareholders doing expropriate on minority shareholders using their control right, while alignment effect happened when majority shareholders has the same aim with minority shareholders to maximize company value (Porta *et al.*, 1999).

### *2.2 Independent Directors*

Independent directors is a position which has no affiliation or relationship with board of directors, board of commissioners and shareholders. Independent directors selected independently and transparently, based on competence, free from the influence of the internal company, working objectively guided by the principles of good corporate governance. The existence of independent directors in the company aims to provide independent management climate and more objective to provide protection not only for shareholders but also stakeholders of the company as a whole. Therefore, in carrying out its duties, the independent directors need qualified and accurate information to carry out its monitoring function.

The post of independent directors is a strategic position. The experience and expertise of independent commissioners beneficial to provide a view on the policies that have been taken or to be taken by the management. They are required to oversee and implement the company's policies, which is prudence. In essence the position of independent directors is a mechanism to provide guidance and direction as well as the mechanism for overseeing the company's operations. Supervisory functions show that independent commissioner served as a center for the company's success and resilience (fcgi).

### *2.3 Audit Committee*

Good Corporate Governance mechanisms that are linked to aspects of openness and dealing with the Board of Directors is the existence of an audit committee as a supervisory function in the company. The audit committee is a position that is required to have specialized in the field of accounting so as to give the contribution of the function

of monitoring that is more specific in the decision-making process related to accounting conservatism. The audit committee may also provide opinions and views on financial policies, internal controls and accounting treatment in each account (Siregar and Utama, 2008).

Audit committees in large numbers makes it possible to carry out oversight functions on operational activities of the company include in its investment activities and give an opinion and a view over the lead on the implementation of accounting conservatism. The audit committee is an independent party which can address the information asymmetry by playing the role of intermediary. Companies that have high information asymmetry have a demand for high-usage policy conservatism. The audit committee which specializes in industrial clients tend to know the risk of the industry and can give specific suggestions for a more conservative in making financial decisions, especially related to accounting (Hamdan et al., 2012).

#### *2.4 Family Ownership*

The ownership structure is divided into two groups which is concentrated and dispersed. Dispersed ownership occurs in some countries such as Britain and the United States. Instead, the concentrated ownership structure occurred in the company in the East Asia and Eastern Europe that centered on a particular owner (Bhasin 2010; Claessens *et al.* 2002). Dispersed ownership structure occurs when the ownership of company shares owned by many investors and each investor has a relatively small equity value or do not have the controlling rights. However, the concentrated ownership structure, shareholders grouped themselves into a controlling shareholder or a shareholder in a large amount of share. The majority shareholder in Indonesia owned by family holdings. This fact is explained by Alijoyo *et al.* (2004).

Family ownership may increase their right into cross-ownership structure, the pyramid, and through involvement in management company's. Increased ownership led to the magnitude of the ability of the majority shareholder to control the company. The ownership structure is said to be structured as a pyramid if there is the ultimate owner and there is at least one company in the chain of ultimate control rights owner (Claessens *et al.*, 2002; Siregar and Utama, 2008; Xu *et al.*, 2012). Thus, the ownership of the company can be traced directly (imediat) and indirectly (ultimate). Pyramid ownership structure allows the founding family control over a very large enterprise networks, both on closed companies or already listed on the stock exchange.

#### *2.5 Accounting Conservatism*

Prudence which replaces the term conservatism was an act of caution in making decisions under uncertain conditions. Management precautions explained that the uncertainty and the risk of a condition attached in managing the company's operations. Related to the concept of conservatism, Lafond and Roychowdhury (2008) stated that in circumstances that are difficult to predict, the management will use the option to illustrate the accounting treatment less favorable circumstances. Conservatism accounting implications for the recognition of expenses or loss as early as possible, but defer the recognition of revenue or profits that are likely to occur in the foreseeable future. Under these conditions, the company will report earnings understatement.

Accounting conservatism is defined by Watts (2003a) as a condition that is not anticipated profit, but anticipate all potential losses. The implication profit can not be recognized as real before legal claims can be verified, which shows that real earnings will be generated. Profit recognition depend on companies verification degree

#### *2.6 The Effect of Independen Directos on Accounting Conservatism (H1)*

Independent Directors is a party that is not affiliated with the management, shareholders and do not have a business relationship or other relationship that could affect independence in the management of the company. Characteristics independent of the existence of independent directors in the company becomes an important factor. The proportion of large amounts can of independent directors in the company allow it to supervise the directors and managers as well as the policies they set associated with conservatism (Indrayati, 2010).

Knowledge of financial issues and business strategies from independent directors to make an independent commissioner to be more conservative. Independent commissioner has an obligation to act in good faith (due diligence) which is divided into two parts, duty of care and the duty of loyalty (Ahmed and Duellman 2007). Prudence obligate independent directors to act and decide based on insufficient information. This action has the same characteristics as conservatism, which reacted cautiously to the uncertainties faced by the company (Fadzil *et al.*, 2014). Independent commissioner requires quality financial statements, so they tend to apply conservatism. Therefore, conservatism became an indispensable tool by the board of directors to perform their functions in the company.

Directors that dominated by internal party would weaken monitoring functions within the company so as to provide more opportunities for managers to perform opportunistic action by implementing a more aggressive accounting (less conservative) (Ahmed and Duellman 2007; Wardhani 2007). Based on the above it can be concluded hypothesis as follows:

## **H<sub>1</sub>: Proportion of Independent directors has positive effect on Accounting Conservatism**

### *2.7 The Effect of audit committee on Accounting Conservatism*

The audit committee has a duty to ensure the financial statements of company in accordance with GAAP, the implementation of the internal control structure has been effective, the implementation of internal and external audit conducted according to prevailing standards, and make sure if there are findings then immediately reported to the management and follow-up the findings. The existence of the audit committee can improve the overall quality of the financial reporting process by applying the principle of conservatism. The existence of the audit committee encourages the implementation of corporate conservatism with consideration of the benefits obtained. Application of conservatism provides many benefits to the value of the company, one of which is mitigate the agency problem and avoid negative investment (Ball *et al.* 2013).

The audit committee which specializes in industrial clients tend to know the risk so that the industry can give specific advice to be more conservative in making financial decisions, especially related to accounting (Hamdan *et al.*, 2012). Uncertainties faced by the company can be mitigate by the presence of an experienced audit committee. The audit committee in carrying out its duties can provide advice on the management of the company to act more carefully .

The existence of audit committees provide oversight functions in each company's operational activities and give an opinion and a view over the lead on the implementation of accounting conservatism. Based on the above it can be concluded exposure hypothesis as follows:

## **H<sub>2</sub>: Audit Committee have positive effect on Accounting Conservatism**

### *2.7 The Effect of characteristics board of directors on Accounting Conservatism with family ownership as moderating variable*

Majority ownership types in Indonesia is concentrated ownership structure (Bhasin, 2008; Claessens *et al.* 2002; Siregar and Utama 2008). Shareholders in concentrated ownership group themselves into a large shareholder or majority shareholder of the company and the majority shareholder in Indonesia owned by family holdings (Alijoyo *et al.*, 2004). Agency theory Type II explain if there is a concentrated ownership then there are two different views, which are alignment effect and entrenchment effect. The effect that can strengthen relationships characteristic of commissioners against conservatism is the alignment effect. The effect of alignment states majority shareholders are aligned with minority shareholders to promote common interests and reduce opportunistic action. Yeh (2005) states that the greater rights of control possessed caused an incentive to manage the company consistent with the rules. The increase in the controlling rights motivate the majority shareholder from not doing expropriate.

Family ownership gives description that family firms are not motivated to do the accounting aggressively by raising the value of earnings. The findings were based that by reporting the overstatement of the financial statements will only damage the reputation that has been built as well as the company's long-term performance (Wang, 2006). When linked with the characteristic relations commissioners against conservatism where commissioners require financial statements presented are conservative figures to still get a loan from a financial institution, the family ownership through the viewpoint of alignment effect can strengthen the relationship between the characteristics of the commissioners towards conservatism. The family as a majority shareholder can exercise the right of control to determine the characteristics of the board of directors that aims to achieve the desired goal. Based on the above it can be concluded exposure hypothesis as follows:

## **H<sub>3a</sub>: Family Ownership Strengthen the effect of proportion independent directors on accounting conservatism**

## **H<sub>3b</sub>: Family Ownership Strengthen the effect of Audit Committee on Accounting Conservatism**

## **3. Research Methodology**

### *3.1 Population and Sample*

This research was conducted by taking the population of the listed companies on the Indonesia Stock Exchange during 2012-2014. The sample is determined by using purposive sampling technique, while the criteria are (1) non-financial companies listed on Indonesian Stock Exchange, (2) corporate data enterprises available and accessible. These criterias obtain number of observations os 297 firm-year. Research model is featured in figure 1.

### *3.2 Data Sources*

This study uses secondary data. The data is published by Indonesia Stock Exchange through the official web IDX [www.idx.co.id](http://www.idx.co.id) and OSIRIS to gahter information about family ownership.

### 3.3 Variables and Measurements

#### 3.3.1. Independent Variables

##### 1. Independent Director

Independent directors are measured using the proportion of independent directors in the company. This data can be viewed in the company's annual report. Formula to calculate proportion of independent directors is the number of independent directors / total number of board of directors.

##### 2. Committee Audit

The audit committee is measured using a dummy. The company that employs the audit committee is given the value 1 while those not given the value 0

#### 3.3.2 Dependent Variable

The dependent variable is accounting conservatism. It is calculated with the model of Beaver and Ryan (2005). Beaver and Ryan (2005) use market approach by using P/B ratio. P/B ratio is based on the conservatism that suppress the book value of net assets relative to the actual economic value of the company. The higher the ratio value, the higher the company's conservatism.

#### 3.3.3 Moderated Variable

Moderated variabel is family ownership. Family ownership can be determined by two approaches, imediat approach and ultimate approach (Porta *et al.*, 1999). Imediat ownership approach is the percentage of direct ownership in public companies. The company is said to family ownership if there is voting rights more than 20% (Anderson *et al.*, 2003; Claessens *et al.*, 2002; Porta *et al.*, 1999). Family ownership through imediat approach can be seen directly in the notes to the financial statements. La Porta *et al.*, (1999) states that if the company is owned by another institution then used ultimate approach. The ultimate approach search voting rights indirectly by using the analysis of pyramids and cross-ownership structure. This information can be done with the assistance of OSIRIS program.

### 3.4 Empirical Model

Family ownership can strengthen or weaken the charactersistics of board directors on conservatism are to be tested by using Moderated Regression Analysis (MRA) as follows:

$$KON\_ACC = \alpha + \beta_1KOM\_INDEP + \beta_2KOM\_AUD + \beta_3KOM\_INDEP*FML\_OWN + \beta_4KOM\_AUD*FML\_OWN + et$$

Notation:

KON\_ACC : Accounting Conservatism calculated with the model of Beaver and Ryan (2005)

KOM\_INDEP : Proportion of Independent Directors

KOM\_AUD : Committee Audit

FML\_OWN : Family Ownership

$\alpha$  : Constanta

$\beta_1, \beta_2, \beta_3, \beta_4$  : Regression Coefficient

## 4. Result and Discussion

### 4.1 Sample Description

Average shareholders control rights of family ownership are 54.24%. These results indicate that the rights of majority shareholders control the company owned by the family while table 1 show that the maximum value of the control rights are 96.31%. These data indicate that the ability of the majority shareholder to control the company is substantial. These research results are consistent with findings of Siregar and Utama (2008). The largest control rights are concentrated in the families. Thus, it is potential for Agency Conflict Type II occurred in public firms in Indonesia. About eighty-six percent pattern of increased control rights are conducted through pyramidal ownership, and the rest of fourteen percent are through direct ownership.

### 4.2 Regression Analysis Results

Table 2 present the regression analysis results for hypothesis 1, hypothesis 2, hypothesis 3 and hypothesis 4. The result interpreted based on p-valued compared to alpha. The result is said to be significant if below alpha (5%). The testing focus is on coefficient  $\beta_3$  and  $\beta_4$  which show family ownership weaken or strengthen the impact of board of directors on accouting conservatism.

Before conducting the hypothesis testing, classic assumption tested on moderated regression model in Table 3. Accordingly, there is no classic assumption problem. Classic assumption tests that have been done include heteroskedasticity, autocorrelation, and normality. If all of the classic assumption tests are fulfilled, then it will produce linear accounting conservatism estimator, minimum variance and unbiased (Best Linear Unbiased Estimator = BLUE).



#### 4.3 The Effect of Independent Directors on Accounting Conservatism (H1)

The results show there is a positive correlation between the proportion of independent directors on the application of conservatism. This study is not able to prove hypothesis 1 (H1). The results of this study are consistent with previous studies conducted by Setia atmaja *et al.*, (2011) and the results of a survey by Alijoyo *et al.*, (2004). Both studies stated that the strong control of the company founder and family ownership as a majority shareholder makes the directors are not independent. The post of independent directors only become the company's needs for regulatory compliance regardless of the function that should be run.

An explanation of these conditions can be seen from the proportion of independent directors in Indonesia up to an average of 35.63%. This amount is considered not high enough to cause the independent directors can dominate the measures taken by the board of commissioners. If the independent directors constitute the majority (> 50%) then it may be more effective to run the monitoring role within the company. Appointment of directors in this case is considered only based on regulatory compliance.

#### 4.4 The Effect of audit committee on Accounting Conservatism

The results are consistent with research conducted by Ward (2007). The audit committee who has specialized in the industry tend to understand and know the risks so that the industry can give specific advice to be more conservative in making financial decisions, especially related to accounting (Hamdan *et al.*, 2012).

Uncertainties faced by the company in its operations lead to more need advice than supervision. The audit committee in carrying out its duties can provide advice on the management of the company to act more carefully. The existence of the audit committee may provide the opinions and views for directing to the implementation of accounting conservatism.

#### 4.5 The Effect of Independent Directors on Accounting Conservatism with family ownership as moderating variable

The test results proved that family ownership weaken the relationships between proportion of independent directors on accounting conservatism. The study's findings are not in accordance with the predictions of the hypothesis 3a (H<sub>3a</sub>) that family ownership can strengthen the effect of proportion of independent directors on accounting conservatism. The Results of the study is not able to affirm the assumption of the alignment effect which states that the ownership of a family trying to act in harmony with the minority shareholders by being conservative in the management of the company.

The control rights is voting rights that can be utilized by the majority shareholder to control the company's important policies. This study shows the majority shareholder want to maximize utility through the hands of management. As described by (Shleifer and Vishny, 1997) and Morck *et al.*, (2004) that the majority shareholders are trying to allocate resources to benefit private companies. The greater concentration of control rights, the more likely the majority shareholder to obtain private benefits (Fan and Wong 2002).

Agency theory which states the agency problem of type II Villalonga and Amit (2004) in concentrated ownership applicable to explain these results. Improved control rights of majority shareholders is explained by entrenchment effect. Improved control rights to encourage the majority shareholders to maximize their own welfare with the distribution of wealth on the other side (expropriation on minority shareholders).

While, the existence of family ownership is not able to strengthen or weaken the audit committee relationship towards conservatism. The study's findings are not in accordance with the predictions of the hypothesis 3b (H<sub>3b</sub>). The situation indicates that the presence of family ownership does not alter the function of the audit committee in carrying out their duties.

### 5. Conclusion and Recommendations

The results showed that conservatism is influenced by the existence of the audit committee. Audit committees can give specific suggestions for a more conservative in making decisions. The results also show that conservatism is not influenced by the proportion of independent directors. This condition is indicated that the post of independent directors only become the company's needs for regulatory compliance regardless of the function that should be run.

In addition, the results also showed that the existence of accounting conservatism becomes weaken in the presence of family ownership as a moderating variable. Family ownership as the majority shareholder has the right to control the board of directors for their utilities. Majority shareholder is motivated to do expropriation by reporting financial statement in overstatement. Reporting financial report in overstatement conditions is againsts the principle of conservatism. The results also show that the presence of family ownership does not strengthen or weaken the audit committee relationship to conservatism. This condition proves that the existence of family ownership does not alter the functions or duties of the audit committee.

Results of this study proved entrenchment effect that occurs in the family company listed on the Indonesia Stock Exchange. High control rights motivated the expropriation of the majority shareholder. With the

right controls, family ownership can increase their utility through the hands of management or in this research board of directors. Improved control rights encourage the majority shareholders to maximize their own welfare with the distribution of wealth on the other side (expropriation of minority shareholders).

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Table 1. Statistic Descriptive Test

Variabel	Minimum Value	Maximum Value	Average Value	Standard Deviation
KOM_INDEP	0	0,667	0,3495	0,1296
KOM_AUD	0	1	0,9552	0,2073
FML_OWN	0,2093	0,9631	0,5424	0,1586
KON_ACC	-3,160	8,280	1,546	1,501

Table 2. Moderated Regression Analysis Result

Variabel	Coefficient	t-value	p-value
Konstanta	0,918	2,063	0,040
Kom_Indep	-0,428	-0,617	0,269
Kom_Aud	0,814	1,877	0,031*
Konstanta	0,263	0,488	0,626
Kom_Indep	-0,559	-0,808	0,210
Kom_Aud	0,879	2,034	0,022*
Fml_Own	1,177	2,122	0,018*
Konstanta	-0,424	-0,231	0,817
Kom_Indep	6,285	2,952	0,002*
Kom_Aud	-1,002	-0,557	0,289
Fml_Own	2,205	0,731	0,233
Kom_Indep*Fml_Own	-12,013	-3,420	0,001*
Kom_Aud*Fml_Own	3,546	1,162	0,123

Dependent variable = Accounting Conservatism

Sig. F Change = 0,003

R<sup>2</sup> = 0,05

**Description:** \*\* significance at  $\alpha = 5\%$

KOM\_INDEP = Proportion of Independent Directors; KOM\_AUD = Committee Audit; FML\_OWN = Family Ownership;  $\alpha$  = Constanta;  $\beta_1, \beta_2, \beta_3, \beta_4$  = Regression Coefficient



Table 3. Classic Assumptions Results

Variabel	Heteroskedacity Test	Normality Test	Autocorrelation Test
KOM_INDEP	0,394		
KOM_AUD	0,158		
FML_OWN	0,443		
KON_ACC	0,578		
Kom_Indep*Fml_Own	0,250		
Kom_Aud*Fml_Own	0,213		
Residual		0,979	
Durbin-Watson			2,126

**Description:** The Heteroskedasticity is tested based on Glejser test. The test carried out on Accounting Conservatism model confirmed there is no heteroskedasticity in the residual. Examination of the normality error term of Accounting Conservatism model employed in this research showed that the error term has a normal distribution.

Figure 1. Research Model

