Conference Paper

The Impact of Concentrated Ownership Structure on Earning Quality with Political Connection As a Moderation

[1] Y. Permatasari*, [1] T. I. M. Cahyadi, [2] S. Trisnaningsih

[1] Faculty of Economics and Business, Airlangga University, Surabaya, East Java, Indonesia
[2] Faculty of Economics and Business, Universitas Pembangunan Nasional "Veteran" Surabaya, East Java, Indonesia

Abstract

This study aims to determine the effect of concentrated ownership structure on earnings quality with the political connection as a moderation variable. The variables used are concentrated ownership structure, earnings quality, political connection. The data used are secondary data and samples used are 229 manufacturing companies listed on the Indonesia Stock Exchange period 2012 to 2016. The data collected were analyzed using SPSS version 20 software tool with multiple linear regression method, linear regression, and Moderate Regression Analysis. Overall, this study proves that political connection can moderate the impact of concentrated ownership structure on earnings quality.

Keywords: Concentrated ownership structure, earning quality, political connections

INTRODUCTION

In this current era of globalization of the economic and community of ASEAN (MEA), economic activities, especially in Indonesia, provide opportunities for companies to expand their business. Stritch competition in the business environment will emerge with the implementation of free trade, especially for the ASEAN community. Because the competition is very tight, every company is competing to become the market center. Therefore, both private companies or government-owned companies must really prepare themselves to survive in carrying out their business activities. One of the most important decisions that must have done by a manager (especially for the financial manager) to maintaining the operation or not operation activities is funding decision. Fulfillment of the company's funding needs can be from the internal or external company.

Efficient funding occurred if the company has an optimal capital structure. An optimal capital structure is a capital structure that can minimize the cost of using overall capital. When a manager decides to use debt, there will be an interest, whereas if the manager decides to use his own capital, an opportunity cost will arise from the capital used. Inaccurate funding decisions will lead to fixed costs in form of high capital costs, which in turn will result in low profitability of the company (Astiti, 2015). To avoid this bad reputation, the company will try to fund its investment based on the risk order, in accordance with the pecking order theory. In pecking order theory, the debt will typically rise when the investment opportunity is less than retained earnings. So if profitability and investment expenditure are fixed, companies with high profitability will use low debt financing. Thus, the company will fund all the projects using retained earnings where possible. To avoid these adverse conditions, the company will try to fund its investment based on the order of risk, according to the pecking order theory. In pecking order theory, debt specifically will rise when the opportunity for investment exceeds retained earnings and falls when the opportunity for

* Corresponding author
Email address: yanipermatasari@feb.unair.ac.id

How to cite this article: Permatasari Y, Cahyadi TIM, Trisnaningsih (2018) The Impact of Concentrated Ownership Structure on Earnings Quality with Political Connection As a Moderation. *International Seminar of Research Month Science and Technology for People Empowerment*. NST Proceedings. pages 457-463.doi: 10.11594/nstp.2019.0261.

investment is less than retained earnings. So if profitability and investment expenditure remain fixed, companies with high profitability will use low debt funding. Thus, the company will fund all projects using retained earnings if possible. If the amount of retained earnings is insufficient, debt financing will be used. For companies in normal operations, equity will not be used and the financing deficit will be in accordance with the issue of net debt (Astiti, 2015). Thus, retained earnings are a better source of funding than debt, and debt is a better source of funding than equity (Allini *et al*, 2018).

Literature Review

Share ownership is said to be concentrated in most of the company's shares are owned by a small number of individuals or groups so that shareholders have relatively dominant shares compared to others (Dallas, 2004). In companies with concentrated share ownership, agency problems will arise between controlling shareholders and non-controlling shareholders (La Porta et al., 1998), in other words, agency conflicts will arise between the majority shareholders and the company's minority shareholders. The majority of shareholders have greater control over the company. The existence of large control rights causes majority shareholders to expropriate minority shareholders. In the highest concentrated ownership, the company manager is a member of the majority shareholder. The close relationship between majority shareholders and managers allows direct managers to manage profits in the interests of majority shareholders and sacrifice the wealth of minority shareholders (Fan & Wong, 2002). The existence of expropriation behavior carried out by the majority shareholders by taking refuge in the voting rights (rights of control), explains that the concentration of control rights can negatively affect the level of quality of information produced profit. In addition to the special relationship between majority shareholders and managers, majority shareholders tend to put pressure on managers to distribute wealth from minority shareholders with the aim of maximizing their own welfare. The pressure from the majority shareholders encourages managers to manipulate profits.

The ownership structure basically comes from the company's capital structure. The greater the source of funding comes from, the more concentrated ownership of the company. The use of debt as external funding to meet the company's capital needs was chosen because it was considered to have a smaller risk (Myers and Majluf, 1984). Thus the company will enter into a debt contract with the creditor. If the company's leverage ratio is high, the company is considered to have violated the debt contract, therefore managers will try to report current profits higher than future profits (Reni & Anggraini, 2006). The pressure from majority shareholders to strengthen managers to manipulate profits by reporting higher current profits. So that it will affect the quality of earnings reported by the company. The negative influence between the ownership structure is concentrated and the quality of earnings has been examined by Fan and Wong (2002). The result states that the controlling owner is considered to report accounting information for attractive purposes, this causes reported earnings to lose credibility and concentrated ownership associated with low-profit information because concentrated ownership tends to prevent leakage of the company's operating activities. The negative influence between the concentrated ownership structure on earnings quality is proven in Kamardin's (2016) study where the conflict between agencies supports the occurrence of opportunistic behaviors that can affect the quality of corporate earnings. According to Sousa and Galdi (2016), The quality of reported accounting numbers is strongly influenced by ownership structures. Increasingly concentrated ownership structure causes profits to be less persistent so that profits shown in this condition cannot provide reliable information for the valuation process by investors.

H1: Concentrated ownership structure has a negative effect on earnings quality

At a high level of concentrated ownership, managers are members of the majority shareholders so that there will be close relations between majority shareholders and managers (Fan & Wong, 2002). Close relations will be strengthened by the existence of a political connection factor from one of the major shareholders or top directors of the company (Chaney, Faccio, & Parsley, 2009). The status of politicians connected to the company will provide legitimacy by connecting their reputation with the company (Hillman, 2005). Reputation owned can encourage majority shareholders or directors to conduct opportunistic behavior. By taking advantage of the politician's status and reputation, the majority of shareholders or directors will pressure managers to take action to manipulate profits for their own welfare which can harm other shareholders.

Agency theory predicts that the existence of political relations can intensify negative relations between dominant owners and accounting earnings information (Bona-Sánchez, Pérez-Alemán, & Santana-Martín, 2014). A complicated agency environment and the existence of more control rights than the specified cut-off can increase the ability of majority shareholders to take over the wealth of minority shareholders (Bebchuk, Kraakman, & Triantis, 2000). Majority shareholders or directors who have political ties will get access facilities to financial capital from investors including government officials (Adhikari, Derashid, & Zhang, 2006). The existence of external funding sources and the existence of political connections make the majority shareholders able to increase their incentives and provide pressure to managers to expropriate minority shareholders' wealth through profit manipulation. This behavior will reduce the quality of information reported by the company as an expropriation effect.

Research by Fan et al. (2007) shows that companies with politically connected CEOs have poor accounting performance. The Chief Executive Officer is the president who has the highest position in a company. Thus, directors who have a political status will negatively affect the company's accounting performance. Poor accounting performance indicates the existence of earnings manipulation in the company resulting in poor quality earnings. This is in line with the research of Chaney et al (2009) and Hashmi et al. (2018) which state that the quality of earnings reported by companies that have a political connection is significantly worse. Underlining the importance of concentration of ownership and company characteristics in explaining the quality of financial statements in developing countries.

H2: Political connections influence the concentration structure of ownership on the quality of earnings.

METHODS

Sample and Methodology

The number of samples used in this study is 229 manufacturing companies listed on the Indonesia Stock Exchange (IDX) in the five-year period, 2012-2016. The hypothesis built in this study will be tested using multiple linear regression, and the Moderate Regression Analysis (MRA) to test the moderating variable.

Operational Definition of Variable

The quality of earnings in this study was measured based on The Modified Jones Model using discretionary accrual (DA) as a proxy. According to Siallagan and Machfoedz (2006), accounting earnings consist of accrual elements and operating cash flows, where accruals consist of discretionary accruals and non-discretionary accruals. Discretionary accruals are a series of adjustments made by managers to cash flow due to the existence of several accounting procedures made by standard manufacturing bodies. Nondiscretionary Accrual or normal accruals are reasonable accruals in the process of preparing financial statements (Kuntariati, 2013). The ownership structure is concentrated as an independent variable measured using the Herfindahl-Hirschman Index (HHI) proxy, which is the sum of the squares of differences between the three largest stocks (Gama & Rodrigues, 2013). The proxy was chosen because it is the latest proxy and special proxy for measuring concentration. Then, there are also moderating variables, namely political connections. Companies are classified as having political connections if one of the company owners, the board of directors or the board of commissioners, and shareholders have served or are becoming Ministers, members of parliament, or closely tied to high government officials during the research period (Faccio, 2006). Political connection is a dummy variable, worth 1 if the company meets one of the above criteria and is worth 0 (zero) if it does not exist. In addition, there are control variables, namely company size (size) which is seen from the number of assets owned by the company.

RESULT AND DISCUSSION

Table 1. Effect of Concentrated Ownership Structure (OWCON) on Profit Quality (DA)

Hypothesis	Sig.	
H1	0.001	Berpengaruh signifikan

Based on the results of the t-test, the calculated significance value of the t-test for the influence of the ownership structure is concentrated on the earnings quality of 0.001. This shows that the significance of the t-test count <0.05. It can be concluded that the concentrated ownership structure has a significant effect on the quality of earnings generated by manufacturing sector companies listed on the Indonesia Stock Exchange for the period 2012-2016.

Table 2. Effect of Concentrated Ownership Structure (OWCON) on Profit Quality (DA) with political connection as a Moderating variable

Hypothesis	Sig.	
H2	0.032	Berpengaruh signifikan

Based on the results of the t-test above, the calculated significance value of the t-test for the effect of the concentrated ownership structure on earnings quality is 0.032. This shows that the significance of the t-test count> 0.05. Thus it can be concluded that the interaction between the concentrated ownership structure and political connections can strengthen the influence of the quality of earnings generated by the manufacturing sector companies listed on the Indonesia Stock Exchange in the period 2012-2016 significantly.

The Effect of Concentrated Ownership Structure on Earning Quality

Hypothesis 1 states that the concentrated ownership structure has a negative effect on earnings quality. The results showed that the concentrated ownership structure had a positive and significant effect on Discretionary Accruals (DA), amounting to 0.001 because of the significant value <0.05 confidence level, which negatively affected the quality of corporate earnings. Accrual value is a component of profit (Gosh and Moon, 2010). The higher the DA value, the lower the quality of earnings generated, thus hypothesis 1 (one) is accepted in this study.

The results showed that the greater the concentration of ownership of a company measured from the square of the difference of the 3 (three) largest shares will have an impact on the discretionary behavior of the manager who is getting bigger as well. High discretionary values indicate that managers have manipulated company profits. The behavior of earnings manipulation arises because of pressure from the majority of shareholders. Majority shareholders have greater control rights than minority shareholders, this has led to the emergence of agency conflicts between majority shareholders and minority shareholders. In agency theory, in companies with high concentrated ownership, the principal problem of agency arises no longer between management and shareholders, but between controlling shareholders and non-controlling shareholders (La Porta et al., 1998). The controlling shareholders are the majority shareholders and managers (Fan and Wong, 2002) therefore in companies with concentrated ownership, the company manager is a member of the majority shareholder. The existence of greater control rights causes the majority shareholders to have the power to carry out opportunistic activities to take over minority shareholders through management policies. Opportunistic activities indicate that manipulating profits will affect the quality of the company's profits. In Asian countries, poor earnings quality is caused by the ownership structure of the company which is concentrated in the 1 largest owner of the company (Lyu et al., 2016).

The ownership structure basically comes from the company's capital structure. The greater the source of corporate funding comes from, the more concentrated ownership of the company. According to Myers and Majluf (1984), the source of corporate funding comes from external and internal. External funding with debt is more often chosen by the company because it has a smaller risk, therefore the manager will make a debt contract with the creditor. Creditors are the company's external funding source, so creditors can also be called company owners. If the ratio of corporate profits is high, the company is considered to violate the debt contract. Therefore, managers will try to report current profits higher than future earnings (Reni and Anggraini, 2006). To meet the demands of shareholders as well, managers will manipulate profits to get high profits to minimize violations of debt contracts, so that capital will run smoothly to meet the operational needs of the company and the majority shareholders will benefit from the company. The behavior of earnings manipulation by managers will affect the quality of earnings reported by the company, thus the negative influence of the concentrated ownership structure on earnings quality is in line with the pecking order theory.

According to Sousa and Galdi, (2016) the quality of accounting numbers must be assessed by considering the concentration of ownership structure. It also contributes to the investment community because the accuracy of estimated earnings is influenced by ownership structures. The results of this study are in line with the results of research by Kamardin and Al-Rassas (2016) which state that the concentrated ownership structure has a negative effect on earnings quality. In line with the research of Kamardin and Al-Rassas (2016) reinforce the statement that ownership concentration triggers agency problems. In the case of a high concentration of ownership, it will limit minority shareholders. This condition leads to the behavior of expropriation of interest towards minority shareholders. The results of this study are also in line with the research of Fan and Wong (2002), which states that firms with a high concentration of ownership and control weaken the quality of earnings information for outside investors because controlling shareholders get incentives to manipulate profits in order to avoid detection of their expropriation activities. The results of this study are also in line with those of Aksu et al (2012) who say that earnings quality will be worse under a concentrated ownership structure, underlining the expropriation of minority shareholders by majority shareholders.

The Effect of Concentrated Ownership Structure with Political Connections as a Moderating Variable

Hypothesis 2 states that political connections can strengthen the influence of concentrated ownership structures on earnings quality. The results showed that political connections were able to increase the influence of concentrated ownership structures on earnings quality. This can be seen from the significant value of the calculation of 0.032 because the value is significant> 0.05 level of confidence in the Discretionary Accruals (DA). This shows that hypothesis 2 (two) is accepted.

Based on agency theory, in companies with high ownership structures, controlling shareholders are the majority shareholders and managers, thus leading to close relationships between majority shareholders and managers (Fan and Wong, 2002). The majority of shareholders have control rights that exceed the limit, so as to increase the ability of the majority shareholders to take over the wealth of minority shareholders (Bebchuk et al., 2000). Close relations will be strengthened by the status of politicians from one of the officials or company shareholders (Chaney et al., 2009). The status of politicians connected to the company will provide legitimacy by connecting their reputation with the company (Hillman, 2005). Majority shareholders or corporate boards that have political ties will get access to financial capital from outside investors, including the government (Adhikari et al., 2006). Companies prefer outside investors such as creditors because debt is considered to have a smaller risk, according to the pecking order theory (Myers and Majluf, 1984). The majority of shareholders will urge the company's policy to increase current profits by expropriating the wealth of minority shareholders so that violations of debt contracts will be minimized. Fulfillment of debt contracts will help capital turnover for the company's operations. Thus shareholders will benefit from these activities. The existence of a manipulation process to increase profits causes the quality of profits generated by the company to decrease.

Companies with a Chief Executive Officer who has a political status will negatively affect the company's accounting performance, including producing poorer earnings quality (Fan et al., 2007; Chaney et al., 2009; Hashim and Devi, 2008). Fan et al. (2007) reinforce the statement that the CEO is the highest official of the company such as the board of commissioners and the board of directors. Companies with CEOs who have political connections are more likely to have councils filled with current or previous government bureaucrats. These councils show a low level of professionalism because fewer board companies have relevant professional backgrounds. The results of this study are also in line with the research of Bona-Sánchez et al (2014) which proves that the corporate environment with a concentrated ownership structure is very common in developing countries, and with the political ties held by the company's board will have a negative influence on the company's earnings information quality. According to Hashmi et al., (2018) in his research stated that the existence of political connections will bring the company to a decline in the quality of earnings. In agency theory, companies with political ties are a fixed part attached to agency conflicts and poor financial statement information. Thus the existence of an element of political connections in the structure of concentrated company ownership will strengthen the negative influence on earnings quality through the existence of agency theory.

CONCLUSION

Concentrated ownership structure has a significant negative effect on earnings quality. The initial hypothesis of the study was accepted because the results of the study showed a positive influence between the concentrated ownership structure on Discretionary Accruals (DA), which means the higher the level of concentration of corporate ownership, the higher the occurrence of discretionary behavior by managers resulting in poor earnings quality, where discretionary behavior indicates manipulation profit. The occurrence of profit manipulation was strengthened by the existence of special connections with politicians. In this study, political connections have a significant positive effect on moderating the concentrated ownership structure towards Discretionary Accruals (DA). The initial hypothesis (H2) of this study was accepted because the results were significant, the results of this study indicate that companies with majority shareholders or corporate boards that are politically connected, produce worse quality earnings.

ACKNOWLEDGEMENT

The authors say many thanks to God because this research can be solved only with His help.

REFERENCES

Adhikari, Derashid, & Zhang. (2006). Public Policy, Political Connection, and Effective Tax Rates: Longitudinal Evidance from Malaysia. Journal of Accounting and Public Policy, 25, 574–595.

Aksu, M., Muradoglu, Y. G., & Cetin, A. T. (2012). Ownership Concentration, IFRS adoption and earnings quality: evidence from an emerging market. Journal of Accounting and Economics.

Allini, A., Rakha, S., McMillan, D. G., & Caldarelli, A. (2018). Pecking order and market timing theory in emerging markets: The case of Egyptian firms. Research in International Business and Finance, 44(July 2017), 297–308.

Astiti, N. P. Y. (2015). Pengaruh Profitabilitas dan Struktur Asset Terhadap Struktur Modal pada Perusahaan Property and Real Estate yang Terdaftar di Bursa Efek Indonesia. Jurnal Akuntansi, 5(2), 59–73.

Bebchuk, L., Kraakman, R., & Triantis. (2000). Stock Pyramids, Cross-ownership, and Dual Class Equity: The creation and agency costs of separating control from cash flow rights (In R. Morc). Chicago.

Bona-Sánchez, C., Pérez-Alemán, J., & Santana-Martín, D. J. (2014). Politically connected firms and earnings informativeness in the controlling versus minority shareholders context: European evidence. Corporate Governance (Oxford), 22(4), 330–346.

Chaney, P. K., Faccio, M., & Parsley, D. (2009). The quality of accounting information in politically connected firms. Journal of Accounting and Economics, 51(1–2), 58–76.

Dallas, G. (2004). Governance and Risk. Analytical Hand Books for Investors, Managers, Directors and Stakeholders. New York: MC. Graw Hill.

Faccio, B. M. A. R. A. (2006). Politically Connected Firms, 96(1999), 369–386.

Fan, J. P. H., & Wong, T. J. (2002). Corporate ownership structure and the informativeness of accounting earnings in East Asia. Journal of Accounting and Economics, 33(3), 401–425.

Gama, A. P., & Rodrigues, C. (2013). The Governance-Performance Relations Publicy Listed Family Controlled Firms: An Empirical Analysis. Journal of Corporate Governance, 13, 439–456.

Hashmi, M. A., Brahmana, R. K., & Lau, E. (2018). Political connections, family firms and earnings quality. Management Research Review, 41(4), 414–432.

Hillman, A. (2005). Politicians on the Board of directors: do connections affect the Bottom Line? Journal of Management, 31, 464–481.

Kamardin, H., & Al-Rassas, A. H. (2016). Earnings Quality and Audit Attributes in High Concentrated Ownership Market. The International Journal of Business in Society, 16(5), 0–31.

Kuntariati, A. (2013). Pengaruh Pengungkapan Corporate Social Responsibility terhadap Kualitas Laba dengan Mekanisme Corporate Governance sebagai variabel Moderator. Universitas Airlangga.

La Porta, R., Lopez-de-Silanes, F., & Shleifer, A. (1998). Corporate Ownership Around The World. National Bureau of Economic Research.

Lyu, C., Yuen, D. C. Y., & Zhang, X. (2016). Individualist-collectivist culture, ownership concentration and earnings quality. Asia-Pasific Journal of Accounting & Economics.

Myers, S., & Majluf, N. (1984). Corporate Financing and Investment Decisions When Firms Have Information. National Bureau of Economic Research.

Reni, F., & Anggraini, R. (2006). Pengungkapan Informasi Sosial dan Faktor-Faktor yang Mempengaruhi Pengungkapan Informasi Sosial dalam Laporan Tahunan (Studi Empiris pada Perusahaan yang terdaftar Bursa Efek Jakarta). Simposium Nasional Akuntansi 9 Padang.

Siallagan, H., & Machfoedz, M. (2006). Mekanisme Corporate Governance, Kualitas Laba dan Nilai Perusahaan. Simposium Nasional Akuntansi 9 Padang.

Sousa, E. F. de, & Galdi, F. C. (2016a). The Relationship Between Equity Ownership Concentration and Earnings Quality : Evidence from Brazil. Journal Finance and Accounting, 331–343.

Sousa, E. F. de, & Galdi, F. C. (2016b). The relationship between equity ownership concentration and earnings quality: evidence from Brazil. Revista de Administração, 51(4), 331–343.