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RESEARCH ARTICLE

The Relationship Between Ownership Concentration, Firm Size, and Earnings Quality in Indonesian Companies

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ABSTRACT

This study aimed to investigate the influence of ownership concentration and firm size on earnings quality in Indonesian companies. Research about the influence of ownership concentration and firm size on earnings quality still provides mixed results. Therefore, it became important to conduct research about it, especially in the context of Indonesian companies. This study used the alignment effect hypothesis as a basis for hypothesis development. The sample of this study consists of 92 Indonesian companies from 2013–2018, with a total of 522 observations. The data analysis technique is multiple regression analysis. The result of this study showed that ownership concentration had a positive influence on earnings quality. In contrast, firm size had no influence on earnings quality. In conclusion, the result of this study supported the alignment effect hypothesis, stating that the interest of the majority shareholder is aligned with that of the minority shareholder, therefore improving earnings quality.

Keywords: Earnings accrual, earnings quality, Firm size, ownership concentration.

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1. Introduction

The main objective of financial reporting is to provide quality financial information to stakeholders. In the accounting context, the quality of financial information is reflected in earnings quality, as it become the most accurate measure of financial reporting quality (An, 2017). However, some cases of financial fraud, such as Enron, WorldCom, and Toshiba, showed that managers seek to manipulate financial reporting through earnings management in order to maximize their private benefits and reduce earnings quality. Therefore, research about earnings quality becomes important in the accounting research area.

According to prior research, factors that influence earnings quality depend on country-level characteristics. One of the important characteristics that significantly influence earnings quality is ownership structure (Abdullah & Ismail, 2016; Alhadi *et al*., 2020; Arthur *et al*., 2019; Fan *et al*., 2023; Ghaleb *et al*., 2020; Tessema *et al*., 2018). These studies provide mixed results about the relationship between ownership concentration and earnings quality. For example, Tessema *et al*. (2018) explained that agency problems between controlling shareholders and minority shareholders in business groups of South Korean companies created the possibility for controlling shareholders to manage earnings because of information asymmetries between them. However, Tessema *et al*. (2018) found that business group ownership had a positive relationship with earnings quality because of the reforms conducted by the government after the Asian financial crisis. Arthur *et al*. (2019) argued that ownership concentration is related to high financial reporting quality. The argument is based on the alignment effect hypothesis, stating that the interest of the majority shareholder is aligned with that of the minority shareholder. In high ownership concentration, the majority shareholder is committed to building a reputation and not risking the company's reputation by expropriating minority shareholders (Gomes, 2000). As a result, Arthur *et al*. (2019) found a positive relationship between financial reporting quality and ownership concentration. In addition, Ghaleb *et al*. (2020) argued that monitoring mechanisms conducted in companies with family ownership concentration are likely to reduce opportunistic behavior conducted by company management.

As a result, Ghaleb *et al*. (2020) found that family ownership concentration is negatively associated with real

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earnings management. This means that family ownership concentration is positively associated with financial reporting quality. This result supports the alignment effect hypothesis.

However, Alhadi *et al*. (2020) argued that majority shareholders in companies with concentrated ownership were likely to expropriate minority shareholders. The argument is based on the entrenchment effect hypothesis, stating that highly concentrated ownership firms had incentives to maximize their benefit, therefore increasing the possibility of earnings management and reducing earnings quality. Furthermore, Abdullah and Ismail (2016) explained that family ownership concentration tends to reduce earnings quality because of ineffective monitoring mechanisms conducted by family-members directors that, as a result, are unable to mitigate the effect of agency problems type 2. Fan *et al*. (2023) conducted research in Chinese firms and found that ownership concentration reduces accounting consistency, therefore reducing financial reporting quality.

This study aimed to examine the relationship between ownership concentration and earnings quality in the Indonesian context. Indonesia was considered a country in which the majority of its companies had a concentrated ownership structure (Carney & Hamilton-Hart, 2015; Claessens *et al*., 2002; Kristiawan, 2020a). The alignment effect hypothesis is used as a basis of hypothesis development since reputation became an important thing in Indonesian companies that had to be maintained by majority shareholders (Kristiawan, 2020b). Therefore, it is argued that firm size is expected to have a positive influence on earnings quality. The argument of this notion is based on the legitimacy theory, which explains that companies need to maintain their reputation in order to maintain legitimacy. Since firm size will increase the company's exposure in society, they had a higher obligation to maintain their reputation in society.

2. Literature Review

2.1. Alignment Effect Hypothesis

The alignment effect hypothesis explained that majority shareholders were not likely to expropriate the interest of minority shareholders in order to maintain a long-term reputation, increase firm value, and impose contractual constraints (Jensen & Meckling, 1976). Therefore, majority and minority shareholder have the same interest in protecting the company's reputation and their investment by conducting a strong monitoring mechanism towards company management. Some research supports this argument and found that ownership concentration has a positive relationship with earnings quality (Arthur *et al*., 2019; Ghaleb *et al*., 2020; Tessema *et al*., 2018). Arthur *et al*. (2019) argued that the interest of majority shareholders in companies that have concentrated ownership structures is aligned with minority shareholders. Therefore, they committed to building a reputation by improving financial reporting quality. Furthermore, Arthur *et al*. (2019) examined the relationship between ownership concentration and earnings quality in 36 countries. The result showed that the relationship between ownership structure and financial reporting quality is negative in a spread ownership structure with no controlling shareholder. On the contrary, the relationship is positive in highly concentrated ownership. Therefore, the result supports the alignment effect hypothesis. Ghaleb *et al*. (2020) conducted research on manufacturing firms listed on the Malaysian Stock Exchange. They examined the influence of family ownership concentration on real earnings management. The result showed that family management ownership concentration is negatively associated with real earnings management, which means that family ownership concentration is positively associated with financial reporting quality. Tessema *et al*. (2018) argued that the agency problem between controlling shareholders and minority shareholders in business groups of South Korean companies created the possibility for controlling shareholders to manage earnings because of information asymmetries between them. However, Tessema *et al*. (2018) found that business group ownership had a positive relationship with earnings quality because of the reforms conducted by the government after the Asian financial crisis.

2.2. Entrenchment Effect Hypothesis

The entrenchment effect hypothesis explained that majority shareholders in companies with concentrated ownership had incentives to maximize their benefit by expropriating wealth from minority shareholders (Fama & Jensen, 1983; Morck *et al*., 1988; Shleifer & Vishny, 1997). In addition, majority shareholders use their voting rights to maximize their personal benefit at the expense of minority shareholders (Arthur *et al*., 2019). Furthermore, information asymmetry between the majority shareholder and minority shareholder creates an entrenchment effect in companies with concentrated ownership, which allows the majority shareholder to report opportunistically by manipulating financial reports (Arthur *et al*., 2019), which reduces accounting transparency. Therefore, the entrenchment effect hypothesis argues that ownership concentration is negatively associated with earnings quality. Several studies use the entrenchment effect hypothesis as a basis of their research. For example, Alhadi *et al*. (2020) argued that majority shareholders in companies with concentrated ownership were likely to expropriate minority shareholders. In addition, they argued that investor protection is important in countries with highly concentrated ownership because it can reduce the entrenchment effect (Hasan *et al*., 2014) and improve monitoring mechanisms (Ben Naceur *et al*., 2007). Abdullah and Ismail (2016) explained that family ownership concentration was likely to reduce earnings quality because of ineffective monitoring mechanisms conducted by the family members' directors that, as a result, were unable to mitigate the effect of agency problems type 2. Fan *et al*. (2023) argued that the effect of ownership concentration toward accounting consistency should be negative since majority shareholders receive less supervision from minority shareholders because of free-riding issues. In addition, they also argued that decision-making in companies with concentrated ownership was dominated by large shareholders. Therefore, it creates an opportunity for the majority shareholder

to manipulate financial reporting that aligns with their interest. The result of their studies found that ownership concentration reduces accounting consistency, therefore reducing financial reporting quality.

2.3. The Relationship Between Ownership Concentration and Earnings Quality in Indonesian Context

This study aimed to examine the relationship between ownership concentration and earnings quality in the Indonesian context. Indonesia was considered a country in which the majority of its companies had a concentrated ownership structure (Carney & Hamilton-Hart, 2015; Claessens *et al*., 2002; Kristiawan, 2020a). Since there are two competing hypotheses about the relationship between ownership concentration and earnings quality, this study must choose one of the hypotheses. The alignment effect hypothesis was chosen as a basis of hypothesis development since a company's reputation became an important thing in Indonesian companies that had to be maintained by majority shareholders (Kristiawan, 2020b). The alignment effect hypothesis explained that majority shareholders were not likely to expropriate the interest of minority shareholders in order to maintain a long-term reputation, increase firm value, and impose contractual constraints (Jensen & Meckling, 1976). Therefore, majority and minority shareholder have the same interest in protecting the company's reputation and their investment by conducting a strong monitoring mechanism towards company management. Furthermore, Kumala and Siregar (2021) argued that majority shareholders had a greater incentive to produce transparent financial reporting to maintain the company's reputation. Their study concludes that ownership concentration tends to produce an alignment effect, in which majority shareholders do not expropriate minority shareholders. Therefore, this study argued that earnings quality will be improved in Indonesian companies that have concentrated ownership. Departing from the elaboration of this subsection, the researcher would like to propose the following hypothesis:

H_1: Ownership concentration has a positive influence on the earnings quality in Indonesian companies.

2.4. The Relationship Between Firm Size and Earnings Quality in Indonesian Context

This study also examined the relationship between firm size and earnings quality. The notion of the hypothesis is based on the legitimacy theory, which explains that companies need to maintain their reputation in order to maintain legitimacy. Since firm size will increase the company's exposure in society, they had a higher obligation to maintain their reputation in society. In addition, Watts and Zimmerman (1978) explained that large companies tend to avoid earnings management because of their political visibility. Furthermore, Kumala and Siregar (2021) argued that large companies tend to have higher earnings quality. In the Indonesian context, prior research found that firm size had a positive influence on earnings quality (Andriani *et al*., 2021; Purnamasari & Fachrurrozie, 2020; Solikhah *et al*., 2022). Andriani *et al*. (2021) argued that large companies need to provide a good signal by improving earnings quality to reduce information asymmetry. Their research found that firm size had a positive influence on earnings quality. Furthermore, Purnamasari and Fachrurrozie (2020) explained that positive signals in the form of earnings information that is free from manipulation increase the trust of stakeholders. In addition, they argued that larger companies will provide better financial reporting quality. In conclusion, their research found that firm size significantly has a positive effect on earnings quality. Solikhah *et al*. (2022) found that firm size was proven to be able to improve earnings quality. According to the argument and the result of prior research, this study argued that firm size is expected to have a positive influence on earnings quality. Departing from the elaboration of this subsection, the researcher would like to propose the following hypothesis:

H_2: Firm size has a positive influence on the ownership concentration in Indonesian companies.

3. Research Methodology

This study used data from a company that is listed on the Indonesia Stock Exchange (IDX). The total population was 536 companies from 2013-2018. Based on the NAICS CODE, there are several industry classifications with code ranges 1–7. Modifications to the NAICS CODE were made to obtain a more appropriate classification for the context of this study, namely using codes 1–6. The sampling technique was proportional random sampling. The number of samples was 100 companies from all types of industries in the NAICS CODE. Based on consideration of the amount of data available, it is necessary to make adjustments to the data. 8 companies were excluded from the sample because their financial data were incomplete to be able to measure earnings quality variables. Therefore, the total number of samples used was 92 companies, with a total of 92 companies for 6 years = 552 observations. The sample was calculated proportionally in each industry with the following formula:

$$\textit{Sample numbers in every industry} = \frac{\textit{Population numbers in every industry}}{\textit{Population numbers in all industries}} \times \textit{Sample numbers in all industries} \quad (1)$$

The result of the sample and observation totals based on industry classification was presented in Table I.

The dependent variable in this study was the quality of financial reports as measured by earnings quality. The earnings quality measurement method was based on the model developed by Dechow and Dichev (2002). In this model, earnings quality was measured by calculating the remaining standard deviation of the regression equation for changes in past working capital, current working capital, and future working capital. Specifically, the regression equation is as follows:

$$\Delta WCA_t = \alpha_0 + \alpha_1 CFO_{t-1} + \alpha_2 CFO_t + \alpha_3 CFO_{t+1} + e_t \quad (2)$$

where:

ΔWC_t = Changes of company's working capital accrual in period t,

TABLE I: Types of Industry, Sample Totals, and Observation Totals

NAICS Code	Type of industry	Sample totals	Observation totals
1	Agriculture	5	30
2	Mining & construction	11	66
3	Manufacture	30	180
4	Trading company, retail & transportation	14	84
5	Financial, telecomunication & real estate	25	150
6	Health, hospitality & restaurant	7	42
	Total	92	552

CFO_{t-1} = Cash flows from the company's operating activities in period t − 1,

CFO_t = Cash flows from the company's operating activities in period t − 1,

CFO_{t+1} = Cash flows from the company's operating activities in period t + 1.

The accrual value that has no relationship with the realization of cash flow is reflected in the residual (et) which is calculated through the following equation.

$$e_t = WCA_t - (\alpha_0 + CFO_{t-1} + \alpha_2 CFO_t + \alpha_3 CFO_{t+1}) \quad (3)$$

The residual standard deviation (accrual) value to the average value was used as an indicator of earnings quality. The higher the residual standard deviation (accruals), the lower the earnings quality. A high residual standard deviation indicates a higher accrual deviation so that earnings do not show actual conditions. Thus, a high residual (accrual) standard deviation value represents a lower earnings quality. In order for the residual standard deviation (accrual) value to be more in line with the dependent variable, namely the quality of financial reports, the standard deviation value is converted by multiplying by minus 1.

The independent variables in this study were concentrated ownership structure and firm size. Ownership concentration was measured based on the definition of ownership concentration by La Porta *et al*. (1999). According to La Porta *et al*. (1999), companies with owners who hold shares of more than 20%, either directly or indirectly, are classified as companies that have a concentrated ownership structure. Furthermore, Dam and Scholtens (2013) explained that a controlling majority shareholder appears if there is at least one shareholder who has a share percentage greater than 20%. They used a dummy variable to categorize whether a company has a concentrated ownership structure or not. To measure the structure of concentrated ownership, this study uses the percentage of ownership with the aim of observing the impact of changes (increases or decreases) in share ownership. Firm size was measured based on total assets. Data on ownership structure and firm size was obtained from the Osiris BVD database. Data on control variables, namely, ROA, ROE, and leverage, was taken from the Osiris BVD database. To test the hypothesis, multiple regression analysis was used, and the research model was presented as follows:

$$\begin{aligned} EQ &= \beta_0 + \beta_1 OWC + \beta_2 Ln_SIZE + \beta_3 ROA \\ &+ \beta_4 ROE + \beta_5 LEV + \beta_6 AUD + \varepsilon \end{aligned} \quad (4)$$

4. Results and Discussion

Descriptive statistic of earnings quality, firm size, and control variables are presented in Table II.

Descriptive statistics presented in Table II showed the minimum, maximum, average, and standard deviation values of each variable. According to the data in Table II, the earnings quality variable (EQ) has a minimum value of −0,19 and a maximum value of −0,01. Earnings quality value showed a negative value. This value was obtained by multiplying the accrual value resulting from the Dechow and Dichev (2002) method with −1, with the aim of changing the direction of the accrual value (which is an indicator of earnings management) to earnings quality. The value of the ownership structure variable (OWC) has a minimum value of 0,07 and a maximum value of 0,98 with an average of 0.5442. This showed that companies in Indonesia had a concentrated ownership structure. The natural logarithm of company size (Ln_Size) showed a fairly high standard deviation. This showed a fairly large variation in company size among companies in Indonesia. Control variable data ROA, ROE, and LEV, with a minimum value that is still negative, show that the performance of companies in Indonesia is still negative but still at a normal level. Audit variable data shows an average value of 0.5978, meaning that an average of 59,78% of companies in Indonesia have been audited by the Big 4.

Hypotheses H_1 and H_2 were tested using multiple regression analysis. A summary of the regression results is shown in Table III.

Hypothesis H_1 stated that ownership concentration has a positive influence on the earnings quality in Indonesian companies. The result of the multiple regression test for Hypothesis H_1 showed a coefficient value of 0.156 with a p-value below 0.001. Therefore, it can be concluded that Hypothesis H_1 is supported. The research findings are in line with prior research that supports the alignment effect hypothesis (Arthur *et al*., 2019; Ghaleb *et al*., 2020; Kumala & Siregar, 2021; Tessema *et al*., 2018). The alignment effect hypothesis explained that majority shareholders were not likely to expropriate the interest of minority shareholders in order to maintain a long-term reputation, increase firm value, and impose contractual constraints (Jensen & Meckling, 1976). Therefore, majority and minority shareholder have the same interest in protecting the company's reputation and their investment by conducting a strong monitoring mechanism towards company management. In addition, the majority shareholders had a greater incentive to produce transparent

TABLE II: Descriptive Statistics of Research Variables

Variable	Min	Max	Average	Std. Dev.
EQ	−0.19	−0.01	−0.0779	0.04932
OWC	0.07	0.98	0.5442	0.23484
Ln_SIZE	9.54	16.76	12.9753	1.53180
ROA	−0.18	0.26	0.0593	0.08296
ROE	−4.99	1.55	0.0812	0.34235
LEV	−2.63	4.35	0.6288	0.77937
AUD	0.00	1.00	0.5978	0.49078

TABLE III: Multiple Regression Results

Variable	Predicted sign	Coefficient	Sig.
OWC	+	0.156	<0.001
Ln_Size	+	0.002	0.957
ROA	+	−0.080	0.119
ROE	+	−0.024	0.618
LEV	+	0.051	0.229
AUD	+	0.309	<0.001
N	552		
R^2	0.123		
Adj R^2	0.113		
F Value	12.712***		

Note: $^{***}p < 0.001$.

financial reporting to maintain the company's reputation (Kumala & Siregar, 2021).

Hypothesis H_2 states that firm size has a positive influence on earnings quality in Indonesian Companies. The result of the multiple regression test for Hypothesis H_2 showed a coefficient value of 0.002 with a p-value of 0.957. Therefore, it can be concluded that Hypothesis H_2 is not supported. The research findings are not consistent with prior research that supports this hypothesis (Andriani *et al*., 2021; Purnamasari & Fachrurrozie, 2020; Solikhah *et al*., 2022). These research findings are also not consistent with legitimacy theory, which explains that companies need to maintain their reputation in order to maintain legitimacy. Since firm size will increase the company's exposure in society, they had a higher obligation to maintain their reputation in society. The different result is thought to be caused by investors' awareness of the company's reputation in Indonesia. According to the research findings by Andayani (2021), the level of investor awareness of the company's reputation in Indonesia was still low. Furthermore, investors in Indonesia were expected to care only about short-term investments instead of long-term investments. Therefore, since there is no exposure in society, the larger company has no obligation to maintain its reputation.

5. Conclusion

This study found that ownership concentration had a positive influence on earnings quality in Indonesian companies. This result supported the alignment effect hypothesis that explained the relation between ownership concentration and earnings quality. The alignment effect hypothesis explained that the majority and minority shareholder had the same interest in protecting the company's reputation and their investment by conducting strong monitoring mechanisms towards the company's management, therefore encouraging companies to produce high-quality financial reporting. In addition, this study didn't find the relationship between firm size and earnings quality. This result is inconsistent with legitimacy theory, which explains that larger companies need to maintain their legitimacy and reputation since firm size increases the company's exposure in society. The different result is caused by the low level of investor awareness towards the company's reputation in Indonesia.

There are several limitations in this research. First, this study didn't consider the type of ownership concentration, for example, family ownership concentration or state ownership concentration, which may have different results. Therefore, future research needs to include the type of ownership concentration. Second, because of data limitations, this study only measures earnings quality using one method, namely accrual quality. Therefore, future research may include other measurements of earnings quality, for example, earnings persistence, earnings predictability, earnings smoothness, and real earnings management as a proxy of earnings quality.

Conflict of Interest

The authors declare that they have no conflict of interest.

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