SOCIAL SCIENCES & HUMANITIES

Family Business and Managerial Ownership: The Effect on the Degree of Accounting Conservatism Practised in Indonesian-Listed Firms

Fendiani, A. and Tandiono, R.*

Department of International Accounting and Finance, Faculty of Business, Bina Nusantara University 10270, Indonesia

ABSTRACT

Accounting conservatism and managerial ownership is applied as a means to minimise agency problems. However, different type of ownership will have different level of conflict. Family ownership is deemed to be more affected by agency problem type II. Using the data of Kompas 100 listed firms in Indonesia, this study aims to comprehend the effect of a family ownership and its level of accounting conservatism. The study also analyses the correlation between managerial ownership toward the level of accounting conservatism. Findings show that family business significantly affects the level of accounting conservatism. In contrast, this study cannot find any effect on managerial ownership on the degree of accounting conservatism.

Keywords: Family business, managerial ownership, accounting conservatism, agency problem type I, agency problem type II, Indonesia listed firms

INTRODUCTION

It is common for businesses to practise the separation of ownership and control between management and owners (LaFond & Roychowdhury, 2007). This practice might place managers in a more beneficial position compared to shareholders, since shareholders are not actively engaged in companies' day-to-day operations and have limited real time access to information about the firms compared to managers (Cullinan et al., 2006). This situation might lead to a misalignment of interests between managers and shareholders, thereby contributing to the creation of a potential conflict of interests, which are known as *type I agency problems* (Jensen & Meckling, 1976; Ali et al., 2007).

To reduce the negative effects of agency problems, several preventative mechanisms have been applied. Among them is the application of accounting conservatism. Accounting conservatism refers to the condition of recognizing more bad news rather than good news (Basu, 1997). Therefore, conservatism will provide stricter standards in recognizing good news that will minimize the potential practice of negative managerial incentives that arise from information asymmetry occurrences between management and owners (Watts, 2003).

In addition to accounting conservatism, managerial ownership can also serve as a facilitator in reducing agency problems (Jensen & Meckling, 1976). According to LaFond and Roychowdhury (2007), managerial ownership itself can be defined as the proportion of shares owned by the top management. Due to the fact that the existence of managerial ownership creating a better alignment of interests between management and owners, information asymmetry agency problems will be reduced; to generate a low level of conservative practices. .

In Indonesia, accounting conservatism has been widely practiced (Lasdi, 2009). Even though Indonesia is now in the harmonization stage of International Financial Reporting Standards (IFRS) that emphasize the usage of fair value measurements (IAS 13), it is still confirmed that the use of a conservative reporting practice is highly preferred in certain industrial sectors, such as the agricultural industry. Although IFRS imposes fair value based accounting for the agricultural industry (IAS 41), PSAK still acknowledges the usage of historical costs or conservative accounting reporting in an Indonesian agricultural context due to the nature of Indonesian biological assets that are not suitable to be measured by fair value. Aside from the IFRS convergence factor, several enforcement measures in using conservative accounting have actually been embodied in the content of PSAK itself. For example, until today, the basis for measuring assets (e.g. property plant equipment, inventory, etc.) still reflects the usage of a cost-based measurement instead of a fair value measurement (PSAK 16, PSAK 14). Contingent liabilities and assets are also required to be disclosed along with their future effects regardless of the good or bad effects represented (PSAK 57). Due to the extensive and mandated use of the conservatism principle, this shows that accounting conservatism is still important in a business practice.

Another unique characteristic of Indonesia firms is the type of ownership. Claessens et al. (2000) declared that among all firms listed in the Indonesia Stock Exchange (IDX), around 67% of them are considered as family firms, while 0.6% of them are publicly-held firms. According to Ali et al. (2007), family businesses face different type of agency problem. The agency problem faced by family-owned companies is the misalignment between majority shareholders and minority shareholders.

The existence of different type of agency problems encountered in both family and non-family firms affect the level of conservatism of the firms. Prior research shows that firms owned by founder or family members tend to have a lower degree of conservatism (Firth et al., 2007; Chen et al., 2011). On the contrary, managerial ownership creates better harmonization between managers and owner. Thus, companies with high managerial ownership tend to have lower degree of accounting conservatism (LaFond & Roychowdhury, 2007). Previous studies consider the relationship between two variables, namely the relationship between family ownership and accounting conservatism or managerial ownership and accounting conservatism in developed countries. This study, however, will examine family businesses, managerial ownership, and accounting conservatism as a single correlated research.

Given the fact that majority of the listed companies in Indonesia is owned by founding family or family members, this study will examine the relationship between family ownership and the degree of accounting conservatism. Furthermore, regulation regarding managerial ownership in Indonesia has not been yet properly established. However, the application of managerial ownership is evidenced among the listed firms. Besides family ownership, this study will also examine the relationship of managerial ownership and the level of accounting conservatism.

THEORETICAL FRAMEWORK

Family Businesses and Accounting Conservatism

Prior researches show that family firm, due to its level and type of agency problem, its level of conservatism is low (Firth et al., 2007; Chen et al., 2009). As explained by Chen et al. (2009) when family members (founders) take part in top management (such as becoming the CEO), the family firms will exert a greater alignment of interests. This alignment forms a significant sense of trust toward management from other family members, thereby indicating a low level of agency problems type I. The over excessive trust placed by other family members, however, induced them to use less effort in monitoring the management functions run by a particular family member. As a result, the option to choose a more conservative accounting method would not be undertaken in a serious manner. Furthermore, Firth et al. (2007) also found that Chinese family firms tend to apply less conservative accounting practices due to the family members' intention to maintain their control and dominance in the firms. Accordingly, this study employs the following hypothesis:

H1: Family ownership affects the level of accounting conservatism

Managerial Ownership and Accounting Conservatism

When firms have managerial ownership, an alignment of interests between shareholders and management will be

better, thus, reducing agency problems type I in the firms (Jensen & Meckling, 1976).

Based on the previous research, there is a negative correlation between managerial ownership and accounting conservatism (LaFond & Roychowdhury, 2007). This is because low managerial ownership leads to higher agency problem type I, thus resulting in greater demand for accounting conservatism. A study conducted by Shuto and Takada (2010) found similar result in Japanese corporations. Based on the above explanation, this study hypothesizes as follow:

H2: Managerial ownership affects the level of accounting conservatism

RESEARCH METHODOLOGY

This study uses data from the Kompas 100 index of 2010-2013. Banking and financial institutions are excluded from the samples.

Additionally, the authors further narrow and categorize the samples into non-family and family firm samples. Family firms are classified based on the following criteria:

1. The firms are not owned by either the government or financial institutions with more than five percent (5%) ownership.

2. The firms are included in family business groups (Morck & Yeung, 2003).

3. The founders or family members hold top management positions (Chen et al., 2007; Anderson & Reeb, 2003; Villalonga & Amit, 2006).

4. The founders have an ownership of more than five percent – 5% (La Porta, 1999; Tong, 2007).

Below is the number of samples used in this research.

Table 1
Number of samples

Sample	Number of Listed Firms
Kompas 100 in 2014	100
(-) Financial Institutions	(14)
(-) Doubt Samples *(Incomplete Documentation)*	(14)
Total Sample	72
Non-Family Firms 30	
Family Firms 42	

As a conservatism measurement is used, the authors applied the Basu (1997) asymmetric timeliness model, which is expressed in the following earnings reverse regression model:

$$\frac{EPS_{it}}{P_{it-1}} = \alpha_0 + \alpha_1 DR_{it} + \beta_0 R_{it} + \beta_1 R_{it} DR_{it} + \varepsilon_{it}$$

EPS_{it} : earnings per share (EPS) for firm i in year t

P_{it-1} : opening stock market price for firm i in year t-1

R_{it} : stock market returns for firm i in year t

DR_{it} : dummy variable

ε_{it} : residual – indicator of conservatism

When $R_{it} \geq 0$, it will represent good news, hence $DR_{it} = 0$

$R_{it} < 0$, it will represent bad news, hence $DR_{it} = 1$

Earnings per share are used as the dependent variable due to its high vulnerability to change for good news or bad news encountered that will help indicate firms' tendency in disclosing good news and bad news. It is then acknowledged to be a good indicator for measuring the asymmetric timeliness of earnings (Basu, 1997). An opening stock market is also used as a deflator of earnings per share in the dependent variable. The independent variables, however, reflect the usage of stock market return of a specific firm in a specific period along with the dummy variables that act as separators for good news and bad news. According to Basu (1997), the stock market return is believed to have an impact on earnings per share. Hence, those two factors (dummy variables and stock market return) will be multiplied as an interactive term and excess correlation between earnings and stock price movement in a good news over a bad news period, which can be defined in ε_{it} generated.

To test the hypothesis, the authors construct the following regression model considering the value of residual generated in the first hypothesis as shown below.

$$\varepsilon_{it} = \alpha_0 + \beta_1 MGTOWN_{it} + \beta_2 DFB_{it} + + \beta_3 FINLEV_{it} + \beta_4 Lnsize_{it} + \beta_5 MBV_{it} + \varepsilon_{it2}$$

ε_{it} : degree of accounting conservatism for firm i in year t

$MGTOWN_{it}$: managerial ownership for firm i in year t

$FINLEV_{it}$: control variable of financial leverage for firm i in year t

$Lnsize_{it}$: control variable of firm size for firm i in year t

MBV_{it} : control variable of market to book ratio for firm i in year t

DFB_{it} : dummy variable – 1 for family firms, 0 for non-family firms

To reduce the potential bias from the regression generated, control variables are applied Watts (2003a). Following Cullinan et al. (2006), this study is employing three control variables, which are:

(1) Financial Leverage (FINLEV)
Degree of financial leverage will be measured by calculating dividing total liabilities by total assets in the firms.

Financial leverage is used as the control variable since the amount of debt contracting undertaken often determines the degree of conservatism demanded in firms (LaFond & Roychowdhury, 2007). Prior researches have declared that conservatism might help reducing contracting costs that might occur due to its capability in protecting both lenders and borrowers engaged in a debt contract (Cullinan et al., 2006; Ahmed et al., 2007).

(2) Firm Size (Lnsize)

According to LaFond and Watts (2006), large firms will have lower information asymmetry due to more information being disclosed to the public; hence, reducing potential agency problem and lead to lower amount of accounting conservatism. Small firms, on the other hand, requires higher degree of accounting conservatism. Due to significant possible influence of firm size toward degree of conservatism practiced, this study acknowledges the usage of firm size. Firm size is calculated by applying the natural logarithm of total assets book value (BV of total assets) from firms' previous year (t-1) to firms' specific year (t).

(3) Market to Book Ratio (MBV)

Market to Book ratio or commonly known as Price to Book ratio (P/B ratio) is calculated by comparing market value of a stock to the stock book value. The market value is the closing stock price at year t divided by book value of the stock at year t.

Market to book ratio is used because prior research showed that MBV affects the practice of the firm's conservatism (Ahmed & Duellman, 2007). Also, MBV is used in order to control the effect of beginning equity to the asymmetric timeliness (LaFond & Roychowdhury, 2007).

FINDINGS AND DISCUSSION

The table below illustrates the descriptive statistics of the samples.

Table 2
Results of Descriptive Statistics

	RESID	MGTOWN	FOWN	FLEV	FSIZE	MBV
Mean	0.0389	0.00019	-	0.4313	29.69	2.1258
Median	0.034	0	0	0.4177	30	1.91
Minimum	-1.5137	0	0	0.0163	28	0.17
Maximum	1.5867	0.001	1	0.8499	31	5.66
St. Deviation	0.6101	0.00028	-	0.1938	0.871	1.283
Frequency of value 0		111				
Frequency of value 1		121				

RESID = residual value regressed from family and non-family firms; MGTOWN = percentage of managerial ownership in firm i in year t; FOWN = dummy variable – 0 as an indication of non-family firms, 1 as an indication of family firms; FLEV = total liabilities divided by total assets of firm i in year t; FSIZE = natural logarithm of total book value of assets (total BV assets) of firm i from year (t-1) to(t); MBV = market stock price divided by book value (BV) of stock for firm i in year t

The descriptive statistics above show that managerial ownership (MGTOWN) has a relatively low value. This indicates that Indonesian firms practice a low level of managerial ownership. In contrast, FOWN as the separator between family and non-family firms shows a greater frequency value of 1 compared to the frequency value of 0, implying that in Indonesia, family firms predominantly exist in the market.

Table 3
Results of the Regression Analysis

Independent Variables	Coefficient	t-stat (*p*-value)
Constant	-1.624	-1.224 -0.222
MGTOWN	-0.07	-1.132 -0.259
FOWN	0.265	4.269** 0
FLEV	0.205	3.324** -0.001
FSIZE	0.052	0.817 -0.415
MBV	-0.161	-2.536* -0.012
Adj. R^2		13.40%
F-test		8.137
(*p*-value)		0

RESID = residual value regressed from family and non-family firms; MGTOWN = percentage of managerial ownership in firm i in year t; FOWN = dummy variable – 0 as an indication of non-family firms, 1 as an indication of family firms; FLEV = total liabilities divided by total assets of firm i in year t; FSIZE = natural logarithm of total book value of assets (total BV assets) of firm i from year (t-1) to(t); MBV = market stock price divided by book value (BV) of stock for firm i in year t

*significant at 0.05 level
**significant at 0.01 level

The multiple regression results show FOWN variable has a highly significant coefficient value of 0.265 due to the *p-value* amount of 0.000 that is less than alpha (0.05). Therefore, it indicates that family ownership significantly affects the degree of conservatism practiced. This finding might be due to the different levels of agency problems faced by family businesses. Also, this result confirms prior studies, as it identifies the possibilities of having different degrees of conservatism due to significantly different ownership types (family versus non-family firms) encountered (Ali et al., 2007; Chen et al., 2009).

As for the MGTOWN variable, the *p-value* is higher than alpha (0.259 > 0.05), thereby indicating that the coefficient value (β_1) of -0.070 generated by the T-test from MGTOWN is insignificant. This implies that managerial ownership does not affect the degree of conservatism. The authors' finding conveys a contradiction with prior research, for instance in studies conducted by LaFond and Roychowdhury (2007) and Akada (2010). A possible explanation for the differences in these findings might be due to the statistical data value of Indonesian firm samples that only have low or even zero values that reflect a low mean value of 0.00019 and a maximum value of 0.001. This leads to the possible explanation that an insignificant value of managerial ownership relationship to the degree of conservatism might result from an insignificant data value of managerial ownership in Indonesia.

Aside from the independent variables, three control variables are employed in the regression model (FLEV, FSIZE, and MBV). In this case, FLEV exhibits a strong positive relationship with RESID (a coefficient value of 0.205) supporting prior research about the positive correlation between the degree of conservatism with a debt contracting mechanism (Holthausen & Watts, 2001; Watts, 2003a; Guay & Verrecchia, 2006; Ball et al., 2008). This implies that among Indonesian firms, debt contracting plays a significant role in determining the degree of conservatism. As a result, the higher the amount of leverage used, the larger the demand of conservative accounting to better reduce possible contracting costs that might incur (Cullinan et al., 2006).

Additionally, MBV also shows a significant value as expressed in a *p-value* of 0.012. Through a significant negative coefficient value of -0.161, it confirms prior research in which the degree of conservatism might significantly result in the low value of the MBV ratio (Ahmed & Duellman, 2007). FSIZE, on the other hand, shows an insignificant *p-value* (0.415>0.05) indicating that different sizes of firms will not affect the degree of conservatism in an Indonesian context.

CONCLUSION

In mitigating agency problems, there are two mechanisms can be employed, namely accounting conservatism and managerial ownership. Family company has different characteristics and nature compared to

widely dispersed ownership company. Studies found that family business is dominated more by agency problem type II rather than the classical agency problem type I.

This study using Indonesian listed companies as samples finds them to have unique characteristics because majority of the companies are family owned. There are also some firms that apply managerial ownership, even though regulation regarding managerial ownership is not yet confirmed.

This study found that family ownership affects the degree of accounting conservatism. The study did not find any correlation between managerial ownership and the level of managerial ownership. This is due to the data available in the sample not significant enough to influence the accounting conservatism variable.

To address some of the latter mentioned limitations the authors suggest utilizing other variables that are not yet measure in this study, yet reflecting the characteristics of the Indonesian corporation. Furthermore, as accounting conservatism is a matter of judgment, the authors suggest using qualitative data to analyse the reason behind the application of conservatism. This should ensure more discussion on the topic of accounting conservatism.

REFERENCES

Ahmed, A. S., & Duellman, S. (2007). Accounting conservatism and board of director characteristics: An empirical analysis. *Journal of Accounting and Economics*, *43*(2), 411–437.

Ali, A., Chen, T. Y., & Radhakrishnan, S. (2007). Corporate disclosures by family firms. *Journal of Accounting and Economics*, *44*(1), 238–286.

Anderson, R. C., & Reeb, D. M. (2003). Founding-family ownership and firm performance: evidence from the S&P 500. *Journal of Finance*, *58*, 1301–1328.

Ball, R., Robin, A., & Sadka, G. (2008). Is financial reporting shaped by equity markets or by debt markets? An international study of timeliness and conservatism. *Review of Accounting Studies*, *13*(2-3), 168–205.

Basu, S. (1997). The conservatism principle and the asymmetric timeliness of earnings. *Journal of Accounting and Economics*, *24*(1), 3–37.

Chen, E. T., Gray, S., & Nowland, J. (2011). Family involvement and family firm performance. *City University of Hong Kong, China*. Retrieved from http://www.umac.mo/fba/conferences/asianfa2011/1419739/Abstract/1101-cover.pdf.

Claessens, S., Djankov, S., & Lang, L. H. (2000). The separation of ownership and control in East Asian corporations. *Journal of Financial Economics*, *58*(1), 81– 112.

Cullinan, P., Wang, F., Wang, P., & Zhang, J. (2006). Ownership structure and accounting conservatism in China. *Journal of International Accounting, Auditing, and Taxation*, *21*, 1–16.

Firth, M., Fung, P. M., & Rui, O. M. (2007). Ownership, two-tier board structure, and the in formativeness of earnings–Evidence from China. *Journal of Accounting and Public Policy*, *26*(4), 463–496.

Guay, W., & Verrecchia, R. (2006). Discussion of an economic framework for conservative accounting and Bushman and Piotroski (2006). *Journal of Accounting and Economics*, *42*(1), 149–165.

Holthausen, R. W., & Watts, R. L. (2001). The relevance of the value-relevance literature for financial accounting standard setting. *Journal of Accounting and Economics*, *31*(1), 3–75.

Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, *3*, 305– 360.

Lafond, R., & Watts, R. L. (2006). The Information Role of Conservative Financial Statement. *The Accounting Review: March 2008, 83*(2), 447-478.

Lafond, R., & Roychowdhury, S. (2007). Managerial ownership and accounting conservatism. *Journal of Accounting Research*, *46*(1), 101–135.

Lasdi, L. (2009). Pengujian Determinan Konservatisma Akuntansi. *Jurnal Akuntansi Kontemporer*, *1*(1). Retrieved from http://journal.wima.ac.id/index.php/JAKO/article/view/376.

Morck, R., & Yeung, B. (2003). Agency problems in large family business groups. *Entrepreneurship Theory and Practice*, *27*(4), 367–382.

Shuto, A., & Takada, T. (2010). Managerial ownership and accounting conservatism in Japan: A test of management entrenchment effect. *Journal of Business Finance & Accounting*, *37*(7-8), 815–840.

Watts, R. L. (2003a). Conservatism in accounting part I: Explanations and implications. *Accounting Horizons*, *17*(3), 207–221.