

Ownership Concentration and Earning Quality: Moderating Role of Board Diversity

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Abstract

Bad management practices that occur in the industry cause a lot of harm to many parties. Bad management practices occur due to managers' efforts to manipulate profits. Bad management practices that are carried out by management will be aggravated if the majority of shareholders participate to press the managers to make a profit manipulation so the earning quality becomes low. The purpose of this research is to find out how ownership concentration affects earnings quality and to determine the ability of directors to reduce the influence of ownership concentration on income quality. The research data used is a manufacturing company registered with the IDX in 2019-2020 with sampling methods using the target population method, that is, a sample determination technique using certain considerations. The data analysis method used is Moderated Regression Analysis (MRA). The results proved that the ownership concentration negatively affects the earning quality and board diversity can moderate the influence of ownership concentration on earning quality. Test results show the implication that Board Diversity can reduce the behavior of Ownership Concentration in performing earnings manipulation

Keywords: Ownership ;Concentration; Earnings Quality;Board Diversity

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INTRODUCTION

(Claessens et al., 2002) provide a statement relating to NEE (negative entrenchment effect) that ownership concentration has a negative effect on firm value. The controlling shareholders use their power of control to influence company policy to obtain personal benefits. In this case, the controlling shareholders are expropriating the minority shareholders. Expropriation will even be greater if there is a greater difference between cash flow rights and control rights. This statement is in line with the opinion of (Velury & Jenkins, 2006), that ownership concentration has a negative impact on firm value. The ownership structure is very important in determining firm value. However, the number of fraud cases committed by managers today cannot be separated from the pressure imposed by the owner to carry out certain actions. Such a condition can lead to the possibility of a profit manipulation process so that earnings information is no longer qualified.

In the process of maximizing the company's profits, there will be agency problems, that is conflicts of interest between agents (company management) and principals (company owners or shareholders). In general, (Jensen, 1976) describe agency theory as a relationship

that arises from a contract between principal and agent, where the principal delegates a job to the agent. Here the shareholder or the company owners, as a principal, plays a role in providing resources to management, as an agent, to run the company's operations, while management must provide reciprocity to the owner of the company or shareholders following the interest of the owner. Management is also authorized by the owner to take decisions in managing the company.

Management as a company manager often has other goals and interests that are contrary to the main objectives of the company and often ignores the interests of shareholders. This difference in the interest between managers and shareholders gives rise to a conflict commonly called agency conflict. Conflicts between principals and agents, as described by (Eisenhardt, 1989), can make it difficult for shareholders to verify management's operational activities. Management has more information about the company's operations and financial position than principals. Conflict occurs because the manager prioritizes his interests. The shareholders, however, do not want this to happen because it will increase costs for the company. The increase in company costs can lead to a decrease in company profits and influence the stock price, thus decreasing the value of the company (Jensen, 1976). Therefore, there must be a supervisory mechanism designed to protect the interests of shareholders, as the owner of the company, namely by implementing corporate governance. According to (Foroughi & Fooladi, 2011), corporate governance serves as a supervisory mechanism that plays an important role in reducing conflicts of interest between agents and principals.

Agency problems between management and capital owners can be reduced with concentrated ownership because controlling shareholders can easily make decisions according to their wishes. According to (Turnbull, 1997), the ownership concentration describes how and who has control over the whole or most of the ownership of the company and the whole or most of the holders of control over the business activities within a company. However, ownership concentrated in some investors will allow for the occurrence of a type two agency problem between majority shareholders and minority shareholders. Ownership concentrated on multiple parties will limit control and decision-making by one party. Ownership concentrated in several owners will provide limits for minority shareholders in exercising their right of control so that decision-making related to the company's operations is dominated by concentrated shareholders only.

Domination in decision-making will have an impact on the ease of pressure given by concentrated shareholders on management to take certain actions to meet shareholder interests. Opportunistic actions taken by concentrated shareholders towards management will have an impact on the earning quality generated by the company. The opportunistic actions will result in profits generated by the company not following the actual conditions (Herninta & Ginting, 2020) and this will provide biased information to minority shareholders regarding the earning quality generated by the company. Because the quality of the company's profit can be used as a measure of the company's management performance, the quality of profit can help decision-makers to make the decision (Dechow et al., 2010). Thus it can be said that the better profit in explaining the performance of management, the better earning quality. (Fernando & Wulansari, 2020) also emphasized that the earning quality can influence decision-making and can be used by investors to assess the company. The quality profit is a profit that reflects the sustainability of future profits, which are assessed from accrual and cash components, and reflects the company's actual financial performance.

According to research conducted by (Anderson & Reeb, 2003) on all sectors of companies listed in the Standard & Poor's 500 except the banking sector, when a family is in the largest control over a company, there will be a weakening of performance. It can be said that when the control of a company is concentrated on a large party only, then the tendency to

manipulate profits will increase due to the imbalance between performance and results achieved by the company. To be able to limit the pressure exerted by concentrated company owners, a component is needed that can limit the opportunistic behavior carried out by concentrated ownership. In addition, a diverse board of directors is also required. (Nasr & Ntim, 2018) defines diversity as the composition of the board of commissioners and directors as well as the combination of different qualities, characteristics, and expertise between individual board members relating to decision-making and other processes on the company's board. (Dewi, 2017) stated that following the role of the board of commissioners and directors to carry out the functions of advisory and control, the diversity of the company's board is expected to maximize the value of the company through cost efficiency, one of which is the tax burden, and at the same time to perform supervisory or control functions to maximize shareholder value. The diversity of the board of directors is expected to provide a more diverse view in managing the company. This will make it difficult for shareholders to put pressure on managers due to the diverse components within the company's management ranks. Companies with a more diversified management structure will give birth to a diversity of views in making decisions so that the imposition of concentrated share ownership can be minimized.

(Carter et al., 2003) provide several empirical propositions and evidence relating to board diversity: (1) board diversity provides a better understanding of the market, (2) diversity can increase creativity and innovation, (3) diversity produces effective problem-solving alternatives, heterogeneity within boards can lead to more conflict, but problem-solving alternatives will be more and more and can lead to accuracy in assessing the effective consequences. As alternatives are taken, (4) diversity can increase effectiveness within the company, where homogeneous board members will have a narrower perspective than heterogeneous board members, (5) diversity can improve increasingly effective global relationships. This is in line with the idea put forward by (Carter et al., 2003) that board diversity is believed to have an influence on the value of the company in the short and long term. According to Ferrwira, (2010) the advantages of Board Diversity are creativity and perspective that differ in solving problems; access to resources and connections; career incentives through signaling and mentoring; public relations, investor relations, and legitimacy.

In Indonesia, there is a two-tier system where the company's board structure consists of directors, as managers, and board of commissioners, as parties who conduct supervision (Asyik, 2017). The role of the board of commissioners is to oversee the policy of the board of directors in running the company and providing advice to the board of directors. The board of commissioners and directors acts as an internal mechanism that controls management to act following the interests of shareholders or owners (Ratnawati, 2020) and through administrative efforts can affect the efficiency of the company. (Khaoula & Mohamed Ali, 2012) define board diversity in two demographically and cognitively measurable perspectives. The first perspective is measured by demographic, where diversity can be observed through the attributes of each individual, such as gender, age, ethnicity, nationality. Whereas the second perspective is measured cognitively, where diversity cannot be observed directly because it can only be measured by the attitudes and normative differences inherent in each individual, such as beliefs, attitudes, and values. It can be concluded that diversity can occur in companies due to demographic changes, such as older employees, women, minorities, and education. The importance of diversity within a company is the realization that diversity can help meet the competitive pressures at hand.

Opportunistic actions taken by agents can negatively impact not only the survival of the company but also the principal. Therefore, to minimize the occurrence of excessive opportunistic actions carried out by agents, there must be diversity in the board of directors, or agents, as executors of the company's operations. Diversity in the board of directors will provide many views in decision-making related to the company so that the possibility of opportunistic actions can be minimized. The diversity of the board of directors can increase the effectiveness of the company's leadership so as not to be concentrated on unilateral decision-making. It can be said that board diversity can moderate the influence of ownership concentration on profit quality because good board performance in managing the company will eliminate manipulation of company data, especially manipulating profits. Thus, corporate profit reporting can be of higher quality leading to higher transparency (Leuz et al., 2003). This is in line with (Hashim et al., 2019) which explains that Board Diversity can affect the earning quality, the more diverse the Board diversity, the better the earning quality. This condition will affect the transparency of financial statements so that investors as part of the principal can give a positive appreciation to the financial statements and investors will increasingly trust the company's survival.

Based on the problems described above, the hypotheses that can be formulated are:
 H1: Ownership Concentration has a negative effect on Earnings Quality.
 H2: Board Diversity can reduce the behavior of Ownership Concentration in performing earnings manipulation

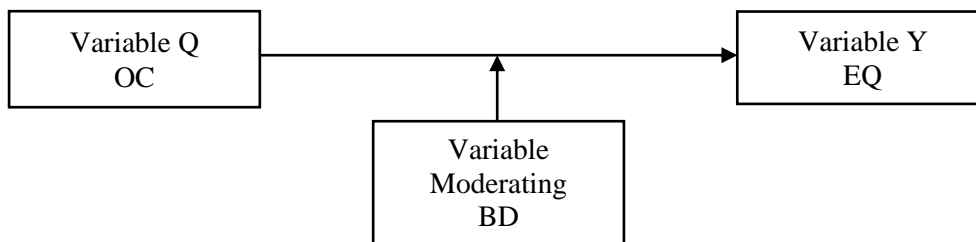


Figure 1. Research Model

Notes:

- OC: Ownership Concentration
- BD: Board Diversity
- EQ: Earnings Quality

RESEARCH METHOD

Data used in this study are obtained from the annual report of manufacturing companies listed on the Indonesia Stock Exchange (IDX) in 2019-2020. This study focuses on the effect of ownership concentration and board diversity on corporate earnings quality. The procedure for determining the sample is done by using the target population method, that is, a sample determination technique using certain considerations (Sugiyono., 2011). The criteria considered in the research sample are manufacturing companies that have been listed on the Indonesia Stock Exchange before December 31, 2019, and are still registered until December 31, 2020. The manufacturing companies have published financial statements accompanied by independent auditor reports for December 31, 2019, until December 31, 2020. The manufacturing companies have presented complete data related to this research variable.

The variables used in this study consist of three variations, that is earning quality as a dependent variable, ownership concentration as an independent variable, and board diversity as variable moderating. Earnings quality is measured by using earnings persistence. The measurement of earnings persistence has been done by (Kousenidis et al., 2013), in which

earnings persistence is calculated with the slope coefficient estimated from the autoregressive profit model.

The ownership concentration in this study follows the opinion of (Gama & Rodrigues, 2013), in which ownership concentration can be measured using the Herfindahl-Hirschman Index (HHI) of the three largest shareholders with the following formula:

$$OC = (\text{Equity 1} - \text{Equity 2})^2 + (\text{Equity 1} - \text{Equity 3})^2 + (\text{Equity 2} - \text{Equity 3})^2 \quad (1)$$

Description:

OC = Ownership Concentration

Equity (1,2,3)= largest shareholder to 1,2,3

Board diversity is measured by three proxies; gender diversity, age diversity, and educational background diversity of board members. For this reason, Blau index measurement is used. This index measurement was introduced by (Blau, 1977). Blau index is a better tool in measuring heterogeneity in categorical characteristics (Ararat et al., 2012). Blau's calculation adds up the squared result of the value of the proxy for gender diversity, age diversity, and educational background diversity. The calculation of the Blau index formulated as follows:

$$Bi = 1 - \sum_{i=1}^k Pi^2 \quad (2)$$

Description:

Bi = Blue index

Pi = propose councils of each category

k = Number of categories of each attribute

Next standardized the Blau index by dividing each board diversity attribute with theoretical maximum value ((k-1)/k). After that sum Blau index value of the three standardized attributes (Ararat et al., 2012)

The analysis method used is the Moderated Regression Analysis (MRA). In hypothesis testing with the MRA model formed the following equations:

$$\text{Model 1: } KL = a + b_1 OC + e \quad (3)$$

$$\text{Model 2: } KL = a + b_1 OC + b_2 DIV + e \quad (4)$$

$$\text{Model 3: } KL = a + b_1 OC + b_2 DIV + b_3 OC * DIV + e \quad (5)$$

Description:

KL = Earning Quality

OC = Ownership Concentration

DIV = Board Diversity

RESULT

Descriptive analysis aims to find out the general description of the variables used in the study. Descriptive analysis of variables is shown in Table 1.

Table 1. Descriptive Statistics

Where	Min	Max	Mean	Std Deviation
EP	-. 99822	. 84612	. 10696	. 42179
OC	.00001	1.64727	. 39421	. 46403
DIV	. 37037	2.60677	1.70185	. 44852

Source: processed data 2021

Based on table 1 it is known that Earnings Persistence (EP) has the lowest value of - 0.99822 at PT Cahayaputra Asa Keramik Tbk and the highest value of 0.84612 at PT Sekar Bumi Tbk. mean value of earnings persistence is 0.10696 with a standard deviation of 0.42179. Ownership Concentration (OC) has the lowest value of 0.000011 in PT. KMI Wire And Cable Tbk and the highest value of 1.64727 at PT. Tunas Alfin Tbk. The mean value of ownership concentration is 0.394207 with a standard deviation of 0.464025. Based on the table it is known that board diversity (DIV) has the lowest value of 0.37037 in PT. Chitose International Tbk and the highest value of 2.60677 at PT. Cottonindo Ariesta Tbk. The mean value of board diversity is 1.701852 with a standard deviation of 0.448517.

Table 2. Classic Assumption test

Classic Assumption	Model 1	Model 2	Model 3
Normality Test			
Sig. Value	.2680	.2798	.2791
Multicollinearity Test			
VIF Value			
X	1.0000	1.0004	3.7821
Z	-	1.0004	1.3938
X*Z	-	-	4.1332
Heteroscedasticity Test (White Test)			
Prob. Chi-Square Value	.8764	.3470	.6535
Autocorrelation Test (Serial Correlation LM Test)			
Prob. F value	.1066	.1106	.1772

Source: processed data 2021

The analysis used in this study is multiple linear regression and moderated regression analysis. Multiple linear regression analysis aims to determine the influence of ownership concentration on profit quality, while moderated regression analysis aims to determine the ability of board diversity in reducing the ownership concentration to profit quality. In the linear regression model must qualify classical assumptions for the model to be valid as an estimator. The Classical assumptions test are shown in the table 2. Based on table 2 it is known that Sig. Value of Normality Test for model 1 is .2680, model 2 is .2798 and model 3 is .2791. The Sig. value of three model is greater than 0.05, it means that data of three model is normally distributed. The VIF Value of model 1, model 2, and model 3 in table 2 show that the value is less than 10. It means that is no multicollinearity problem. The white test obtained prob. chi-square value is .8764 for model 1, .3470 for model 2, and 6535 for model 3, the value is greater than 0.05. It means that heteroscedasticity does not occur to three model. Based on table 2 show that prob.F value from autocorrelation test of three model is greater than 0.05, It means that is no autocorrelation problem.

Table 3. t- Statistical test

Variable	Coefficient	p-value
Model 1		
(Constant)	0.1463	.0003
OC	-0.1065	.0472
Model 2		
(Constant)	0.1873	.0231
OC	-0.1071	.0465
DIV	-0.0131	.5659
Model 3		
(Constant)	0.2866	.0020
OC	-0.3090	.0030
DIV	-0.0456	.0881
OC*DIV	0.0675	.0228

Source: processed data 2021

The results of the regression analysis are shown in table 3. Based on table 3, regression equations can be drawn up for each model:

$$\text{Model 1: } KL = 0.1463 - 0.1065 \text{ OC} + \varepsilon \quad (6)$$

$$\text{Model 2: } KL = 0.1873 - 0.1071 \text{ OC} - 0.0131 \text{ DIV} + \varepsilon \quad (7)$$

$$\text{Model 3: } KL = 0.2866 - 0.3090 \text{ OC} - 0.0456 \text{ DIV} + 0.0675 \text{ OC} \cdot \text{DIV} + \varepsilon \quad (8)$$

Based on the results of the research shown in table 3 model 1, it can be concluded that variables, ownership concentrations (OC) negatively affect earnings persistence (EP). This can be seen based on the p-value of 0.0472 where the value < 0.05 and the coefficient value of -0.1065. It can be concluded that hypothesis 1 (one) namely the variable ownership concentration negatively affects the earning quality received. Based on table 3 in model 3 shows an insignificant DIV value as evidenced by a p-value of 0.0881 where the value > 0.05, while a significant OC*DIV value is evidenced by a p-value of 0.0228 where the value < 0.05. This indicates that the Board Diversity (DIV) variable is a pure moderation variable. This means that board diversity (DIV) can moderate the ownership concentration (OC) to earnings persistence (EP) and has no effect as an independent variable. The coefficient value of OC*DIV of 0.0675 means that the Board Diversity (DIV) variable can moderate the positive influence of ownership concentration (OC) on earning persistence. Therefore, it can be concluded that hypothesis 2 (two) namely Board Diversity can reduce ownership concentration behavior to manipulate received profits.

Based on the results of the study showed that the first hypothesis was accepted, which means that the ownership concentration has a negative effect on the earning quality. The higher the concentration of the company's shareholding, the lower the earning quality. The results are in line with (Oyebamiji, 2021) which proves that ownership concentration negatively affects the earning quality. (Sousa & Galdi, 2016) explained that the higher the concentration level of ownership, the less profit will be less persistent. Persistent profit is quality profit (Schipper & Vincent, 2003)(Secundo et al., 2016). The higher the rate of profit persistence, the more quality the profit (Thakolwiroj & Sithipolvanichgul, 2021). Quality profit is a profit that reflects the sustainability of profits (sustainable earnings) in the future. Concerning the quality of the company's profits as a gauge of the company's management performance, quality of the profit can help decision making by decision-makers (Dechow et al., 2010). The better the profit in explaining the performance of management, the more

quality the profit. also emphasized that quality the profit can affect decision-making and can be used by investors to assess the company.

The ownership concentration by multiple parties will limit control and decision-making by one party. The ownership concentration by some owners will provide limits for minority shareholders in using their control rights so that the domination of decisions in the company's operations is only owned by concentrated shareholders. As a result of domination in decision making will have an impact on the ease of encouragement or pressure exerted by shareholders who are concentrated on the management to take certain actions to meet the interests of shareholders. It can be said that when the control of a company is concentrated on a large party only, then the tendency to manipulate profits will increase due to the imbalance between performance and results achieved by the company.

Opportunistic actions taken by shareholders are consistent with management will have an impact on the earning quality generated by the company. Opportunistic actions created will result in profits generated by the company not following the actual conditions. The results of this study are in line with research conducted by (Zeitun & Tian, 2007) which provides empirical evidence that when there is an ownership concentration in five top-level shareholders it will have a positive impact on the company's performance seen through profit quality.

Based on the results of statistical tests showed that Board Diversity (DIV) was able to moderate the influence of ownership concentration (OC) on Earning persistence. This shows that with board diversity, the influence of high ownership concentration levels will have a quality profit impact that is more persistent profit. So that the second hypothesis is acceptable, that is Board Diversity be able to reduce ownership concentration behavior to manipulate profits. Manipulating profits is an opportunistic act that results in the company's profit not being following the actual conditions so that profits are not qualified.

(Carter et al., 2003) provide several empirical propositions and evidence relating to board diversity: (1) board diversity provides a better understanding of the market, (2) diversity can increase creativity and innovation, (3) diversity produces effective problem-solving alternatives, heterogeneity within boards can lead to more conflict, but problem-solving alternatives will be more and more and can lead to accuracy in assessing the effective consequences. As alternatives are taken, (4) diversity can increase effectiveness within the company, where homogeneous board members will have a narrower perspective than heterogeneous board members, (5) diversity can improve increasingly effective global relationships.

Based on this, it shows that the diversity in the ranks of agents will provide many views that appear in the company's decision-making by agents so that the possibility of opportunistic actions can be minimized. The diversity of the board of directors can increase the effectiveness of the company's leadership so as not to be concentrated on unilateral decision-making. It can be said that board diversity can moderate the influence of ownership concentration on profit quality because good board performance in managing the company will eliminate the manipulation of company data. Thus, corporate profit reporting can be of higher quality leading to higher transparency (Leuz et al., 2003). This condition will have an impact on the increasingly open financial statements of the company so that investors as part of the principal can give a positive appreciation to the company's financial statements.

CONCLUSIONS

Hypothesis 1 states that ownership concentration has a negative effect on earnings quality. The results of the hypothesis test show that high ownership concentration will make it easier for majority shareholders to put pressure on the management to carry out opportunistic accounting actions to provide more benefits to the majority shareholders. Accounting opportunistic actions carried out by management to provide support to shareholders will have an impact on the decline in the quality of earnings generated by the company. The results of this study are in line with the research conducted by (Zeitun & Tian, 2007) which provides empirical evidence that when there is an ownership concentration in the five top-level shareholders, it will have a positive impact on company performance is seen through earning quality. The results of the study are also in line with de Sousa & Galdi (2016) which shows that the higher the level of ownership concentration, the less persistent profit.

Hypothesis 2 states that board diversity reduces the behavior of ownership concentrations in manipulating profits which can affect the earning quality. The results proved that a Board Diversity (DIV) can moderate the positive influence of ownership concentration (OC) on earning persistence. This shows that board diversity, the influence of high ownership concentration levels will have a quality profit impact that is more persistent earning. It can be said that board diversity can moderate the influence of ownership concentration on earning quality because good board performance in managing the company will eliminate the manipulation of company data. Thus, corporate profit reporting can be of higher quality leading to higher transparency (Leuz et al. 2003).

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