

Special Issue for "International Conference on Accounting Studies (ICAS 2015), 17-20 August 2015, Institute for Strategic and Sustainable Accounting Development (ISSAD), Tunku Puteri Intan Safinaz School of Accountancy, College of Business, Universiti Utara Malaysia, Malaysia"

The Influence of Agency Conflict Types I and II on Earnings Management

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ABSTRACT

This study examined the influence of agency conflict Type I (as represented by managerial ownership and institutional ownership), and agency conflict Type II (as represented by control rights, cash flow rights, cash flow rights leverage) on earnings management. A model was developed and tested using a sample of 108 pyramidal structure companies listed on Indonesian stock exchange from 2008 to 2012. Data were collected and analyzed using least square regression model. The result showed that there is a significant association between managerial ownership and control rights. However, control rights (in agency conflict Type II) have the greatest influence on earnings management. Consequently, Type II agency conflict have the largest influence on earnings management compared to Type I agency conflict. The significance of the study is the potentials to assist the institutions and investors know the actual company performance and provides a better understanding of the agency theory more broadly *viz.* the relative impacts of Types I and II agency conflicts.

Keywords: Earnings Management, Agency Conflict Types I and II, Developing Nation

JEL Classifications: G32, G23, M410

1. INTRODUCTION

Earnings management itself does not always imply a negative action because it is not entirely oriented towards earnings manipulation. Managerial discretion is required on earning reporting because of the conflict of incentives between the principal and the agent. The conflict can cause managers to use the flexibility allowed under statement of financial accounting standard (SFAS) to create distortions in reported profit called opportunistic earnings management. While the managerial discretion stated in accounting standards are meant to increase the information content of profit reporting it allows the communication of private information called efficient earnings management. Opportunistic earnings management, in general, is due to the existence of agency conflict arising between principal and agent conflict which can be Types I and II.

Previous studies on earnings management viewed the principal-agent conflict from the perspective of agency problem of Type 1,

without considering the possible effect of the agency problem Type II. Type 1 is the agency problem agency problem that arises between the principal as the owner of companies and agents as the manager who is the executor the company's operations. While the issue of agency Type II is the agency problem that occurs between controlling shareholders and minority shareholders. Studies (Sanjaya, 2010; 2011; Ratnawati and Abdul-Hamid, 2015) found that the practice of earnings management occurs because of an agency problem between controlling shareholders and minority shareholders (Type II agency conflict).

The prior literature showed that ownership structure of firms at Jakarta Stock Exchange is organized as concentrated ownership. Siregar (2008) found that as many as 99% of companies listed on the Jakarta stock exchange are those with concentrated ownership structure. Meanwhile, continental data of Asia as a whole revealed that as many as 93% of public companies in the continent are owned by the controlling shareholders and concentrated (Claessens

et al., 2000). Siregar and Sidharta (2008) also found that in general the companies listed on the Jakarta stock exchange are mostly with a concentrated structure. Another researcher (Sanjaya, 2010) found that most companies listed on the Jakarta Stock Exchange are the concentrated regarding ownership. Thus, the tendency of earnings management is likely to be caused by the presence of Type II agency problems.

According to Siregar (2008), of the total 90% of companies with concentrated ownership structure, 66% are companies with a pyramid structure. With the ownership structure of the pyramid, the controlling shareholder will have control rights and cash flow rights. To cover the expropriation done to minority shareholders, the controlling shareholder will make a separation between cash flow rights and control rights it has. The controlling shareholders may also try to increase their control rights on excess cash flow.

With the control rights on excess cash flow, it is most likely for controlling shareholders to engage in expropriation. Studies have proved that one way to engage in expropriation is earnings management practices (Bebchuk, 1999; Bebchuk et al., 2000; La Porta et al., 1998; 1999). Consequently, the purpose of this study was to investigate which of Type I or Type II agency conflicts is more dominant in influencing the practice of management of the company's earnings.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

2.1. Managerial Ownership, Institutional Ownership and Earnings Management (Type I)

In the literature, studies that examine earnings management mostly do so from the viewpoint of agency problem of Type I. Such studies identify managerial and institutional ownership as factors affecting earnings management. According to Kole (1995), managerial ownership of different sizes will have a different impact on the relationship between managerial ownership on earnings management.

Managerial ownership among companies can reduce the level of agency problems. This is evident from the findings of Short and Keasey (1999) who found that managerial ownership has a non-linear relationship with the value of the company. Meanwhile, Morck et al. (1988), McConnell and Servaes (1990), and Kole (1995) found that a linear relationship is also reflected in the performance of the company. Jensen and Meckling (1976) found that the ownership of shares by the manager can help the pooling of interest between shareholders and managers. Based on this it can be concluded that the greater the number of share ownership by managers, the better the performance of the company, the fewer earnings management practices.

In the view of agency theory, the proportion of managerial ownership will affect their behavior towards alignment with the company's objectives (Alzoubi, 2016; Fama and Jensen, 1983; Jensen and Meckling, 1976). Studies have documented that insider ownership can be considered as a mechanism to limit managerial

opportunism behavior since insider ownership has a negative correlation with earnings management (Alzoubi, 2016; Teshima and Shuto, 2008; Warfield et al., 1995).

Warfield et al. (1995), and Yeo et al. (2002) also reported that earnings management will increase if the manager has a low ownership in the company. Based on this findings, it can be concluded that the higher managerial ownership, the lower earnings management. Otherwise, the lower managerial ownership, the higher earnings management. Based on this reasoning, the hypothesis is developed thus:

Hypothesis H1a: Managerial ownership has a negative influence on earnings management.

Agrawal and Mendelker (1990) stated that institutional investors have an important role as an external oversight on the stock market. They also argued that institutional investors provide meaningful supervision services as well as acting as a barrier to the opportunistic behavior of managerial companies. So with the presence of institutional ownership would hinder the practice of earnings management. Besides, in general, institutional investors are sophisticated investors. According to Veluri and Jenkins (2006), institutional ownership has a positive effect on the quality of earnings. Increasing the quality of earnings will reduce earnings management. In line with the reasoning, the hypothesis is developed as follows:

Hypothesis H1b: Institutional ownership has a negative influence on earnings management.

2.2. Control Rights, Cash Flow Rights, Cash Flow Leverage, and Earnings Management (Type II)

According to La Porta et al. (1999), control rights signify the right to participate in decisions about the company (Siregar, 2008). Shleifer and Vishny (1997) stated that Control rights may affect the company's policy and allow the occurrence of expropriation by controlling shareholders. Shleifer and Vishny (1997), La Porta et al., (1999), and Claessens et al. (2000) also found that the concentration of control rights among controlling shareholders may lead to the expropriation of the minority shareholders. The adverse effect of control rights on earnings management is in line with the argument that major shareholders will be able to manage the company to obtain a private benefit. Therefore, when control is exerted by the major controlling shareholder, the controlling shareholder will seek to allocate the company's resources to generate the private benefits. Controlling shareholders could use the implementation of policies and incentives to obtain private benefits over the minority shareholders. It indicated that the higher the control rights, the higher earnings management. Based on the literature discussion, the relationship between control rights and earnings management is hypothesized as follows:

Hypothesis H2a: Control rights has positive influence on earnings management.

Claessens et al., (2000) and Siregar (2008) stated that the cash flow rights and control rights have different implications for policy as well as the value of the company. This may result in cash flow rights, control rights and cash flow rights leverage having different implications for earnings management practices. Studies found that

the higher cash flow rights will increase the value of the company (La Porta et al., 2002; Claessens et al., 2002). Increasing corporate value indicates a decrease in earnings management practices. Sanjaya (2010), Ratnawati and Abdul-Hamid (2015) found that the cash flow rights affect earnings management positively.

Cash flow rights represent a source of financial incentives to limit the expropriation, while the Control Rights constitute a source of incentives to obtain private benefits (Siregar, 2008). Such private benefits through controls are the advantages achieved by the controlling shareholder of both financial and non-financial form, through the domination and control exerted by them on minority shareholder (Ratnawati and Abdul-Hamid, 2014). Based on the deductive literature, the relationship between cash flow rights and earning management is hypothesized as follows:

Hypothesis H2b: Cash flow rights has negative influence on earnings management.

Cash flow rights leverage is the deviation between cash flow rights to control right. La Porta et al., (1999) stated that the cash flow rights leverage increase over the controls through a variety of mechanisms such as pyramid ownership and cross-ownership (Siregar, 2008). According to Gugler and Yurtoglu (2003), the emergence of the agency problem would be affected by the value of cash flow rights leverage. The higher cash flow rights leverage, the greater the likelihood of the agency problem. The higher the control right leverage, the greater the tendency of controlling shareholders expropriating minority shareholders. Through cash flow rights leverage, the controlling shareholders increasingly have the opportunity to intervene in determining the policy of the company. Hence, policies are may be made to provide private benefits or advantages for controlling shareholders through earnings management. Kim and Yi (2006) stated that divergence between control rights and cash flow right will motivate the controlling shareholders to expropriate the company's asset for their private benefit. Study of Gugler and Yurtoglu (2003) also found that the higher cash flow right leverage, the higher the tendency of controlling shareholder to expropriate non-controlling shareholders. Therefore, there are conditions to motivate controlling shareholders to manage earnings. Later studies (Haw et al., 2004; Sanjaya, 2010) are consistent with the study of Gugler and Yurtoglu (2003). The next hypothesis is developed as stated thus:

Hypothesis H2c: Cash flow right leverage has a positive influence on earnings management.

3. RESEARCH METHODOLOGY

3.1. Population and Sample

The population of the study is all listed companies on the Indonesian stock exchange between 2008 and 2012, except financial institutions. The list of the company with pyramid ownership structure was obtained from Indonesian Business Data Center and other sources. From all of the companies listed on the Indonesian stock exchange from 2008 to 2012, a total of 141 companies had a pyramid structure. Following the screening based on criteria depicted in Table 2, the final sample size comprised 108 companies. The sample description of the study is illustrated in Table 1.

Table 1: Sample description

Companies with pyramid ownership pattern	141
Cut off (companies with less 10% pyramid ownership)	(20)
Outlier data	(13)
Qualified pyramid companies	108
Total year-observations	5*108=540

Table 2: Tolerance and VIF value

Model	Collinearity statistics	
	Tolerance	VIF
MgrOwn	0.979	1.022
InsOwn	0.985	1.015
CR	0.112	8.893
CFR	0.128	7.806
CFRLev	0.645	1.550

Dependent variable: DACC. VIF: Variance inflation factor, MgrOwn: Managerial ownership, InstOwn: Institutional ownership, CR: Control right, CFR: Cash flow rights, CFRLev: Cash flow rights leverage

3.2. Measurement of Earnings Management (Dependent Variable)

Earnings management is measured by using a discretionary accrual (DACC). The findings of the Tsai and Chiou (2009) study found that the cross-sectional Jones model (Jones, 1991) is the most popular model in the literature for detecting earnings management. The following model is cross-sectional Jones model to estimate for non-discretionary accruals.

The Jones model:

$$NDA_{ijt} = \alpha_0 (1/TA_{ijt-1}) + \alpha_1 (\Delta REV_{ijt}/TA_{ijt-1}) + \alpha_2 (PPE_{ijt}/TA_{ijt-1}) \quad (1)$$

In which:

ΔREV_t = Earnings changes for period t and t-1

PPE_t = The fixed assets of firm i in year t divided by total assets of firm i at the end of year t-1

TA_{t-1} = Total asset at the end of the year t-1 period

i = Industry

J = The sample of companies.

α_0 , α_1 and α_2 = Company-specific parameters, obtained from the following models:

$$TACC_{ijt} = \alpha_0 (1/TA_{ijt-1}) + \alpha_1 (\Delta REV_{ijt}/TA_{ijt-1}) + \alpha_2 (PPE_{ijt}/TA_{ijt-1}) + \varepsilon_{ijt} \quad (2)$$

$DACC = TACC_{it} - NDACC_{it}$

TACC = Total accrual

NDACC = Nondiscretionary accrual.

3.3. Measure of Independents Variables

3.3.1. Managerial and institutional ownership

Managerial ownership = % managerial ownership in the company (Morck et al. (1988).

Institutional ownership = % institutional ownership in the company (Siregar and Sidharta, 2008).

3.3.2. Control right

Control rights are voting rights to determine company policy (La Porta, 1999). Control rights consist of direct and indirect control

rights. Direct control rights are the percentage of shares held by the controlling shareholder on behalf of himself at a company. While indirect control rights are the sum of the minimum control in every chain of ownership (La Porta, 1999; Siregar, 2008). Thus, the control rights are the summation of the weakest relationship in any chain of ownership.

3.3.3. Cash flow rights

Cash flow rights comprised of Cash Flow Rights directly and indirectly. Direct cash flow rights represent the percentage of shares owned by shareholders in a public company on its own. While the indirect cash flow rights indicate multiplying the number of shareholders with the percentage of ownership in each chain of the ownership. Thus, the cash flow is the sum of the percentage of direct and indirect Cash Flow Rights (Sanjaya, 2010; La Porta et al., 1999).

3.3.4. Cash flow rights leverage

Cash Flow Rights leverage is the difference between control rights and cash flow rights of the controlling shareholder. The greater the difference between control rights and cash flow rights, the higher the control of the controlling shareholder that exceeds its cash flow rights (La Porta et al., 1999; Sanjaya, 2010).

3.4. Techniques of Data Analysis

The test of hypotheses was done using multiple regression models as stated below:

$$DACC = \alpha + \beta_1 MgrOwn + \beta_2 InstOwn + \beta_3 CR + \beta_4 CFR + \beta_5 CFRLe + v + \varepsilon$$

Where:

DACC = Discretionary accrual

MgrOwn = Managerial ownership

InstOwn = Institutional ownership

CR = Control right

CFR = Cash flow rights

CFRLev = Cash flow rights leverage

3.5. Descriptive Statistics, Data Normality, and Classical Assumption Test

3.5.1. Normality testing

The normal distribution of data obtained for the study was detected using normal probability plot analysis. Normality test results in this study showed that the points spread around the diagonal line, and the distribution follows the direction of the diagonal line. This indicates that the data meet the normality assumption. The normality testing of the study is represented in Figure 1.

3.5.2. Multicollinearity testing

To determine whether there is autocorrelation, the result of the test conducted showed variance inflation factor (VIF) value of each independent variable as represented in Table 3.

The above Table 3 showed that all the independent variables have a tolerance value > 0.10 and VIF < 10. Therefore, it can be concluded that the independent variables used in the regression model of this research are free from the problem of multicollinearity (Gozali, 2013).

3.5.3. Autocorrelation testing

To determine whether there is autocorrelation can be seen from the DW value was calculated for each variable, as shown in Table 4. The Durbin-Watson value of 1.761 and the value range between the values DW -2 to +2, which means there is no autocorrelation (Gozali, 2013). Thus, there is no problem of autocorrelation in the regression model of this study.

3.5.4. Heteroscedasticity testing

The results demonstrated that the points on the image did not form a specific pattern and the data spread above and below the number 0 on the Y-axis. This indicates that the model did not experience heteroscedasticity, which means the sample variance of the observation residuals to other observations have in common and could be said to be efficient. Thus, based on the assumptions of a classical test result that the model is free of autocorrelation, multicollinearity and heteroscedasticity, thus, this model fit for use in this study. Figure 2 depicts the heteroscedasticity testing of the study.

4. FINDINGS AND DISCUSSIONS

4.1. Hypotheses H1a, H1b, and H1c (Agency Conflict Type I)

From Table 5, it was shown that Beta coefficient, t-value, and P-value for hypothesis 1a, testing the influence of managerial ownership on earnings management are -0.066, -7.541 and 0.000 respectively. Based on the negative sign, it indicates that managerial ownership has a negative influence on earnings management. This implies that if the manager has ownership in the company, the manager would not be motivated to practice

Figure 1: Normality testing of the study

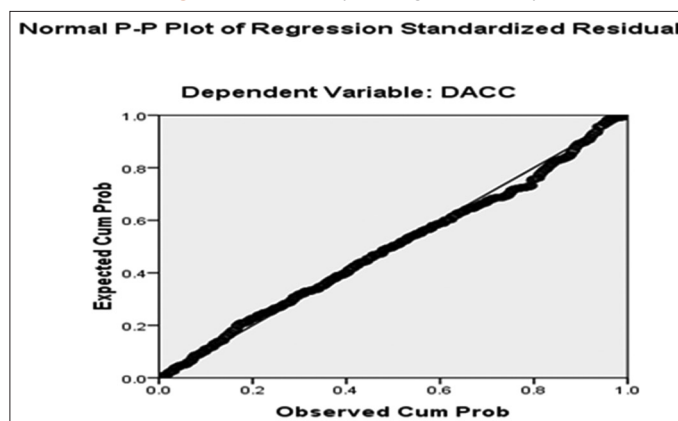


Table 3: Model summary^b

Model	R	R ²	Adjusted R ²	Standard error of the estimate	Change statistics					Durbin-Watson
					R ² change	F-change	df1	df2	Significant F-change	
1	0.356 ^a	0.127	0.119	0.10876970	0.127	15.513	5	534	0.000	1.761

^aPredictors: (Constant), Mgrins, CFRLev, MgrOwn, CFR, CR, ^bDependent variable: DACC. DACC: Discretionary accrual, MgrOwn: Managerial ownership, CR: Control right, CFR: Cash flow rights, CFRLev: Cash flow rights leverage

earnings management. Based on this finding, it could be concluded that the higher managerial ownership, then the lower earnings management. Thus, hypothesis H1a was accepted. This finding agreed with the prior literature of Alzoubi (2016), Teshima and Shuto (2008); Warfield et al., (1995), and Yeo et al. (2002).

As for hypothesis H1b, the Beta coefficient (0.019), the t-statistic (2.552) and P-value (0.011) both indicated significant value. However, finding of this study did not show that the higher institutional ownership, the lower earnings management practice as hypothesized, because of the positive sign of beta coefficient (0.019) from Table 5. Consequently, hypothesis H1b was rejected. Possible explanations for this finding could be accounted for by the difference in the type of institutional investor as stated in the literature. According to Shleifer and Vishny (1997), Allen et al. (2000), largest institutional investors are better able to monitor the company's management compared to smaller institutional investors. The proprietary spread of the institutional investors could also lead to less control on management if there is the lavish, broad and uncoordinated spread of institutional investors. Similarly, the size of institutionally held ownership could also impact on the influence of institutional investors. Higher institutional ownership guarantees more efficient utilization of assets of the company with greater institutional ownership outstanding ability to monitor management and vice-versa.

Furthermore, the characteristics of institutional investor also affect the impact of institutional ownership on earning management. Such characteristic of the institutional investor includes sensitivity. According to Chen et al. (2007), there are two types of institutional investor, long-term, and short-term investor, and that two types of investor have a different characteristic with varying level of sensitivity. Wahab et al. (2007) identify insensitive investor (that do not have any business relationship with the firm as pressure) and sensitive investors (investors who do have business relationships). Sensitive investors will monitor the company better than the insensitive investor. Thus, the earnings management would be higher if the institutional ownership is held by insensitive investors, and will decrease if owned by sensitive investors. There are possibilities that the difference with the previous studies is due to differences in the characteristics of institutional investors which this study did not distinguish. Therefore, the causes of the variance of the results of this study with previous research may be due to the different types of institutional investors.

The regression results as shown in Table 5 for hypothesis H2a indicate that beta coefficient, t-value, and P-the value of CR on DCAA are equal to 0.084, 3.140 and 0.011 respectively, which indicate significantly and have a positive sign. The meaningful and positive beta sign means that the higher control rights, the lower earnings management. Accordingly, hypothesis H2a was accepted. This means that the higher control rights of controlling shareholders, the higher earnings management. These findings are in agreement with Sanjaya (2010) and Ratnawati and Abdul-Hamid (2015).

Regarding hypothesis H2b which stated that cash flow rights have a negative influence on earnings management. The Beta

Figure 2: Heteroscedasticity testing of the study

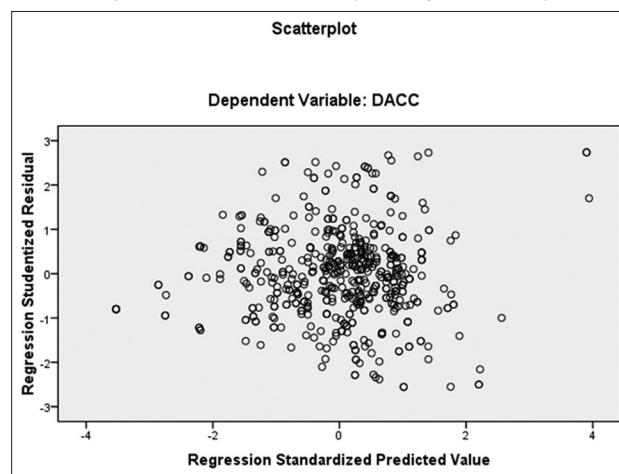


Table 4: Regression results

Model	Beta	t-value	Significant
MgrOwn	-0.066	-7.541	0.000
InsOwn	0.019	2.552	0.011
CR	0.084	3.140	0.002
CFR	-0.040	-2.886	0.004
CFRLev	0.079	-4.722	0.000

Dependent variable: DACC. DACC: Discretionary accrual, MgrOwn: Managerial ownership, InstOwn: Institutional ownership, CR: Control right, CFR: Cash flow rights, CFRLev: Cash flow rights leverage

coefficient, t-value, and P-value for hypothesis H2b are 0.040, -2.886 and 0.004 respectively, which means that cash flow leverage affects earnings management negatively. The negative sign indicates that the greater cash flow rights, the smaller earnings management. Based on that finding, hypothesis H2b was accepted. Thus, if cash flow rights of controlling shareholders are more than his control rights, it will reduce earnings management practices. These findings are supported by previous studies of Sanjaya (2010), and Ratnawati and Abdul-Hamid (2015).

Lastly, the results of hypothesis H2c, which states that cash flow right leverage has a positive influence on earnings management showed beta value, t-value, and P-value of 0.079, 4.722 and 0.000 respectively, although the t-value is smaller than 1.965 and P-value maintain smaller value than 0.005, the beta value has a negative sign, so hypothesis H2c is not supported. This finding is in line with Ratnawati and Abdul-Hamid (2015), but contrary to Sanjaya (2010).

From the Table 5, it is also shown that the beta's value of MgrOwn, CR, and CFR each are -0.066, 0.084, and -0.040 respectively. It can be seen that CR has the highest beta value. The highest beta's value illustrated the agency conflict Type II is the most influential on the earnings management practice, compared to Type I agency conflict.

5. CONCLUSION AND IMPLICATION

The objective of this study is to provide empirical evidence of how agency Types I and II affect earnings management. In this study,

it was proposed that managerial ownership, control rights, and cash flow rights affect earnings management. Most importantly, this study found that institutional ownership and cash flow rights leverage has no relationship with earnings management. This finding also suggested that CR has the greatest beta value. Furthermore, the finding indicated that the agency conflict Type II has the largest influence on earnings management when compared to Type I agency conflict.

The results of this study could help institutions such as the Jakarta Stock Exchange and investors to know that companies in Indonesia, in general, have a pyramidal ownership structure. Hence, it is necessary to trace ownership until the end of the series. This is crucial so that users can get to know the actual performance of the company. Besides, from the theoretical aspect, these findings provide a better understanding of the agency theory more broadly vis-a-vis the relative impacts of Types I and II agency conflicts.

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