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INSTITUTIONAL OWNERSHIP AND EARNINGS OPACITY

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Abstract

The level of earnings opacity in Indonesia is very high. One cause of the high earnings opacity of a country is concentrated ownership (Anderson et al. 2006; Anderson et al. 2009). Most of single majority shareholders in Indonesia are institutions, including government, bank, insurance, pension, and mutual fund, thus, it is assumed that each kind of single majority shareholders has different motivation towards corporate earnings opacity level. Therefore, the purpose of this study is to test the effect of institutional ownership on earnings opacity. Sample of this study consists of all firms listed on Indonesia Stock Exchange in 2009-2013. Regression analysis test hypothesis is used in this study. This study builds an index to measure earnings opacity. The findings suggest that: (1) the higher concentrated ownership by government tends to have greater earnings opacity (2) the higher concentrated ownership by bank tends to have greater earnings opacity (3) firms with concentrated ownership by pension fund tends to have higher earnings opacity (4) firms with concentrated ownership by mutual fund tends to have higher earnings opacity.

Keywords: *earnings opacity, institutional ownership, government, bank, insurance, pension fund, mutual fund*

Introduction

In open economic era and free trading like now, foreign investors who will be investing in public company will consider the risk of information faced by them. One of the information risks is the high earnings opacity in public company in a country. Opaque earning is the earning that is not transparent, so it might increase the information risks borne by investors. Higher earnings opacity index of companies in a country may detain the flow of investment and foreign funding that may affect on social welfare of the country.

Based on the previous research, it shows that the level of company earnings opacity in Indonesia is very high, which is on the 32nd place from 34 countries (Bhattacharya et al., 2003). Therefore, it is important to conduct a study about factors affecting earnings opacity on public companies in Indonesia, which one of them is the high ownership concentration in Indonesia. Based on the previous research (Anderson et al. 2006; Anderson et al. 2009), family ownership affects on earnings opacity in public companies in America, so this study may broaden researches about the relationship of ownership structure and earnings opacity. Different with the previous research (Anderson et al. 2006; Anderson et al. 2009) this study tests the affect of

institutional ownership on earnings opacity. It is because the majority of companies in Indonesia has single majority shareholder that is institution. The previous studies about concentrated ownership in Indonesia among others are: (1) Siregar (2008) used sample of all companies listed on Indonesia Stock Index in 2000 – 2004, with control right cutoff of 50%. The level of public company ownership concentration in Indonesia was high, which was 68% of the sample. (2) Prabowo (2010) used the sample of all companies listed on Indonesia Stock Index (in exception of bank and finance). It found the evidence that companies that had controlling shareholders more than 50% was 70% of the sample. (3) Muazaroh and Lucyanda (2011) used the sample of manufacturing companies listed on Indonesia Stock Index in 2009, with dengan majority shareholder cutoff that had share directly was 50% or more. It found the evidence of ownership concentration average that was 65.8%.

This study is an advanced research from (2011) that tests factors affecting on earnings opacity of public company in Indonesia. The result of this study shows that a small company tends to have higher earnings opacity than a large company. It shows that the small company tries to cover corporate information from external parties in order to avoid unprofitable competition because it usually maximizes its position in competitive environment. The research result also shows that a company with concentrated ownership tends to have low earnings opacity level. It shows that the existence of majority shareholders in the company may add the function of corporate governance. Then, this study suggests that the existence of qualified auditor may also increase the effectivity of corporate governance in the transparency of corporate financial reports. Therefore, the research result is inconsistent with the research result of Anderson et al. in 2006 (Anderson et al. 2009), which is that the higher ownership concentration is, the higher earnings opacity level will be. It is because controlling shareholders will use corporate earnings opacity to get personal profit. Meanwhile, Zuhrohtun (2011) proved the opposite, that the existence of single majority shareholders actually reduces earnings opacity because it will conduct monitoring function, so it can replace the function of financial report transparency. Based on those matters, this study wants to retest the effect of share ownership on earnings opacity by identifying types of majority shareholders that mostly are institutions included in five groups which are government, bank, insurance, pension, and mutual funds. It is because each type of single majority shareholders has a different motivation on financial reporting policy, so it is predicted may affect earnings opacity level. Therefore, it is necessary to have empirical evidence whether types of institutional shareholders will affect earnings opacity level on public company in Indonesia. The finding suggest that the higher of concentrated ownership by government, bank, pension fund, and mutual fund will increase the level of earnings opacity. This study couldn't find evidence the effect of insurance company ownership on earnings opacity. The result of this study is expected to give input to Financial Services Authority (FSA) about the regulations regarding the importance of earnings transparency to protect minority shareholder.

Concentrated Ownership and Earnings Opacity

Some previous researches have proven that ownership concentration affects accountancy information quality. Claessens *et al.* (2000) has proven that most of company's shares in a country categorized by LaPorta *et al.* (1999) to have low investor protection level (such as Indonesia, The Phillipines, Korea, Japan, and Taiwan) are owned by family. According to Arping and Sautner (2010), CEO power can facilitate in preventing opaque information

environment for personal interest. CEO domination indicates how much the power of decision maker concentrated on the hand of CEO. Finkelstein (1992) identified four sources of CEO power, which are: structural power, ownership power, expert power, and perestige power. Anderson et al. (2006) suggested that family may create corporate opacity or still in the company because they are able to exploit the opacity to produce private profit on cost of majority investors.

Zuhrohtun (2011) tested factors affecting earnings opacity on public companies in Indonesia. The result of this research has proven that small company tends to have higher earnings opacity compared to larger company, that shows that small company tries to cover corporate information from external parties to avoid unprofitable competition because it usually tries to maximize its position in competitive environment. The research result also shows that a company with concentrated ownership tends to have low earnings opacity. It shows that the existence of majority shareholders in the company may add the function of corporate governance, especially in increasing corporate financial reporting transparency. This research then shows that the existence of qualified auditor is also able to increase the effectiveness of corporate governance in corporate financial reporting transparency policy. Single majority shareholders in Indonesia are institutions, including government, bank, insurance, pension, and mutual funds. Therefore, this research predicts that each single majority shareholders has different motivation on the level of corporate earnings opacity.

Cheng and Reitenga (2001) tested the effect of institutional investor size on management performance. The research differentiated between large/small institutional investors and active/passive institutional investors. They estimated that small institutional investors are encouraged to maximize short-term performance and encourage managers to increase current earnings. On the contrary, large institutional investors arrange important resources, collect information, and try to maximize corporate performance in the future. The power of disciplinary from the investors can be reached as long they are able to resist manager's decision. The research result implies that the existence of large active institutional investors in a company might limit manipulation of discretionary accruals when there is important difference between expected earnings and resulted earnings. Otherwise, they boost the increase of management profit with discretionary accruals when the company is under pressure on short-term earnings. Institutional investors will be neutral when the initial pressure on result is low.

Share Ownership by Government and Earnings Opacity

Government as a single majority shareholder is motivated to monitor company to achieve public purpose, which is social welfare (Shleiver & Visny, 1999; Eng & Mak, 2003) and add the function of corporate governance (Blanchard & Shleiver, 2000), so the existence of government can replace extensive disclosure in the company in order to increase earnings opacity. On the contrary, the existence of government in the company can sacrifice corporate wealth for political benefit (Wang & Sheiler, 2006), and achieve political purposes at the expense of social welfare (Bennedsen, 1999), so the company tends to use earnings opacity to cover its politician's relationship and interests. Because the legal enforcement in Indonesia is still low, it is predicted that the existence of government as single majority shareholders will increase earnings opacity, so the second hypothesis is as the following:

H1: The higher share ownership by the government will increase the level of earnings opacity

Share Ownership by Bank and Earnings Opacity

Bank will take credit decision based on the information from accountant. Based on this fact, corporate manager will be encouraged to manage result/performance of corporate finance as a signal of corporate quality towards bank. Baralexis (2004) states that company having financial needs, is encouraged to manage corporate financial performance. Somehow, when bank is the owner of the corporate capital, then, it will be more profitable to get relevant information source about corporate financial situation, so that the managers will conduct earnings management as the signal of their corporate capacity towards bank. Therefore, it is predicted that the existence of bank as single majority shareholder will increase earnings opacity, so the third hypothesis is as the following:

H2: The higher share ownership by bank will increase earnings opacity level.

Share Ownership by Insurance Company and Earnings Opacity

Insurance company might want to keep both existing business relation and potential relation with a company, so it is less encouraged to resist management decision. Insurance companies are usually named as grey institutional investors. They deal with high monitoring expenses because they may ruin the relationship with corporate management and lose business potential (Bricley et al., 1988). Therefore, it is suspected that they do not limit management discretion, so it will increase earnings opacity.

H3: The higher share ownership by insurance company will increase the level of earnings opacity

Share Ownership by Pension Fund and Earnings Opacity

Qiu (2004) suggests that pension fund controls corporate manager maneuver to protect their share ownership. Black (1990) states that pension fund is the most active institutional investor because of its importance of containment and independence towards its relationship with corporate manager. Contrary to investment fund that is oriented to the efforts in maximizing short-term earnings, pension fund is more interested in maximizing long-term earnings. Del Guercio and Tkac (2000) stated that pension fund is paid in its responsibility to be able to ensure the pension payment, so they try to encourage corporate manager to limit discretionary accruals management. Pension fund is affected by sponsor companies or state agency, and mutual fund, they do not want to offend their clients' companies, so it can be said that pension fund is controlled by corporate management. An institution selling product and financial services (such as bank and insurance) has urge to inactively resist a company that will be its potential client (Cox and Thomas, 2006). Therefore, it is predicted that the existence of pension fund as single majority shareholders will increase earnings opacity.

H4: The higher share ownership by pension fund will increase the level of earnings opacity

Share ownership by Mutual Fund and Earnings Opacity

Ramaswamy and Veliyath (2002) classified investment fund among rejections on pressures because this institution does not have business relation with corporate manager, and because of fiduciary responsibility to its customer, investment fund will limit manager discretion. Badrinath and Wahal (2002) stated that investment fund is usually more interested in investment in short-term project. Baysinger et al. (1991) stated that the fund is remunerated by manager based on quarterly performance, so the decrease of present performance is related to the fund cancellation

by administrator. The involvement of investment fund in corporate capital will encourage the action of earnings management. Thus, it is predicted that the existence of mutual fund as single majority shareholders will increase earnings opacity.

H5: The higher share ownership by mutual fund will increase the level of earnings opacity

Research Method

The research sample are 548 firms listed on the Indonesian Stock Exchange from 2009-2013 that issued yearly financial reports per 31 December. This research uses data pooling with the total observations are 2,740. This study omitted 367 hence the final observations are 2,373. The yearly financial reports were obtained from the Indonesian Stock Exchange. Meanwhile, trading volume and bid ask spread data were collected from Bloomberg.

Independent variables in this study are government ownership (GovOwn), bank ownership (BankOwn), insurance company ownership (InsuranceOwn), pension fund ownership (PensionOwn), mutual fund ownership (MutualOwn) and firm size (Size). Hence the dependent variable is earnings opacity index (Index_Op). The ownership is measured using the highest percentage of companies share that owned by institutional shareholder. Single majority Ownership is measured using dummy variable, 1 if , 0 otherwise (DsingleOwn). Firm size is proxied with natural log of total asset.

Earnings opacity is the earnings reported by firms that fail to provide information on the real economic earnings distribution (Bhattacharya et al., 2003). The earnings opacity in this study is measured by earnings opacity index established from two main elements of earnings opacity namely internal and external earnings opacity. Internal earnings opacity is measured by earnings aggressiveness and income smoothing. On the other hand, external earnings opacity is measured by bid-ask spread and trading volume. From those four measurement tools, earnings opacity index is established. This study categorizes all earnings opacity proxy into scales. The most opaque firms are graded 10 and the least opaque is graded 1. All four categories are added and scaled by factor 40 (the possible total value) to make index ranging from 0.1 to 1. The higher the index means the higher the earnings opacity. This index gives relatively robust measure from opacity because it calculates all earnings opacity measurement. This measurement is a modification from the opacity index from Anderson et al. (2009) and Bhattacharya et al. (2003).

The followings are the measurements from internal and external earnings opacity. Earnings aggressiveness (Bhattacharya et al., 2003) is calculated using scaled accruals. Scaled accruals are defined as:

$$ACC_{it} = (\Delta CA_{it} - \Delta CL_{it} - \Delta CASH_{it} + \Delta STD_{it} + \Delta DEP_{it} + \Delta TP_{it}) / TA_{t-1} \quad (1)$$

Notes:

ACC _{it} :	scaled accrual company i period t
ΔCA _{it} :	total change of assets company i period t
ΔCL _{it} :	change of current debt company i period t
ΔCASH _{it} :	change of cash of company i period t
ΔSTD _{it} :	change of long-term debt proportion included in short-term debt company i period t
DEP _{it} :	depreciation and amortization cost company i period t
ΔTP _{it} :	change of taxable income company i period t
TA _{it-1} :	total asset company i period t-1

Income smoothing, which is calculated using the correlation change in the accrual and cash flow from operation (Leuz et al., 2003), with the following formula:

$$PL_{it} = \rho [\Delta Acc, \Delta CFO] \quad (2)$$

Notes:

PL_{it} : income smoothing of company i period t
 ΔAcc_{it} : accrual change of company i period t
 ΔCFO_{it} : change of operational current cash of company i period t
 ρ : correlation level

External earnings opacity is developed from trading volume and bid-ask spread. Volume of share trading, is proxy of asymmetric information and uncertainty (Leuz and Verrecchia, 2000; Anderson et al., 2006), which is calculated by natural log of average volume of daily share trading during the fiscal year. Bid ask spread (Anderson et al., 2006) is the proxy of asymmetric information among investors. Bid ask spread is defined as follows:

$$Bid\ Ask\ Spread = (bid\ price - ask\ price) / average\ bid\ and\ ask\ price \quad (3)$$

The calculation for bid-ask spread is carried out by counting the average of all trade for each company every Wednesdays of the third week, then the result is calculated to find the mean during the year based on the 12 observations. Due to too many observations related to the share trade data, this research limits the analysis to a typical trade day of each month. The monthly data are then calculated for its mean every year. This study chooses the third Wednesday in each month to eliminate the loss of data because of holidays and to minimize the weekly effects.

This study uses multiple regression analysis with dummy variable as the additional analysis to test hypotheses. The regression model is:

$$Index_OP_{it} = \beta_0 + \beta_1 GovOwn_{it} + \beta_2 BankOwn_{it} + \beta_3 InsuranceOwn_{it} + \beta_4 PensionOwn_{it} + \beta_5 MutualOwn_{it} + \beta_6 DSingleOwn_{it} + \beta_7 Size_{it} + e \quad (4)$$

Notes:

$GovOwn_{it}$: the percentage of share that owned by government of company i period t
 $BankOwn_{it}$: the percentage of share that owned by bank of company i period t
 $InsuranceOwn_{it}$: the percentage of share that owned by insurance company of company i period t
 $PensionOwn_{it}$: the percentage of share that owned by pension fund of company i period t
 $MutualOwn_{it}$: the percentage of share that owned by mutual fund of company i period t
 $DSingleOwn_{it}$: dummy variable, 1 if the institutional ownership as a single majority ownership and 0 otherwise
 $Size_{it}$: total asset of company i period t

Analysis and Discussion

The hypothesis 1, 2, 3, 4, and 5 are test using multiple regression analysis (equation 4). The result is presented in Table 1.

Table 1 . Regression Analysis Result

$$Index_OP_{it} = \beta_0 + \beta_1 GovOwn_{it} + \beta_2 BankOwn_{it} + \beta_3 InsuranceOwn_{it} + \beta_4 PensionOwn_{it} + \beta_5 MutualOwn_{it} + \beta_6$$

$$DSingleOwn_{it} + \beta_7 Size_{it} + e$$

Variable	Coefficient	t-statistic
C		
GovOwn	0.414031	6.092322***
BankOwn	0.067185	2.200018**
InsuranceOwn	0.052449	-1.659810*
PensionOwn	-2.87E-05	0.602550
MutualOwn	0.000129	0.069330*
DSingleOwn	0.000131	0.526715*
Size	-0.000255	0.008750*
	-0.022215	-1.667060
N	2,373	
Adj R ²	0.062	
F-statistic	2.105**	

This table shows regression result for equation 4. Equation 4 contains 7 independent variables, which are government ownership (GovOwn), bank ownership (BankOwn), insurance company ownership (InsuranceOwn), pension fund ownership (PensionOwn), mutual fund ownership (MutualOwn), dummy variable *i* if the institutional ownership as single majority ownership, 0 otherwise (DSingleOwn) and firm size (Size). The dependent variable is Index_Op (an index developed by internal and external opacity). ***Statistically significant at the 1 percent level, **Statistically significant at the 5 percent level and *Statistically significant at the 10 percent level

Based on Table 1, GovOwn variable has positive coefficient 0.067185 and significant. It means the first hypothesis is supported. The higher share holder owned by government increase the earnings opacity. BankOwn variable also has a significant positive coefficient, 0.052449, thus the second hypothesis also supported. The higher bank ownership will increase the earnings opacity level of the firm. InsuranceOwn variable has a negative coefficient and not significant. It means that the third hypothesis is not supported. The insurance company become one of financial sector that face a high market competition, thus they have to maintain their relationship with manager to protect their business. This finding consistent with Bricley et al.(1988) that insurance company deal with high monitoring expenses because they may ruin the relationship with corporate management and lose business potential (Bricley et al., 1988). The PensionOwn variable has positive coefficient 0.000129 and significant. it means that hypothesis 4 is supported. The higher shareholder owned by pension fund increase the earnings opacity. The MutualOwn variable has positive coefficient 0.000131 and significant. Thus the last hypothesis is supported. The higher mutual fund ownership increase the earnings opacity level. The size variable has a negative coefficient -0.022215 but not significant. It indicates that size do not matter in earnings transparency decision of the firms. The dummy variable DsingleOwn has the coefficient of 0.116 and significant. This indicates that the earnings opacity level between firms that has institutional ownership as single majority ownership is different from that of non-single majority.

Conclusions

This study investigates the effect of institutional ownership on earnings opacity. The research result shows that majority share ownership by government will increase earnings opacity. It is because government as a majority shareholder is motivated to monitor the company to obtain

public purpose, which is social welfare (Shleiver & Visny, 1999; Eng & Mak, 2003) and to increase the function of corporate governance (Blanchard & Shleiver, 2000), so the existence of government can replace the extensive disclosure in the company to increase earnings opacity. Otherwise, the existence of government in the company may sacrifice the corporate wealth for political benefit (Wang & Sheiler, 2006), and to achieve political purpose at the expense of social welfare (Bennedsen, 1999), so the company tends to use earnings opacity to cover its political relation and interest.

This research result also proves that the higher share ownership by pension fund will increase the level of earnings opacity. It is because pension controls the maneuver of corporate manager to protect its share ownership. Moreover, pension fund is the most active institutional investor because its importance of containment and independence towards its relation with corporate manager. Contrary to investment fund that is oriented towards the efforts to maximize short-term earnings, pension fund is more interested in maximizing long-term earnings (Qiu, 2004; Black, 1990). The higher share ownership by mutual funds is also increase the earnings opacity level. It is in accordance with Badrinath and Wahal (2002) stating that investment fund is usually more interested in short-term project, so they are encouraged to exploit the earnings opacity for their private benefit.

Majority ownership by Bank is also proven will increase earnings opacity. It is in accordance with Baralexis (2004) stating that company having financial needs is motivated to manage the result of corporate financial performance. However, when bank is the owner of corporate capital, it will be more profitable to get relevant information source about corporate financial situation. Therefore, managers will conduct earnings opacity as the signal of their corporate capacity towards bank. This study doesn't find that insurance company ownership affect the earnings opacity. This finding support Bricley et al. (1988) insurance company might want to keep both existing business relation and potential relation with a company, so it is less encouraged to resist management decision in financial reporting decision. The result also shows that a company with concentrated ownership tends to have low earnings opacity. It is shows that the existence of majority shareholder in the company may increase the function of corporate governance, especially in increasing corporate financial report transparency. This study use dummy variable to control the single majority ownership. The future research should develop sub sample based on the type of institutional ownership, so the relative opacity level that compared to each sub sample can be known. This study also use immediate ownership to measure the institutional ownership structure. Future research could use ultimate ownership to trace the institutional ownership as controlling shareholder.

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