

**THE INFLUENCE OF EARNINGS QUALITY IN  
INSTITUTIONAL INVESTORS' DECISION  
MAKING IN INDONESIAN FAMILY OWNED  
BUSINESS**

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**THE INFLUENCE OF EARNINGS QUALITY IN  
INSTITUTIONAL INVESTORS' DECISION-  
MAKING IN INDONESIAN FAMILY OWNED  
BUSINESS**

by

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## **LIST OF ABBREVIATIONS**

ADB	Asian Development Bank
APB	Accounting Principles Board
ASEAN	Association of South East Asia Nation
BAPEPAM	Badan Pengawas Pasar Modal
BAPEPAM LK	Badan Pengawas Pasar Modal & Lembaga Keuangan
DJLK	Direktorat Jenderal Lembaga Keuangan
ERC	Earnings Response Coefficient
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GNP	Gross National Product
GSE	Ghana Stock Exchange
IAI	Ikatan Akuntan Indonesia
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IBRA	Indonesian Bank Restructuring Agency
IDX	Indonesian Stock Exchange
IFRS	International Financial Reporting Standards
IHSG	Index Harga Saham Gabungan
JATS	Jakarta Automatic Trading System
JCI	Jakarta Composite Index

JSX	Jakarta Stock Exchange
NCCG	National Committee on Corporate Governance
OJK	Otoritas Jasa Keuangan
PAKTO	Paket 27 Oktober 1988
PSAK	Pernyataan Standar Akuntansi Keuangan
SEC	Securities and Exchange Commission
SFAC	Statement of Financial Accounting Concepts
SOE	State-Owned Enterprise
SSX	Surabaya Stock Exchange
VOC	Vereenigde Oostindische Compagnie

**PENGARUH KUALITI PENDAPATAN DALAM MEMBUAT KEPUTUSAN  
INSTITUSI PELABURAN TERHADAP PERNIAGAAN MILIK FAMILI DI  
INDONESIA**

**ABSTRAK**

Ramai pelabur menganggap pendapatan adalah kriteria terpenting dalam menilai sesuatu saham. Walau bagaimanapun, bagi memenuhi jangkaan pendapatan pelabur, pengurus boleh memanipulasi pendapatan dengan menggunakan kaedah perakaunan tertentu yang dilaporkan tanpa melanggar Prinsip Perakaunan yang di terima Umum (GAAP). Bagi mengelak pelabur dari tingkah laku oportunistik pengurus firma, pelabur boleh bergantung kepada kualiti pendapatan. Kualiti pendapatan yang tinggi merupakan asas operasi firma itu sendiri. Kedua-dua ciri utama kualiti pendapatan yang lebih tinggi adalah berkait rapat dan kebolehpercayaan. Kajian ini dijalankan untuk mengkaji hubungan di antara kualiti pendapatan dengan keputusan pelabur untuk membeli dan menjual saham syarikat yang dimiliki oleh famili di Indonesia. Kaedah Regresi Logistik digunakan untuk menganalisis hubungan diantara kedua-dua pembolehubah tersebut. Analisis kajian ini berdasarkan kepada sampel pada tahun 2000 hingga tahun 2009 yang meliputi 1,450 firma tahun pemerhatian untuk menilai kualiti pendapatan manakala sampel pada tahun 2007 hingga tahun 2010 yang meliputi 50,688 firma tahun pemerhatian untuk membuat keputusan pelabur. Hasil kajian menunjukkan bahawa terdapat hubungan yang signifikan di antara kualiti laba yang di percayai dengan keputusan pelabur untuk membeli dan menjual saham syarikat yang dimiliki oleh famili di Indonesia. Kajian ini gagal membuktikan hubungan di antara keputusan pelabur

untuk membeli dan menjual saham dengan kualiti pendapatan tersebut. Kualiti pendapatan dipercayai dapat mengurangkan ralat pengukuran dengan magnitude ralat yang dianggarkan dengan akruan. Kualiti pendapatan yang berkaitan adalah bukan penentu keputusan pelabur kerana pengurangan semasa untuk meramalkan aliran tunai. Ini disebabkan oleh turun naik akruan. Secara keseluruhannya, kualiti pendapatan dipercayai lebih penting daripada kualiti pendapatan berkaitan untuk pelabur dalam membuat keputusan kerana matlamat pelabur adalah untuk memaksimumkan pulangan di luar jangkaan mereka di mana dapat mengurangkan risiko yang berkaitan. Walau bagaimanapun, nilai penentu pekali di selaraskan bagi model keputusan pembelian dan penjualan saham adalah rendah (antara 12.7 peratus dan 13.6 peratus). Oleh itu, untuk menganalisis tingkah laku pelabur dalam membuat keputusan, kajian ini perlu dibangunkan dengan pembolehubah pada spektrum yang lebih luas dari kualiti pendapatan seperti maklumat bukan kewangan, keuntungan modal jangka pendek dan kecenderungan untuk menjadi spekulasi atau tidak rasional bagi acara yang luar biasa.

**THE INFLUENCE OF EARNINGS QUALITY IN INSTITUTIONAL  
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**ABSTRACT**

Earnings are considered by many investors to be the important criteria to assess the stock. However, to meet investors' earnings expectations manager could manipulate reported earnings by using specific accounting methods without violating Generally Accepted Accounting Principles (GAAP). To avoid investors from the opportunistic behavior of firms' managers, Investors can rely on earnings quality. Higher earnings quality represents the operating fundamentals of the firm. The two primary characteristics of higher earnings quality are relevance and reliability. This study examines the relationship between earnings quality and investors' decision of buying and selling Indonesian family firms' stock. Logistic regression was used to analyze the relationship. The analysis of this study is based on a sample from 2000 to 2009 which covers 1450 firm-years observations for earnings quality value and sample from 2007–2010 which covers 50,688 observations for investors' decision making. The result shows that there is a significant relationship between reliable earnings quality and investors' decision to buy and sell family firms' stock. This study failed to prove the relationship between the investor's decision to buy or sell stock and relevant earnings quality. Reliable earnings quality assists investors' decision making because reliable earnings quality emphasizes reducing measurement error by the magnitude of estimation error in accrual. Relevant earnings quality is not a determinant of investors'

decision because those current earnings understate to predict cash flow. This is due to the accrual volatility. Overall, it is concluded that reliable earnings quality is more important than relevant earnings quality for investors in decision-making, because the goal of investors is to maximize their expected return due to reducing its related risks. However, the adjusted coefficient determination of of buy decision model and sell decision model are very low (between 12.7 and 13.6 percent). Therefore, further research on behavior of investors' decision-making should be developed with a variable on a broader spectrum of earnings quality such as non-financial information, short term capital gains and tend to be speculative or irrational for unusual events.

# **CHAPTER 1**

## **INTRODUCTION**

### **1.1 Preamble**

In recent years, the prevalence of investing in the stock markets increased around the world (Markku, 2006). This also happened in Indonesia, where the tendency to invest is increasing. According to the Asian Development Bank (2009), in 2007, the Indonesian market capitalization increased by 59.18 percent to Rupiah (Rp) 1,988.33 trillion (USD 207,767 million) which equalled to 49.01 percent of the Gross Domestic Product (GDP). At the end of 2008, the stock market capitalization declined by almost half, at Rp 1,076 trillion (USD \$ 112,435 million) which equalled to 19.34 percent of the GDP, because of the global financial crisis. In 2009, the stock market capitalization increased to Rp 1,847.63 trillion (USD 178,190 million), which equalled to 32.98 percent of the GDP.

The finance theory suggests that investors used expected future cash flows to value stocks. Investors often relied on reported earnings to help them to estimate future cash flows (Salavei, 2009). As a result, investors devoted a great deal of attention to firms' reported earnings. News that a firm has fallen short of earnings expectations could immediately send its stock price plummeting. Firms that beat expectations, on the other hand, were handsomely rewarded by investors (Chan, 2001).

Nevertheless, managers could mislead investors about the underlying strength of the firms. As a primary motive, a firm's manager has to manipulate reported earnings to influence investors' perceptions of the firm's value (Fischer and Stocken, 2004). Generally, there have been growing concern about firms' earnings quality or the extent to which reported earnings reflect operating fundamentals. From investors' perspective, low quality earnings indicate a defective resource allocation signal. In other words, low quality earnings are inefficient because they reduce economic growth by causing capital to be misallocated (Schipper and Vincent, 2003).

Dechow, Ge, and Schrand (2010) defined higher earnings quality as earnings that provide more information about features of a firm's performance relevant to a specific decision made by a specific decision maker. There are three features in this definition. Firstly, earnings quality is conditional on the decision relevance of information. Secondly, the quality of reported earnings number depends on whether it is informative about the firm's financial performance, many aspects of which are unobservable. Thirdly, earnings quality is jointly determined by the relevance of the firms' underlying performance to the decision and by the ability of the accounting system to measure performance.

Barua (2006) used qualitative characteristics, relevance and reliability, of financial statement information specified in the Statement of Financial Accounting Concepts (SFAC) No. 2 (Financial Accounting Standard Board, (FASB) 1980) to measure the quality of earnings.



Relevance is related to the metric timeliness and has predictive power. In order to be relevant, the information must be timely and must have predictive value or feedback value or both. According to Basu (1997) timeliness reflects the ability of accounting earnings to differentially reflect economic losses (measured as negative stock returns) and economic gains (measured as positive stock returns). The predictive value of earnings is motivated by the assumption that more persistent earnings will yield better inputs to equity valuation models (Dechow et al., 2010).

Meanwhile, reliability constitutes a metric that is verifiable, free from error or bias and accurately represents the transaction. To be reliable, information must have representational faithfulness and be neutral. Neutrality is the absence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behavior. Earnings can reflect neutrality if managers faithfully report earnings, then the earnings number would be devoid of bias (Velury and Jenkins, 2006). Representational faithfulness is the correspondence or agreement between a measure or description and the phenomenon that it purports to represent. According to Ball and Brown (1968), earnings are a summary of events that affect the firm over the fiscal period during which the report is prepared. Similarly, returns capture financial market changes in firm value during that same period. Representational faithfulness of earnings numbers can be examined by examining the association between earnings and stock market returns (Velury and Jenkins, 2006).

Capital markets developed rules, regulations and additional mechanisms to ensure protection for capital providers, such as financial institutions, investors and stockholders, considered as corporate governance systems (Hart, 1995). Corporate governance deals with the mechanisms that ensure that investors in corporations get a return on their investments (Shleifer and Vishny, 1997). Bushman, Qi, Engel, and Smith (2004) defined corporate governance as a set of internal and external mechanisms to avoid stockholders' expropriation by managers, to improve earnings quality and to protect the returns of capital borrowed by lenders. Thus, corporate governance has the capacity to improve the reliability of accounting earnings, increases the informativeness of accounting earnings and therefore improves capital market efficiency (Ewert and Wagenhofer, 2010).

In Indonesia, *The National Committee on Corporate Governance* (NCCG) which was established by Decree of the Coordinating Minister for Economy, Finance and Industry Number: KEP/31/M.EKUI/08/1999, issued the first Code of Good Corporate Governance in 1999. The Code was revised several times the latest being the 2006 Code revision of the previous Code of 2001. The purpose of this Code is to maximize corporate and stockholders value by enhancing transparency, responsibility, fairness in order to strengthen the firm's competitive position both domestically and internationally as well as to create a sound environment to support investment.

In 2010, a survey of corporate governance standards conducted by Gill, Allen, and Powell stated that Indonesia was ranked 10 out of 11 countries with a score of 40 which

was considered low level of corporate governance standard. In the first rank was Singapore followed by Hong Kong and Japan which received 67, 65, 57 scores respectively. Unfortunately, Indonesia's score reflected that there was little progress in the movement of corporate governance in the country which did not bring a significant alteration for Indonesian firms.

Lower levels of corporate governance reduce investors' perception of the reliability of a firm's performance, as measured by earnings. Therefore, in Indonesia, information regarding earnings quality is very important for investors to make decisions, because a majority of publicly listed companies in Indonesian capital market suffer from lower level of corporate governance. Lower level corporate governance could cause the lack of its level of information disclosure, asymmetric information, control problems and the expropriation of minority stockholders (Grishchenko, Litov, and Mei, 2006). The World Bank (2004) stated that Indonesia's business culture is based on relationships rather than rules, largely due to high incidence of concentrated ownership, family-owned businesses and controlling stockholders.

## **1.2 Background of Studies**

According to Claessens and Fan (2002), there is extensive family control in more than half of East Asian firms, such as those in Indonesia, Malaysia, Philippines, Singapore, Thailand, Japan, Hong Kong, Korea and Taiwan. Firms in Indonesia have the same pattern with firms in Malaysia, Philippines, Singapore and Thailand, where many large

firms are controlled by families. On the other hand, in Japan, Hong Kong, Korea and Taiwan, there exists family control in many small firms. Indonesia stands out with the largest number of firms controlled by a single family; of more than four in average. Japan has the fewest, with each family controlling approximately one firm only.

At one extreme, 16.6 percent and 17.1 percent of the total value of listed firms' assets in Indonesia and the Philippines, respectively, can be traced to the ultimate control of a single family. The largest ten families in Indonesia, the Philippines and Thailand control half of the firms' assets, while the largest ten families in Hong Kong and Korea control about a third of the corporate sector. The exception is Japan, where family control is insignificant. Across the nine East Asian countries, Japan has ownership by financial institutions of 38.5 percent while another 41.9 percent of corporations are widely held. At the other extreme, Indonesia has more than two-thirds (67.1 percent) of its publicly listed firms in family hands and only 0.6 percent are widely held <sup>1</sup>.

In 2013, the majority firms in Indonesia still are family firms (65.35 percent) followed by foreign ownership firms (19.80 percent) and State Owned Enterprise (11.8 percent). Widely held firms and financial institution controlled firms are less common, with 1.98 and 0.99 percent of Indonesian firms respectively (Darmadi and Gunawan, 2013).

According to Tabalujan (2002), in the Indonesian corporate context, family is important. Studies by Zhuang (2000) and Fitzpatrick (2000) revealed that a large

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<sup>1</sup>firm held is widely if there is no controlling blockholder who owns more than 20% of the votes (La Porta et al., 1999)

proportion of aggregate Indonesian economic activities revolved around firms controlled by a small group of wealthy and powerful families. The values and culture of these families, therefore, presumably affect how their firms are run and indirectly, how Indonesian firms are run.

Based on the *Indonesian Stock Exchange* Report (2010), these family firms are included in the group of LQ 45. The LQ 45 index (Indonesian Stock Exchange) consists of 45 firms that fulfil certain criteria, which are being included in the top 60 firms with the highest transaction value in the regular market in the last 12 months; have been listed in the Indonesian Stock Exchange for at least 3 months; have good financial conditions; prospects of growth and high transaction value frequency.

In contrast to other types of ownership, family firms could affect the supply of quality financial reporting in one of two competing ways: the alignment effect and the entrenchment effect (Shleifer and Vishny, 1997; Villalonga and Amit, 2006; Wang, 2006). According to Wang (2006), the alignment effect occurs because families' firms have incentive to produce higher quality earnings. The alignment effect implies that controlling stockholders are less likely to engage in opportunistic behavior in reporting accounting earnings in order to avoid potential damage to the family's reputation, wealth and long term firm performance.

Wang (2006) stated that the entrenchment effect views that corporate governance of family firms might be poor because important positions on both the management team

and the board are held by family members. As a result, monitoring by the board may be ineffective. Concentrated ownership enables controlling stockholders to determine how profits are distributed among stockholders and motivates controlling stockholders to expropriate wealth from other stockholders that lead to greater information asymmetry between controlling stockholders and minority stockholders. Information asymmetry decreases the transparency of accounting disclosures. As a result, family members have the opportunity to manipulate accounting earnings. Therefore, the entrenchment effect causes lower quality earnings.

Earnings quality is important to evaluate an entity's financial health. According to Bellovary (2005), earnings quality reflects the firm's true earnings, as well as the usefulness of reported earnings to predict future earnings. To measure earnings quality, qualitative characteristics of financial statement information is used. This characteristic is specified in the Statement of Financial Accounting Concepts (SFAC) No. 2 (FASB 1980) which stated that relevance and reliability are the two primary qualities that make accounting information useful for decision-making.

Relevant earnings quality assists investors in making decisions to buy and sell stock. The firm that has a commitment of timely reporting of low realizations leads to full disclosure of information which reduces the uncertainties about expected future cash flows (Sujis, 2008).

Reliable earnings quality emphasizes on reducing measurement error caused by discretionary accruals, so that investors find these earnings useful and reflect the information contained in returns. If managers use their discretion to opportunistically manipulate accruals, earnings will become a low earnings quality. Earnings then become less reliable to measure the firm's performance. Therefore, stock prices or returns do not fully reflect information in accruals and cash flows about future earnings (Dechow, 1994). Lev (2002) argued that the stocks of firms with low quality of earnings appeared to be properly priced, as evidenced by the absence of subsequent abnormal returns, while the stocks of firms with a high quality of earnings were systematically undervalued, as evidenced by the existence of positive abnormal returns.

### **1.3 Problem Statement**

Financial reporting should be able to present useful information to help investors to make decisions. Usefulness to decision-making is by providing the information that users need. The quality of financial report is determined by its ability to capture the information of future prospects based on current information (Wahlen, Stickney, Baginski and Bradshaw, 2006). The accounting earnings is the most important element because of its ability to forecast the company's future cash flows. The key to insurance of the company's future cash flows is higher quality of earnings (Mulford and Yom, 2012).

However, in Indonesia, the capability of financial reporting to provide sufficient and appropriate information to help users to make decisions is questionable. In Indonesia,

pressure for improvement of financial reporting practice grows in the wake of a series of financial reporting scandals. These scandals show the companies' failure in providing accurate information for investors. That made investors wonder about the quality of corporate financial reports, especially the quality of earnings (Chariri, 2009).

One of the scandals involved a family firm, Barito Pacific Timber, which decided to go public in 1993. Barito's float was dogged by widespread concerns about the firm's entrenchment effect (Rosser, 1999). The entrenchment effect was based on the argument that concentrated ownership enabled controlling stockholders to maximise their private benefits, at the expense of other shareholders. The firm maintained the funds and channelled them to other firms within the same group. This expropriation is called tunnelling (Bhaumik and Gregoriou, 2009).

Barito injected funds in the form of loans into Chandra Asri, a dubious petrochemical joint venture owned by Barito's boss, Prajogo Pangestu. This tunnelling took the form of expropriation of cash flows that lowered the quality of earnings. The tunnelling process has implications for the earnings statement and it could significantly affect a firm's long-term ability to generate cash flows because of the issue of loans to the families that would not have to be repaid if the associated business venture is unsuccessful (Bhaumik and Gregoriou, 2009).

Another case of misleading financial reporting was that of Lippo Group, which published two different financial reports to the public and to *Badan Pengawas Pasar*



*Modal (BAPEPAM)* in 2002, although the firm had an independent board of directors and audit committee. In the first financial report, the Lippo Group claimed a net profit of Rp 98 billion. A month later, the group had to release a second financial report, telling the *Jakarta Stock Exchange (JSX)* that the earlier report was all a mistake and that they had, in fact, posted a loss of Rp 1.27 trillion. BAPEPAM imposed an administrative sanction on the board of directors over misleading statements in the first financial report (Guerin, 2003).

In 2010, BAPEPAM levied its heaviest sanctions on three firms owned by the Bakrie Group - the holding firm PT Bakrie and Brothers Tbk, its subsidiary PT Bakrie Sumatra Plantations Tbk and its affiliated unit, PT Energi Mega Persada Tbk and an unaffiliated oil and gas firm PT Benakat Petroleum Energy Tbk for publishing false information on the amount of their deposits at a local bank (Guerin, 2003).

The penalties were given because the firms failed to meet deadlines to provide documentation to clarify the status of their deposits. This finding was identified by the *Indonesian Stock Exchange*. The statements reported that the Bakrie firms had Rp 9.05 trillion (about US\$1 billion) invested in time deposits at Bank Capital. However, the bank's first quarter financial reports indicated that its total deposit was only Rp 2.69 trillion, of which Rp 2.17 trillion was in time deposits. Thus, there was a seven trillion rupiah discrepancy between these reports (Simanjuntak, 2010).

The restatement of financial reports by Lippo and the mistakes of financial reporting by Bakrie Group were caused by the managers' opportunistic behavior using unacceptable methods, estimates or other intentional errors that influenced the earnings statement (Callen, Livnat and Segal, 2005). The Accounting Principles Board (APB), 1971, Opinion No. 20, states that restatement involves the changes in accounting principles and accounting errors. The situations which change in accounting principles are: changes in inventory valuation methods; changes in the method of accounting for long-term construction-type contracts; changes to or from the full-cost method of accounting in the extractive industries; issuance of financial statements by a company for the first time to obtain additional equity capital, to effect a business combination or to register securities. The restatement is caused by accounting errors involving mathematical mistakes, oversights, changes from accounting principles that are not in accordance with Generally Accepted Accounting principles (GAAP) and changes in estimates not prepared in good faith, misuse of facts as well as misclassifications.

Accounting restatements lead to lower earnings quality because the restatement affects the past time series of earnings, downward revisions in future expected earnings. Thus, firm value tends to decrease simply because the expected stream of future cash flows is lower (Callen et al., 2005).

A common aspect characterizing the main scandals is the relevance and reliability of a firm's reporting failure, as shown by the willingness of the firm's managers to divert firm funds to private uses and make the restatement of financial reporting. This

causes investors' confidence in the quality of corporate financial reporting to be seriously damaged (Tiscini and Donato, 2006).

The financial reporting scandals occurred because companies do not abide by the Indonesian rules, such as accounting standards, company law and the Code of Good Corporate Governance. The Indonesia's accounting standards called *Pernyataan Standard Akuntansi Keuangan* (PSAK) adopted the International Accounting Standards. These rules were released by the Accounting Standards Committee of the Indonesian Institute of Accountants in 1994. The company law No 40/2007 was issued by the government in 2007. This company law replaced the Company Law No 1/1995 which was translated from the Dutch commercial laws. The Code of Good Corporate Governance was released by the National Committee on Corporate Governance (NCCG) in 1999, completed in March 2000 and revised in 2006. This code is guidance for companies in running a transparent, responsible, accountable and fair business (Chariri, 2009).

In Indonesia, although there are regulatory bodies, they are not able to ensure the quality of financial reporting because the law enforcement is weak (Asian Development Bank, 2002). The weak law enforcement allowed some companies to make and use their own systems, which often ignore the principles of corporate governance and ethics. It can be said that the commitment to quality financial reporting and regulatory compliance is determined by the companies themselves in their own cultural ethics (Chariri, 2009).

The above discussions attest that in Indonesia, there are some financial scandals involving family firms. This happens because of weak law enforcement and firms could prepare the financial statements based on their own culture and ethics. The quality of the financial statement becomes inadequate to help investors to make decision. Managers could mislead investors about the underlying strength of the company with opportunistic earnings manipulation. For Indonesian investors, knowledge of relevance of earnings quality and reliable information is needed. Relevant earnings show that earnings are asymmetric timeliness of loss recognition commitment to timely reporting of low realizations that leads to full disclosure of information. It could increase the precision of accounting information to assess the firms' futures. Reliable quality earnings emphasize on the reducing of measurement error by the magnitude of estimation error in accruals. The accrual earnings could provide information on the returns. Therefore, this study develops a link between earnings quality and investors' decision of buying and selling Indonesian family firms' stock.

#### **1.4 Research Questions**

The research questions for this study are:

1. Is investor's decision to buy Indonesian family firms' stocks positively associated with relevant earnings quality?
2. Is investor's decision to sell Indonesian family firms' stocks positively associated with irrelevant earnings quality?

3. Is investor's decision to buy Indonesian family firms' stocks positively associated with reliable earnings quality?
4. Is investor's decision to sell Indonesian family firms' stocks positively associated with unreliable earnings quality?

### **1.5 Research Objectives**

The objectives of this study are:

1. To study the influence of relevant earnings quality on the investors' decision to buy Indonesian family firms' stocks.
2. To study the influence of reliable earnings quality on the investors' decision to buy Indonesian family firms' stocks.
3. To study the influence of relevant earnings quality on the investors' decision to sell Indonesian family firms' stocks.
4. To study the influence of reliable earnings quality on the investors' decision to sell Indonesian family firms' stocks.

### **1.6 Contribution of study**

This study provides empirical evidence about the usefulness of earnings quality for investors' decision-making. The results from this study would improve investors' decision-making process, especially for the uninformed investors. The usefulness of earnings quality for investors' decision-making will make managers aware of a number

of factors related to earnings quality. These factors may affect investors' perception of the quality of earnings. Managers must also consider the trade-off between improvements in reported earnings and a possible negative perception of earnings quality if the improvements in earnings are perceived to have resulted in lower earnings quality. Managers should be held accountable for making an assertion about the firm's quality of earnings. Higher disclosure about earnings quality could reduce the costs of processing the firms' specific public information. Therefore, higher disclosure about earnings quality will induce more trading in the firms' stocks by uninformed investors.

### **1.7 Outline of the Remaining Chapters**

The remaining chapters are organised as follows. Chapter 2 outlines the institutional setting in Indonesia, focusing on the Indonesian capital market, firms' rules and regulation as well as Indonesian family firms. Chapter 3 summarises the relevant past researches on earnings quality and investor decision-making. The main hypotheses are developed in Chapter 4. Chapter 5 discusses the research methods. The result and discussion of findings are described in chapter 6. In chapter 7, the conclusions and the limitations and suggestions for future research are mentioned.

## **CHAPTER 2**

### **BACKGROUND OF FAMILY OWNED FIRMS IN INDONESIA, INDONESIA CAPITAL MARKET AND LEGISLATION**

#### **2.1 Introduction**

This chapter explains about Indonesia's institutional setting. Section 2.2 discusses the background of family owned firms in Indonesia. Section 2.3 discusses the development of the Indonesian Capital Market while the Indonesian rules and regulations are discussed in section 2.4, and Summary in section 2.5.

#### **2.2 Background of Family Owned Firms in Indonesia**

Indonesian firms' ownership are classified family firms, and non family firms. The non family firms include foreign-controlled firms, State Owned Enterprise, widely held firms and financial institution-controlled firms (Darmadi and Gunawan, 2013).

##### **2.2.1 Indonesian Family Owned Firms**

Family firm is defined as a business that is owned and or managed (controlled) by one or more family members (Handler ,1989). Indonesia has the largest number of companies controlled by a single family (Claessens, Djankov, Fan, and Lang, 1999). These family firms contribute greatly to the Gross National Product (GNP). According to Badan Pusat Statistik Indonesia or the Indonesian Central Agency on Statistics

(2011), the family firms contribute to the formation of 53.28 percent of GNP. In terms of capitalization, the top family controls 16.6 percent of total market capitalization while the top 15 families control 61.7 percent of the market (Husnan, 2001). This was confirmed in the Claessens et al. (1999) study, which showed that in 1996, two thirds (67.1 percent) of Indonesian publicly listed companies were in family hands, and only 0.6 percent widely held. These figures suggested that Indonesian companies had highly concentrated ownership structures, particularly in the form of family ownership.

In Indonesia, around 80 percent of large companies have business groups dominated by families (Susanto, 2005). Indonesian business groups (conglomerates) range widely in size, scope, importance, nature and degree of political connections. Some business group leaders were cronies of the Suharto<sup>2</sup> regime, corruptly receiving very valuable special economic benefits and privileges, such as borrowing beyond the legal limits of their affiliated banks. Suharto stimulated some of these business groups because they could be useful in the development of the country, as well as for private and political reasons. Some were closely connected to Suharto himself, such as Bob Hasan,<sup>3</sup> who had

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<sup>2</sup>Suharto (1921-2008) was an army officer and political leader who was president of Indonesia from 1967 to 1998. Suharto and Liem Sioe Liong's first major money-makers were the giant Bogasari flour mills in Jakarta and Surabaya, set up in 1971-1972). The lucrative west Indonesian market, which consumed 80 percent of the flour, became Bogasari's monopoly. 32 years in power, the Suharto's family controlled at least 20 foundations with own stakes in numerous large firms, including cement factories, fertiliser factories, toll roads, timber concessions, oil palm plantations and many others.

<sup>3</sup>Bob Hasan (born 1931) is an [Indonesian](#) businessman and friend of former [president of Indonesia, Suharto](#). After Suharto took the presidency in 1966, he initiated a massive expansion of Indonesian commercial logging, especially in the islands outside of [Java](#). In 1981 Hasan was a major stockholder in the timber firm, Georgia Pacific's Indonesia. Starting from timber, he expanded his business interests into financial, insurance, automotive and other industries, primarily through his Kalimantan [holding company](#).



large timber concessions and Liem SioeLiong,<sup>4</sup> whose Salim Group became the largest diversified group in Indonesia (Patrick, 2001).

Other family business groups built their fortunes on local products, such as the tobacco-based Sampoerna and Gudang Garam groups and yet others manufactured in partnership with foreign firms, such as the Astra automotive firm. Other groups exploited Indonesia's rich resources or its rich land, such as the Raja Garuda Mas and Sinar Mas groups, active in wood, palm oil and other interests. Two large groups were led by Suharto's children, namely Tommy Suharto's<sup>5</sup> Humpuss Group and Bambang Trihatmodjo's<sup>6</sup> Bimantara Group. Of the 20 most prominent business groups in the late 1990s, a large majority only emerged in the Suharto era (Dieleman, 2008). In 1996, family business groups controlled 61.1 percent of all publicly listed companies, while other families controlled another 5.4 percent. The Suharto family was the largest group;

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<sup>4</sup>LiemSioeLiong (born in 1916) was a [Chinese Indonesian](#) businessman. He was the head of the conglomerate [Salim Group](#). The Salim Group is [Indonesia's](#) biggest [conglomerate](#) with assets including [Indofood Sukses Makmur](#), the world's largest [instant noodle](#) producer, and Bogasari, a large [flour](#)-milling operation. The Salim Group also owns major [oil palm plantations](#), logging concessions and has been involved in Property Development and Leisure Industry for around 30 years. The businesses include hotel and resort development, golf courses, real estates, commercial buildings, shopping centers and industrial estates.

<sup>5</sup>Tommy Suharto (born in 1962) is the youngest son of [Suharto](#), the former [President](#) of [Indonesia](#). Under the banner of the Humpuss Conglomerate, Tommy holds significant stock in an estimated 90 of companies. His wide-ranging business interests stretch throughout [Indonesia](#) to the United States, to New Zealand and [Nigeria](#). Their activities range from oil exploration to natural gas, pharmaceuticals, construction and shipping.

<sup>6</sup>Bambang Trihatmodjo (born in 1953) second son of Indonesian President Suharto, is the major stockholder of Bimantara group. The Bimantara group companies are concentrated in a number of core business groups, notably entertainment, telecommunications, infrastructure, finance, autos and electronics. The company also has tie-ups with high-profile multinationals such as Hyundai, Ford, Nestlé, Union Carbide and NEC.

it alone controlled 16.6 percent of the stock market total capitalization. The top five families controlled 40.7 percent, the top ten families 57.7 percent.

The Asian crisis hit Indonesia business groups, both member companies and banks, particularly hard since they had relied so extensively on unhedged foreign loans. The extreme Rupiah depreciation alone increased corporate liabilities so much as to make them virtually insolvent. These balance sheet problems were exacerbated by business groups' heavy reliance overall on debts in addition to equity finance, notably domestic loans from banks under group control. Their bank portfolios were excessively concentrated in loans to group members. A domino effect was in operation; the failure of one company led rapidly to failure of both of the member banks and other member companies. *The Indonesian Bank Restructuring Agency (IBRA)* came to obtain control over so many corporate assets which had been put up as collateral. The consequence was bankrupt or insolvent companies and banks and debts far greater in some cases than the value of the assets the IBRA took over. The gap had to be covered by the government (Patrick, 2001).

Ten years after the Asian Crisis, it was clear that most of the large groups survived and were again growing. Despite considerable difficulties in the aftermath of the Asian Crisis, most business groups have re-organised their trimmed empires and are putting together fresh business deals (Dieleman, 2008). In the present day, nine Indonesian business groups at least tripled their wealth since last year. The country now has 12 billionaires with a combined wealth of \$28 billion, up from seven billionaires, including

Low Tuck Kwong<sup>7</sup>, a coal tycoon of Bayan Resources; whose stock was up 474 percent in the past year. Another coal billionaire is Aburizal Bakrie<sup>8</sup>, whose holding is in Bumi Resources. Sandiaga Uno<sup>9</sup> and Edwin Soeryadjaya<sup>10</sup> make their debut this year in a coal company Adaro Energy. Kusnan and Rusdi<sup>11</sup> hold their budget carrier, Lion Air. Budi and Michael Hartono<sup>12</sup> hold in tobacco and the banking sector (Nam, 2009).

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<sup>7</sup>Low Tuck Kwong was born in Singapore in 1949, worked for his father's construction company in his twenties. He then moved to Indonesia in 1972 seeking better prospects. He bought Bayan Resources in 1997, five years after becoming an Indonesian citizen. Today, the group owns and operates seven mines in East Kalimantan, one in South Kalimantan and owns rights to almost 500 million tons of coal deposits.

<sup>8</sup>Aburizal Bakrie was born in 1946. In 1972 he joined PT Bakrie & Brothers Tbk - the conglomerate founded by his father Ahmad Bakri - which had prospered during the [Soeharto](#) regime. The Bakrie Group conducts business in agriculture, real estate, trade, shipping, banking, insurance, media, manufacturing, construction and mining. In this group, Bumi Resources is the country's largest and most aggressive player in the coal mining sector.

<sup>9</sup>Sandiaga Uno, (born in 1969) is one of Indonesia's richest men with estimated net worth of US \$795 million. In 1994, he joined MP Group Holding Limited as an investment manager. In 1995, he moved to NTI Resources Ltd in Canada and worked as Executive Vice President in the company. Unfortunately, the monetary crisis in 1997 hit NTI Resources Ltd hard and caused it to go into administration and left Sandi unemployed. This prompted Sandi to return to Indonesia. Seeing no real future as an employee, he decided to set up and run his own business. In 1997, he founded PT Recapital Advisors and in 1998, he co-founded Saratoga Capital with Edwin Soeryadjaya. Twelve years later, Saratoga Capital was one of Indonesia's largest investment firms employing more than 20,000 people. Saratoga Capital, holds most in coal miner Adaro Energy.

<sup>10</sup>Edwin Suryadijaya (born in 1949), son of a former billionaire who founded automotive group Astra, is a shareholder in PT Adaro Indonesia. Adaro's first exploration contract was signed in 1982 and in 1991 the company began production with concessions in South Kalimantan. Today Adaro is the second largest thermal coal miner in Indonesia.

<sup>11</sup>Rusdi and Kusnan are two brothers. After 13 years of experience in the travel business, they determined to make their dreams of owning a business flight come true. Equipped with high ambition and initial capital of US \$10 million, they established Lion Air in October 1999, but the operation started running in June 30, 2000. Lion Air, is [Indonesia's](#) largest private carrier and Asia's first hybrid carrier which offers both economy and business-class seating, based in [Jakarta](#), Indonesia. Lion Air also flies to [Singapore](#), [Vietnam](#), [Malaysia](#) and [Saudi Arabia](#). Its main base is [Soekarno-Hatta International Airport](#), [Jakarta](#). It operates scheduled passenger services on an extensive network from Jakarta to 56 destinations.

<sup>12</sup>Budi Hartono (born in 1940) and Michael Hartono (born in 1939) are two brothers, inherited clove cigarette maker Djarum from their father. They also have palm oil interests as they picked up 65,000 hectares of land in West Kalimantan in 2008. Together they also own Grand Indonesia, a luxury shopping mall, office buildings and hotel complex in the centre of Jakarta.

In 2012, sixty percent of the twenty five biggest companies in Indonesia were family firms. The Astra company, owned by the Soeryadjaya family, is the biggest company in Indonesia with revenues of 188 trillion Rupiahs. The full list of the 25 Biggest Indonesian companies is presented in Table 2.1.

As the biggest companies, family firms could reduce unemployment (See figure 2.1). 80 percent of family firms have more than 150 employees, 16 percent had 100-150 employees, 2 percent had between 51-99 employees and 19-50 employees (Susanto, 2005).

Indonesia's family firms run businesses in various fields and sectors. More family firms run businesses in sectors such as commerce and distribution, professional service, transportation, printing and publication as well as manufacturing (Susanto, 2005). Figure 2.2 shows an overview of the proportion of family firms in all categories.

Survey by Koh, Tong, and Waltermann (2012) showed that family businesses in Indonesia have long been a key pillar of the Indonesian economy. Collectively, family businesses account for about 40 percent of the market capitalization of the top 125 listed companies in Indonesia and dominate key industries including real estate, agriculture, energy, and consumer goods. Industry breakdown by ownership can be seen in Table 2.2 and Figure 2.3.

**Table 2.1 Indonesian Biggest Companies (in 2013)**

Company	Ownership	Revenue (in trillion Rupiahs)
Astra International	Family	188
Telekomunikasi Indonesia	State	77.1
HM Sampoerna	Family	66.6
Bank Rakyat Indonesia	State	58
Bank Mandiri	State	56.9
United Tractor	Widely held	55.9
Indofood Sukses Makmur	Family	50
Gudang Garam	Family	49
Bumi Resources	Family	35.4
Bank Central Asia	Family	35.2
Adaro energy	Family	34.9
Garuda Indonesia	State	32.6
Bank Negara Indonesia	State	31.2
Smart	Widely held	27.5
Unilever Indonesia	Widely held	27.3
Perusahaan Gas Negara	State	24.2
Bank Danamon Indonesia	Family	23.9
Indah Kiat Pulp & Paper	Family	23.6
Sumber Alfaria Trijaya	Family	23.4
Indo Tambangraya Megah	Family	22.9
Indosat	Widely held	22.4
AKR Corporindo	Family	21.7
Indofood CBO Sukses Makmur	Family	21.6
Barito Pacific	Family	21.5
Chandra Asri Petrochemical	Family	21.4

Source: Fortune Indonesia Magazine, special edition July 2013

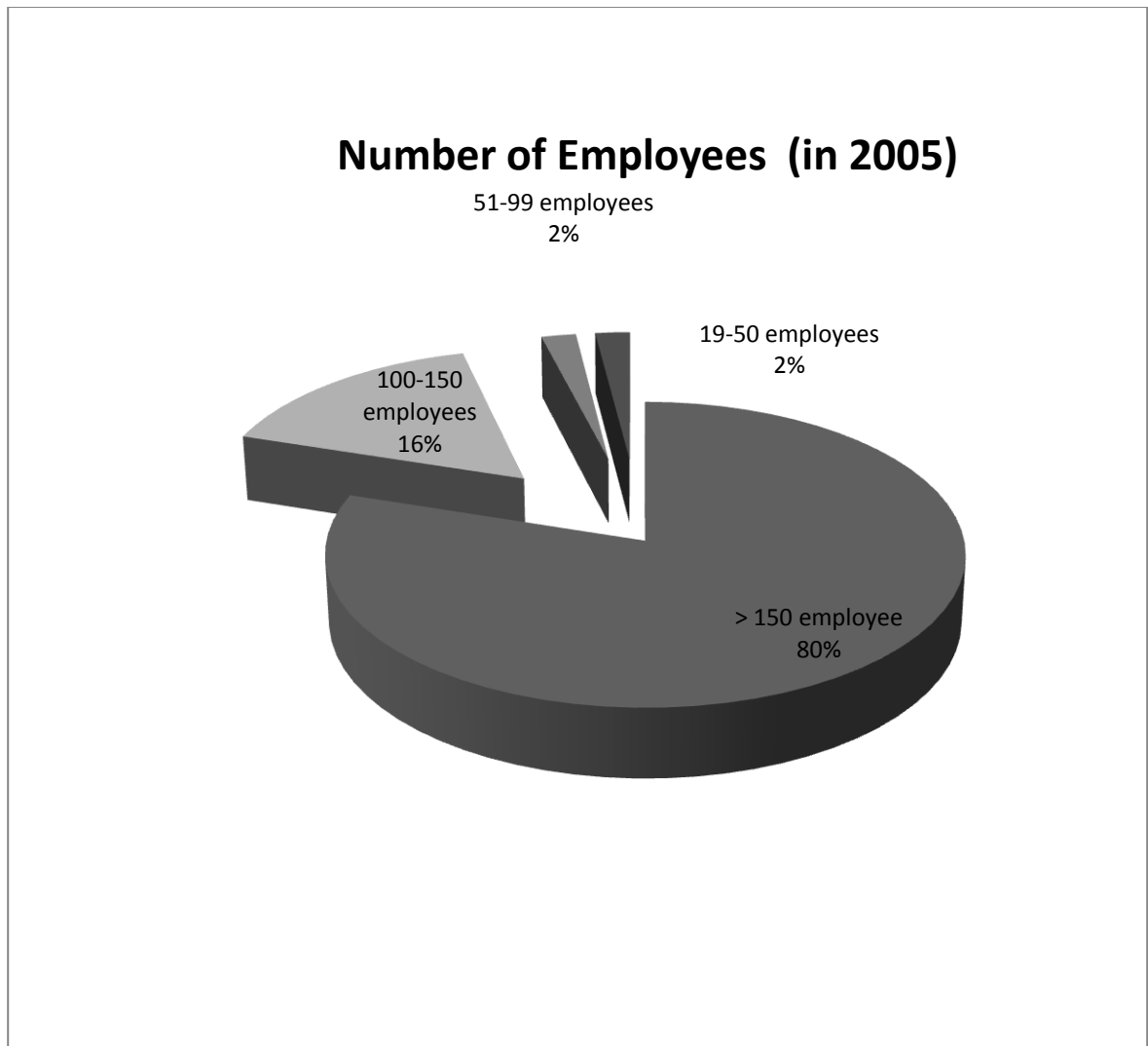


Figure 2.1 Number of Employees in Family Firms

Source: Susanto A.B, 2005