Pertanika J. Soc. Sci. & Hum. 25 (S): 241 - 254 (2017)

SOCIAL SCIENCES & HUMANITIES

Journal homepage: http://www.pertanika.upm.edu.my/

Managerial Ownership, Corporate Governance and Earnings Quality: The Role of Institutional Ownership as Moderating Variable

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ABSTRACT

The purposes of this study are first, to analyse the influence of corporate governance structure and ownership structure on earnings quality and second, to examine the role of institutional ownership on the causal relationship between managerial ownership and market outcomes. The sample of the study was 242 companies from 430 companies listed on the Indonesia Stock Exchange (IDX) using purposive sampling technique. Data analysis technique used moderating variables regression with institutional ownership. The results showed board composition of directors and managerial ownership significantly affected market outcomes. The number of audit committees did not affect significantly market outcomes while institutional ownership did not affect significantly the profit but as a moderating variable, institutional ownership significantly improved the effects of managerial ownership on earnings quality. Accounting-based profit quality is reflected by the solid profit persistence and predictability.

Keywords: Corporate governance, earnings quality, institutional ownership, managerial ownership

ARTICLE INFO

Article history:
Received: 20 May 2017
Accepted: 01 October 2017

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ISSN: 0128-7702

INTRODUCTION

International Financial Reporting Standards (IFRS) states that the objective of financial statements is to provide information related to financial position, performance and changes in financial position of an entity that is useful for the users in making economic decisions (Epstein & Jermacowicz, 2009). Information about earning triggers various responses from investors which indicate the presence of market reaction towards earning disclosure (Boediono, 2005). Moreover, strong market reaction on earning as reflected in higher Earnings Response Coefficient (ERC) shows quality of earnings (Francis, Olsson, & Schipper, 2006).

Basically, earnings quality is determined by accounting process (Francis et al., 2006). Preparation of financial reporting involves management and board. There are policies and decision regarding income by management which affect financial reporting process. Therefore, earnings quality can be influenced by earnings management and corporate governance mechanism. Furthermore, Boediono (2005) found that institutional ownership, managerial ownership and composition of Board of Commissioners have effect on earnings quality.

Jensen and Meckling (1976) stated that managers are more aware of internal information and company prospects than the shareholders. Moreover, managers tend to be opportunistic and thus they may provide different information to the shareholder. This condition creates information asymmetry, which can be minimised via corporate governance. Corporate governance provides the structure that facilitates the determination of company objectives and becomes a medium to determine performance monitoring techniques (Deni, Khomsiyah, & Rika, 2004).

However, there are two conflicting theories on reducing conflict of interest between managers and shareholder. According to managerial entrenchment hypothesis, managers have so much power that they have opportunity to utilize the firm to further their own interests rather than the interests of shareholders in the accounting reporting context (Niu, 2006). Therefore, when managerial ownership exists, monitoring will be more difficult as well. On the other hand, based on interest alignment hypothesis, stock ownership by either Board of Commissioners or management can effectively motivate managers to perform well. Furthermore, Jensen and Meckling (1976) argued that managers with lower ownership manipulate financial statements in order to eliminate barriers imposed on compensation contract based on accounting. Meanwhile, Board of Commissioners with small ownership are not monitoring the managers effectively. In fact, many companies are asking their commissioners to increase their stock ownership (Hambrick & Jackson, 2000).

A closely related issue of managerial ownership is institutional ownership. Nevertheless, there is a debate on the effect of institutional ownership to earnings quality (Jiang & Andarajan, 2009). On one hand, the managers' tendency to manage reported earnings may be reduced by the effectiveness of external monitoring by institutional investors. However, institutional investors may direct managers to make accounting decisions that improve short-term profits at the expense of long-term value (Jiang & Andarajan, 2009; Jones, 1991; Porter, 1992). Some institutional investors are "temporary owners" and too focused on current profit. Short-term institutional ownership drives managers to reduce their investment in R & D to generate higher earnings (Jiang & Andarajan, 2009). Jiang and Anandarajan (2009) found that strong shareholder rights leads managers to report higher earnings quality. On the contrary, when most stocks are owned by short-term institutional investors, shareholders' attempt to reduce the aggressiveness and earning management will be ineffective to generate higher earnings

The purpose of this study is to provide insight on these ongoing debates by examining the relationship between corporate governance mechanism, managerial ownership and earnings quality. In addition, accounting-based measure of earnings quality is examined to see if it has a correlation on market-based earnings quality. This study proposes institutional ownership to moderate the effect of managerial ownership on earnings quality. Overall, the findings of previous researches regarding the problem studied remain inconsistent. Furthermore, while most research related to earnings quality have been focused on developed countries, this study looks at Indonesia as an emerging country. Moreover, most Indonesian firms have concentrated ownership and there is a lack of investor protection (Utama, Utama, & Amarullah, 2017). Thus, these characteristics may create different market reaction (here is earnings quality) than those in developed countries.

LITERATURE REVIEW

Nitkin (2007) stated that company with better governance mechanism will have better earnings quality. He argued that high quality governance produces Commissioners who effectively monitor management performance in financial reporting to ensure high-quality earnings report. Moreover, Board of Commissioners is responsible to ensure the integrity of accounting process, provide an independent oversight of management performance and report their activity to shareholders (Skinner & Sloan, 2002). According to the agency theory, monitoring is essential to minimise manipulation by managers (Jensen & Meckling, 1976). Monitoring can be maximised by employing non-executive on board or independent board. They are expected to act objectively and protect stockholder interest including the minority. Independent board can be a watchdog to control the managers (Ramdani & Witteloostuijin, 2010).

Earlier studies (Al-Abbas, 2009; Benkraiem, 2009; Huang, Louwers, Moffit, & Zhang, 2007; Niu, 2006; Petra, 2007) have examined the connection between corporate governance mechanisms related to board characteristics (namely board independence, board size, board expertise and board ownership) and earnings quality. However, the findings are inconsistent. Most of the studies found that the board is more effective in monitoring the management when there is an independent member. Independent commissioners will reduce the possibility of fraudulent financial reporting (Niu, 2006). Similarly, Klein (2002) revealed that companies with independent commissioners are less likely to report abnormal accruals. Furthermore, a study conducted by Niu (2006) in a public company in Canada showed that board composition is negatively related to the level of abnormal accruals, and positively related to earnings. Thus, independent commissioners on the board may ensure that firms provide high-level earnings quality.

Based on the description above, the following hypothesis is proposed:

H1: Independent board has positive effect on earnings quality.

Another element of governance that affect board monitoring activity of managers is board or managerial ownership. There are two different views in the literature on managerial ownership and earnings quality. Generally, large ownership leads to moral hazard and information asymmetry between internal and external investor. According to managerial entrenchment hypothesis, managers may receive more incentive to manipulate financial statement and monitoring will be more difficult if there is managerial ownership in the company (Niu, 2006). On the other hand, agency theory predicts that managers with lower stock ownership have a greater incentive to manipulate accounting numbers in order to eliminate barriers imposed on accounting-based compensation contract (Jensen & Meckling, 1976). In addition, outside board with small stock ownership in the company cannot effectively monitor the managers. However, interest alignment hypothesis believes that ownership by board and management can effectively motivate manager performance and create incentives for independent board to monitor the management.

Niu (2006) and Nitkin (2007) found that managerial ownership can improve earnings quality. Managerial ownership is negatively associated with earnings management, and thus provide higher financial reporting quality and higher earnings quality as well (Alzoubi, 2016). Furthermore, Kamardin (2014) concluded that managerial ownership improves firm performance and entrenchment effect of managerial ownership at the high level of ownership is not supported in Malaysia. Taking on from Kamardin (2014), this study proposes interest alignment hypothesis. Therefore, ownership by board or management is expected to motivate the performance of managers. It also motivates the board to put more effort in monitoring managers' actions. Consequently, managers will work at their best to produce higher earnings quality.

Based on the above, the second hypothesis is proposed:

H2: Managerial ownership has positive effect on earnings quality.

Financial reporting depends on independence and integrity in audit process. The audit committee has a duty to assists Board of Commissioners to monitor financial reporting process by managers and boost the credibility of financial statements (Al-Abbas, 2009). The existence of an audit committee is to monitor and minimise asymmetric information between principal and agents in agency theory concept. Empirical studies generally support the positive impact of audit committee. Xie et al. (2003) reported a negative correlation between earnings management and audit committee independence. In addition, Niu (2006) found size of the audit committee affects financial reporting. Furthermore, quality internal and external audit processes improve financial statements' accuracy, which in turn earns them investor trust (Anderson & Reeb, 2003).

McMulen (1996) revealed that audit committee is associated with fewer shareholder lawsuits for fraud, fewer correction of quarterly earnings, fewer illegal acts, and fewer changes in auditors when there is different opinion between client and auditor. These results indicate that firms with reporting errors, violations, and other indicators of unreliable financial reporting could be due to poor audit committees. Klein (2002) showed a negative correlation between independent audit committee and abnormal accruals. Lin et al. (2006) found a negative relationship between audit committee size and earnings restatement as a measure of earnings quality. However, other characteristics of audit committee, such as independence, financial expertise, activity and stock ownership, have been found not to significantly affect earnings quality.

Based on these, the third hypothesis is proposed:

H3: Audit committee has positive effect on earnings quality.

Institutional investors have a role in managerial decisions. When institutional ownership increases, institutional investors become more actively involved in the company (Jiang & Anandarajan, 2009). They give more consideration on firm performance to increase stockholder value. Moreover, agency theory states fraud among managers can be prevented by implementing effective monitoring mechanisms, such as increasing institutional ownership (Jensen & Meckling, 1976). This theory is supported by Gillan and Starks (2000) who opined that "institutions that hold large equity positions in a company have been motivated to actively participate in the company's strategic direction". Meanwhile, Chung et al. (2002) found that institutional investors will be able to control management of earnings. Nevertheless, Cornett et al. (2007) concluded that control by institutional investors may encourage the managers to be more focused on their attention on firms' performance and reduce their opportunistic behaviour. Furthermore, Ajinkya, Bhojraj and Partha (2005) suggested that firms with greater institutional ownership prefer publishing forecast analysis and the forecast tends to be more specific, accurate, and has minimum bias.

Thus, it is expected that institutional investors have more effective monitoring power over the managers. In addition, institutional and managerial ownership are expected to improve earnings quality because institutional investors are expected to effectively perform their monitoring activities. Therefore, the following hypothesis is proposed:

H4: Institutional ownership strengthens the effect of managerial ownership on earnings quality.

Investors considered earnings disclosure in financial statements before making an investment decision, including to assess firm's ability to pay dividends. Petra (2007) found that investor's confidence regarding the information reported in net income can be measured by the magnitude changes in stock prices or the magnitude of abnormal market returns at the time when market gives responses to net income. Moreover, Arifin (2005) stated that the investor's perception depends on information quality which is disclosed by the company. Therefore, companies are required to provide clear, accurate, timely and comparable information. Some empirical studies generally support that quality of accounting-based earnings affect market-based earnings y which is measured by earnings response coefficient, expected return and abnormal return. Francis et al. (2006) reported that expected return is affected by accruals quality, earnings persistence, earnings predictability, income smoothness, value relevance, timelines, and conservatism. Boediono (2005) noted the same that that earnings quality is significantly but weakly affected by earnings management, ownership structure, and composition of Board of Commissioners.

A correlation between accounting-based earnings quality and market-based earnings quality can be explained using signalling theory. This theory explains the behaviour of two parties (individuals or organisations) when they have access to different information. Sender requires to choose how to communicate the information, and the receiver has to decide how he interpret signals provided by sender (Connelly, Certo, Ireland, & Reutzel, 2011). In this case, firms give signal about earnings quality in their financial statements (accounting-based earnings quality) and then the signal will receive responses from investors (market-based earnings quality. Finally, good accounting-based earnings quality, which is measured using earnings persistence and earnings predictability, is expected to receive good responses from the investors.

Based on the above, the following hypothesis is proposed:

H5: Earnings persistence has positive effect on earnings quality.

H6: Profit predictability has positive effect on earnings quality.

METHODS

Research Design

The population of this research was 430 companies listed on the Indonesia Stock Exchange (IDX). The number of companies listed on the Indonesia Stock Exchange

(IDX) is based on data as at June 30, 2011 (when the research was conducted) by retrieving from IDX database (http://www.idx.co.id/). The sample companies were selected based on certain criteria (purposive sampling). The criteria that serve as the basis of sample selection are:

1. Being listed in Indonesia Stock Exchange (IDX) before 2005.
2. Publishing financial report from 2005-2010, and
3. Data that is required for the measurement of research variables comprising the composition of the board of directors (board composition), managerial ownership (shareholders by manager/director), institutional ownership (institutional investors), the audit committee, the earnings quality, and stake price during the period of observation.

A purposive sampling technique was employed.

Table 1
Research sample

Criteria	Total
Companies that are listed in Indonesia Stock Exchange as at 30 June 2011 (source: www.idx.co.id)	430
Companies are listed on the Stock Exchange since 2004	(133)
Companies whose annual report are not found between 2005 and 2010 during the period of data collection (July 2011)	(23)
Unavailable data on stock price in the period of data collection	(32)
Total sample	242

Source: Processed research data

Data Analysis

Data was analysed using descriptive statistical analysis and inferential statistical analysis. This research employs regression analysis with moderating variables / Moderated Regression Analysis (MRA) (Ghozali, 2011). In addition, to produce a research model that is BLUE (Best, Linear, Unbiased Estimator) multicollinearity test, autocorrelation, heteroscedasticity test, normality test and the linearity test are performed.

Illustrations

Research model below is proposed based on Francis et al. (2006) and previous researches:

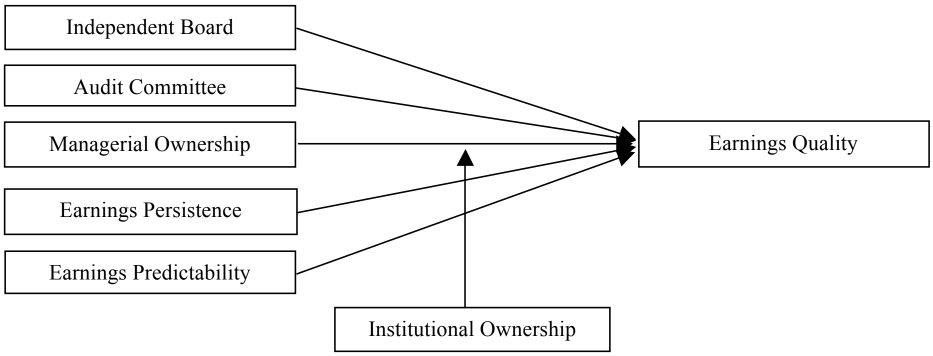

Figure 1. Empirical Research Model
Source: Developed for this research

RESULTS

Based on the MRA, here is the equation:

MO = $\alpha + \beta 1KD + \beta 2KM + \beta 3KA + \beta 4KI + \beta 5PERS + \beta 6PRED + \beta 7 (KM * KI) + \beta 8size + \varepsilon$

Where:

EQ = Quality of profit with the persistence measurement and profit predictability

MO = Market outcome with the size of cumulative abnormal return

KD = The composition of the board of commissioners

KM = The ownership by the management or the directors

KA = Audit Committee

KI = Institutional Committee

Size = The size of the company as a control variable that is measured from the total assets

The descriptive statistics for each variable is presented in Table 2 below:

Table 2
The result summary of research hypothesis test

Research Variable	Mean	Mode	Std. Deviation	Minimum	Maximum
KOM_DK	42.01	33.33	11.67	16.67	100.00
KEP_MAN	1.83	0.00	5.66	0.00	43.58
KO_AUD	3.15	3.00	0.60	2.00	6.00
KEP_INST	65.32	0.00	24.69	0.00	99.89
PERSIST	0.27269	0.00001	0.29513	0.00001	0.97094
PRED_LB	242,448,275,220	286,114,793	571,671,530,537	286,114,793	3,992,325,287,634
MAR_OUT	0.01338	-0.68022	0.16464	-0.68022	0.88595

KOM_DK : The Composition of the Board of Commissioners
KEP_MAN : Managerial Ownership
KO_AUD : Audit Committee
KEP_INST : Institutional Ownership
PERSIST : Profit Persistence
PRED_LB : Profit Predictability
MAR_OUT : Market Outcomes

Table 3
The F Test

Model		Sum of Squares	Df	Mean Square	F	Sig.
1.	Regression	6.539	8	.817	22.434	.000[a]
	Residual	8.490	233	.036		
	Total	15.029	241			

a. Predictors: (Constant), ASET, KEP_INST, PERSIST, interaksi, KOM_DK, KO_AUD, PRED_LB, KEP_MAN
b. Dependent Variable: MAR_OUT

The table below is a summary of hypothesis testing and its results.

Table 4
The result summary of research hypothesis test

Research Hypothesis				t-value	Sign.	Conclusion
H1	KOM_DK	→	MAR_OUT	1.553	0.122	Refused
H2	KEP_MAN	→	MAR_OUT	4.569	0.000	Accepted
H3	KO_AUD	→	MAR_OUT	-1.172	0.242	Refused
H4	KEP_MAN * KEP_INST	→	MAR_OUT	3.057	0.002	Accepted
H5	PERSIST	→	MAR_OUT	2.069	0.040	Accepted
H6	PRED_LB	→	MAR_OUT	5.620	0.000	Accepted

Source: The data processed result

DISCUSSION

Profit quality which is the dependent variable is based on market outcomes (market-based profit quality). This model influences the composition of the board of directors, audit committee, managerial ownership, institutional ownership, and profit persistence, predictability of profit, moderating institutional and managerial ownership on market outcomes. To obtain the Best Linear Unbiased Estimator (BLUE), the model in the regression equation is tested through several classical assumptions. The test results have confirmed that the present model is free from classical assumptions. Table 2 shows that overall predictor consisting of variables such as composition of board of directors, audit committee, managerial ownership, institutional ownership, profit persistence, predictability of profit, the interaction between managerial ownership and institutional, and assets as control variables significantly affect the quality of profit-based market that is measured by market outcomes in the form of cumulative abnormal return. The magnitude of the variation of the overall ability of the independent variables (the composition of the board of directors, audit committee, managerial ownership, institutional ownership, profit persistence, predictability of profit, the interaction between managerial ownership and institutional) in explaining the variation in the dependent variable (market-based earnings quality) can be seen from Table 3 on the model summary.

Based on the hypothesis monitoring, the high quality of governance will produce directors who effectively monitor the work of management in the company's financial report to ensure high-quality profit report. When monitoring hypothesis suggested a causal connection, matching hypothesis shows that the quality of governance and the quality of profit are together determined by several variables, which will result in better quality governance and profit. The company management will appreciate the responsibility of its shareholders who choose the quality of governance and the quality of profit together.

One of the important factors that influence the integrity of the financial accounting process is the involvement of the board of the directors that is responsible enough to provide an independent oversight of management performance and after that account for this activity to the shareholders. Based on the agency theory, the monitoring effort is essential to minimise the manipulation of managers' behaviour (Jensen & Meckling, 1976). Therefore, one suggestion is to hire directors from outside of the company (independent directors). Independent commissioner is expected to act objectively, protect all owners of the company, including the minority owners.

Previous research (Al-Abbas, 2009; Huang et al., 2008; Niu, 2006; Petra, 2007) has examined the link between corporate governance mechanisms related to the board of the directors (e.g. independence of the board, board size, the expertise of the board of the directors and board members stake ownership) and profit manipulation. The results were inconsistent. The results of this study showed that institutional ownerships did not significantly affect the quality of profit, for the three models of empirical research. However, institutional ownership variable significantly strengthens the effect of managerial ownership on profit quality. Despite the fact institutional shareholders did not directly affect the quality of profit, the managerial ownerships strengthened market outcomes.

CONCLUSION

This study found composition of board of commissioners and audit committee have no significant impact on market outcomes. However, managerial ownership and the quality of accounting-based profit with the size of the persistence of profit and profit predictability are proven to positively and significantly affect market outcomes. Moreover, institutional ownerships do not significantly affect the quality of profit, for the three models of empirical research. Institutional ownership variable significantly strengthens the effect of managerial ownership on profit quality. The existence of institutional shareholders does not directly affect the quality of profit but, the owner is able to strengthen the influences of managerial ownerships on market outcomes.

There are some limitations in this study, as institutional ownerships in this research are defined as ownership by the institutions, without restricting to banking institutions and financial institutions. Additionally, this research has not revealed the behaviour of institutional owner. Thus, future research must reveal the behaviour of institutional owners; different types of institutional ownership between the temporary owner and the permanent owner are thought to have differences in monitoring activity. The temporary owner tends to prioritise short-term profit, while the permanent owner is more concerned with the long-term profit.

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