

## **BOARD STRUCTURE AND EARNINGS MANAGEMENT: EVIDENCE OF SOUTH EAST ASIA COUNTRIES CATEGORISED BY AGENCY COST LEVEL**

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**Abstract:** Agency theory infers that investors will incur cost to make alignment on principal-agent interest. A critic, however, has pointed out that the conflict of interest between principal and agent is not the only cause for agency cost. Cultural context (Johnson & Droege, 2004) and legal system (La Porta, et al., 2000) are also found as contributing factors. This study is to empirically investigate how board size, board independency, audit committee size and audit committee independency affect the earnings quality in the context of low or high level agency cost country according to Transparency International's corruption level and Hofstede's cultural values. 538 firm-year across 6 South East Asian countries (Indonesia, Malaysia, Philippines, Singapore, Thailand, and Vietnam) are observed in this research. Five Different accrual models (Jones, 1991; Dechow, Sloan, & Sweeney, Detecting Earnings Management, 1995; Kasznik, 1999; Dechow, Richardson, & Tuna, Earnings management and costs to investors from firms meeting or slightly exceeding benchmarks, 2002; Dechow & Dichev, The Quality of Accruals and Earnings: The Role of Accrual Estimation Errors, 2002) are used to generate abnormal accruals which will be used as proxy for earnings management while to generate suitable factors from corporate governance variables, principal component analysis (PCA) is employed. Results indicate that (1) earnings management is efficient; (2) size and independency of Board of Director and audit committee are effective in reducing earnings management behaviour; (3) the management of firms operating in higher agency cost context will take advantage from the structure of corporate governance (size and independency of Board of Directors and audit committee) to conduct earnings management. Additionally, it is also found that bigger size (higher leverage) firms perform less (more) accounting discretion compared to their counterparts.

**Key words:** *corporate governance; earnings management; South East countries; accrual model; principal component analysis (PCA)*

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## INTRODUCTION

According to general theory of agency, it is predictable that investors will incur cost to make managers operate for maximisation of firm's value because interests between agents and principal are different (agency conflict). Jensen and Meckling (1976) argue that it is impossible for agents to operate at absolutely no cost in order to maximise principal's wealth. Managers implicitly require stimulus from shareholders to assure that each action taken in a firm is consistent with maximising company's value.

However, critic has pointed out that social life also considers about relationship, legal/political environment and other social constructs. Therefore, the principal-agent conflict is not the only determinant for agency cost. Empirically, it is found that preference toward risk (Stroh, Brett, Baumann, & Reilly, 1996; Ghosh & John, 2000) and cross-culture differences that distinguish understanding of compensation between US and European societies (Pennings, 1993) influence the agency cost. Considering that, studies of correlation between cultural contexts (Johnson & Droege, 2004) or legal system (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000) and agency costs are immensely relevant. To know the correlation will be useful to understand the circumstances embedding agency costs which in turn help various stakeholders, with various interests, to take proper actions across countries.

Furthermore, the correlation of agency cost and cultural context and legal system will be useful to answer concerns of corporate governance in specific nationality (Judge, 2012). In emerging countries, the ownership tends to be concentrated and the conflicts mostly are between principal and principal

i.e. between majority and minority shareholder. This is different from UK and US context. Young, et al. (Corporate Governance in Emerging Economies: A Review of the Principal–Principal Perspective, 2008) pointed out principal-principal modus operandi that causes conflict such as signing in the unqualified relatives or cronies to urgent positions and conducting abuse of company asset and resource. Therefore, studies of corporate governance in countries with certain level of agency costs are worth of conduct because agency costs embedded from cultural values and legal systems vary across countries. The correlation of earnings quality and corporate governance whether the agency cost is higher or lower will be useful for various stakeholders.

Thus, this study scrutinises the cultural and corruption level differences across South-East Asian (SEA) countries affecting earnings management. This study is intended to contribute to the existing literature by examining how differences in culture and corruption may affect the agent behaviours in smoothing earnings. This is due to the fact that the correlation between earnings management and agency cost are still controversial. In one hand, it is argued that earnings management and agency cost are negatively correlated. In the context of low agency cost, managers may do earnings smoothing to predict future performance and to signal the market about the current performance (Arya, Glover, & Sunder, 2003). Shareholders, in this condition, support their agent to conduct such action. On the other hand, it is contended that managers in firm with high agency costs are more likely to do misconduct that detrimentally affects stakeholders (Healy & Wahlen, A Review of the Earnings Management Literature and Its Implications for Standard Setting, 1999). Concealing information

and deciding less conservative accounting report are opportunistic behaviours that could risk the value of firm (Healy & Palepu, 1993). Risks such as low credibility of financial statement (Ragan, 1998) and get sued by external stakeholders for reporting deceitful information are indeed undeniable.

The second phase of this study investigates the correlation of corporate governance and earnings quality and their correlation when agency cost level (lower/higher) is taken into account. Four corporate governance variables identified in this study are size of board directors, independency of board directors, size of audit committee, and independency of audit committee.

Existing literatures mostly focus on East Asia (EA) not SEA countries (Claessens, Djankov, & Lang, 2000; Fan & Wong, 2002). Instead of EA countries, this study focuses on SEA countries because there are huge differences between EA and SEA countries. Even though SEA is a part of EA, they vary on geographical area, economic cooperation of Association of South-East Asian Nations (ASEAN), and more importantly in terms of cultural values and corruption index. EA countries that are not included in SEA (such as Japan, Korea, Taiwan, and Hong Kong) are perceived cleaner in public governance than SEA countries in 2015 (Transparency International, 2015). Also, cultural values of collectivism and power distance are generally higher in SEA countries rather than the rest of EA countries (Culture Compass, 2010).

538 firm-year observations of the 30 biggest market capitalisations in Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam from 2012 to 2015 are used in this research. The level of agency cost of each country is ranked based on corruption perception index obtained from Transparency International and cultural values from

Hofstede Centre. Author employs five different accrual models across countries and predict error term as abnormal accruals. Two types of regression are used when running accrual models namely fixed effect model (FEM) and pooled panel data model. The absolute abnormal accruals are set as proxy of earnings management. Moreover, to generate suitable factors from corporate governance variables, principal component analysis (PCA) is employed. Then, using linear regression, author scrutinises the correlation between abnormal accruals and (1) high agency cost country, (2) corporate governance factors and (3) interaction of high agency cost country and corporate governance factors.

Results indicate that (1) earnings management is efficient, (2) indeed independency and size of board directors and audit committees are effective reducing earnings management behaviour and (3) firms in countries with higher agency cost level will take advantage corporate governance structure (size and independency of board directors and audit committees) to conduct earnings management. Furthermore, I also find that firms with bigger size (higher leverage) perform less (more) accounting discretion rather than its counterparts. This result is robust to different specifications of different models of generating abnormal accruals.

## **LITERATURE REVIEW**

Investors generally are in favour towards legal mechanism for (1) protection of their property from expropriation, (2) high probability of claiming contracts, (3) calling for a meeting with management if there is a significant concern, and (4) cleanliness of public governance to avoid extra undesirable costs (Larcker & Tayan,

2011). Additionally, in the condition of market and firm control system are poor, they still may benefit from government's intervention to overcome agency problem (Jensen, 2005), and to even improve economic condition (Nguyen & van Dijk, 2012). However, Larcker and Tayan (2011) argue that public governance with so-called interventions does not work properly (i.e. in protecting property rights) if corruption is perceived high. It is empirically evidenced that there is a significant inter-relationship and correlation between corruption and legal ineffectiveness (Herzfeld & Weiss, 2003) (Fisman & Miguel, 2007). Therefore, higher corruption level can be a measure to predict a country having ineffective legal system and lack investor protection implying higher agency cost.

Culture values in a country deliberately influences firms' activity. These values also define particular priorities and ambitions of firms (Schwartz, 1999). Culture defines whether firms, as a structural part of society, are doing the correct operation in businesses or not. Countries across the world are culturally different. Hofstede (1980) developed national cultural dimensions.

Power distance portrays how unequal the distribution of power between leaders and workers within an institution. In countries with high score of power distance, the agency cost is perceived lower because social stratification is permissible and well-practiced. Consequently, it is effortless to align incentives of management and shareholders. In contrast, low power distance countries require normative means e.g. outcome compensation to align agents and principal's incentives (Johnson & Droege, 2004). Empirically, low power distance is significantly correlated with higher dividend pay-outs (Fidrmuc & Jacob, 2010). Therefore, it can be hypothesized that lower power

distance is a sign of high agency cost.

Another cultural dimension is tendency to avoid uncertainty which indicate how tolerance a society is for ambiguous situations, unknown future occasions, and unpredictable behaviour and thoughts (Hofstede, 1980). It is argued that civilians with high uncertainty avoidance are more risk averse so they require higher rewards (e.g. higher discount rate or dividend pay-out ratio). Johnson and Droege (2004) propose that gain potential should outweigh the loss potential in the context of society with high avoidance of uncertainty. However, this idea is not always the case because a lower dividend pay-out ratio given by a firm is a sign of high predictability and stability. Research has been done supporting this idea that high uncertainty avoidance is correlated with high cash flow holding or low dividend pay-out ratio (Ramírez & Tadesse, 2009; Chang & Noorbakhsh, 2009; Fidrmuc & Jacob, 2010). Thus, it is justifiable to consider high uncertainty avoidance as indicator of low agency cost.

Individualism is also an important dimension implying that an individual only concerns about himself and, if any, the closest colleagues (Hofstede, 1980). Not surprising that agency theory empirical studies are found massively in western-countries (Johnson & Droege, 2004) because what drives this opportunistic-prospecting behaviour is claimed to be individualism as the main value of western culture. This is consistent with Fidrmuc & Jacob (2010) proposing idea that the agency cost of companies is higher in high individualism countries. In contrast, collectivist countries, mostly found in Eastern part of the world, are considered as countries with value that can align principal-agency interests. Thus, it can be assumed that high individualism contributes to high agency cost.

Lastly, Hofstede and Minkov (2010) developed new perspective of cultural dimension which is long-term orientation characterised by future-oriented, avoiding risk, maintaining current behaviour and perpetuating specific & innovative leadership. This is also a relevant culture dimension in this case. Chang and Noorbakhsh (2009) proved that firms operating in a higher long-term orientation country tend to retain more cash. Investors in long-term oriented culture are dependent on long-term profitability (e.g. maintaining the business performance is more preferable than taking high risk projects) or non-economic achievement (e.g. sustainability of worker) when they look for investment opportunity. Hence, this paper hypothesises high long-term orientation as a signal of low agency cost.

This study is to analyse the correlation between agency cost (based in cultural values and corruption level) and earnings management. Teoh, et al. (1998) find that earnings management is opportunistic. This detrimentally affect the principal as agents tend to choose reporting mechanism that may benefit their own interest (Healy & Palepu, 1993). Discretion may result in low credibility of financial statements hence arising of difficulty for external source of fund (Ragan, 1998). However, Arya, et al. (2003) contend that earnings management can be the similar form of interest between managers and agents. By doing earnings management, managers – by communication with expertise and high motivation of successful performance – may “improve” the firms’ value and give the best prediction for future performance which is consistent with principal interest. Therefore, agency cost and earnings management are negatively correlated. Jiraporn, et al. (2008) and Subramanyam (1996) support this idea.

H1. *Earnings quality is lower for firms in lower agency cost countries.*

Corporate governance structures will be elaborated as the second phase of this study whether they are correlated with earnings discretion. Also, this study is to investigate the correlation of earnings management and interaction of corporate governance and high agency cost countries. There are four corporate governance variables studied in this study. Board of directors are liable in advisory and oversight (Larcker & Tayan, 2011). Advisory role is the place of management to consult of strategic and operational directions while oversight role which covers monitoring power over management being at shareholders’ interest. Such an important duty is hiring/firing CEO. Research showed that board size and meeting have correlation to firms’ performance (Guest, 2009; Yermack, 1996; Eisenberg, Stefan, & Wells, 1998). Empirically, studies in New Zealand (Ahmed, Hossain, & Adams, 2006) and US (Vafeas, 2005) found that board size has negative correlation with earnings quality. Different studies found that board size is insignificantly correlated with earnings timeliness (Bushman, Chen, Engel, & Smith, 2004) while other found positive correlation (Dalton, Daily, Johnson, & Ellstrand, 1999). Therefore, this study is firstly to investigate the size of board of directors in its correlation with earnings quality.

Board independence is also relevant having incentives such as maintaining reputation. Proven by research, independent boards work on-behalf of shareholders (Brickley, Coles, & Terry, 1994; Byrd & Hickman, 1992). Empirically in Hong Kong (Jaggi, Leung, & Gul, 2009) and in US (Xie, Davidson III, & DaDalt, 2003; Klein, 2002) studies found that independence board is positively correlated with earnings

quality. Thus, board independence is the second variable of corporate governance of this study.

Lastly, audit committee is in charge of preventing audit fraud of firms overseeing the hiring, performance, and independence of external auditor chosen by management. Additionally, it is also supervising performance of internal audit function. Audit committee size and percentage of independent audit committee are factors that contribute to the high quality of audit committee. It is empirically evidenced that the percentage of independent audit committee is found to be negatively correlated with internal control problems (Krishnan, 2005). It is because independent audit committees are at the interest of protecting reputation and credibility of company by finding error in internal audit function in the company. Similarly, previous literatures find a negative correlation between percentage of audit committee independence and abnormal accruals in US (Klein, 2002; Xie, Davidson III, & DaDalt, 2003; Vafeas, 2005). The size and independence of audit committee are the third and fourth variable of corporate governance in this study respectively.

*H2. There is a significant correlation between corporate governance factors and earnings quality.*

*H3. The correlation between corporate governance factors and earnings quality is stronger or weaker for firms in high level of agency cost countries.*

**RESEARCH METHODOLOGY**

This research collects 180 firms sample from the 30 biggest market capitalisations in Indonesia, Malaysia, Philippines, Singapore, Thailand, and Vietnam for 2012-2015. It excludes 32 firms in financial sector since the

estimation of accruals is different in such industry leaving this study with 148 firms to survey therefore there are 538 firm-year observations in this study. Financial data is collected from Worldscope database using US dollar currency rate as measurement for consistency while corruption perception index (CPI) is obtained from Transparency International and cultural values from Hofstede Centre.

Firstly, the agency scores are predicted as ranging from 0-100 based on country-specific measure: cultural values and CPI scores. Since the score of cultures and CPI are also ranging from 0-100, it is unnecessarily to rescale the measurement. Power distance, individualism, uncertainty avoidance, long-term orientation and CPI are assumed to have correlation with agency costs as discussed in literature review (see Figure 1).

*Figure 1 Assumed Correlation of Country-Specific Measures with Agency Cost*

No	Country-Specific Measure	Assumed Correlation with Agency Cost
1	Corruption Perception Index	(-)
2	Individualism	(+)
3	Power Distance	(-)
4	Uncertainty Avoidance	(-)
5	Long-term Orientation	(-)

Then, countries are raked based on this total agency cost score. I define the first, second, and third rank countries as countries having high agency cost and lower rank countries (4<sup>th</sup>, 5<sup>th</sup> and 6<sup>th</sup>) as countries with low agency cost (see Figure 2).

Figure 2 Calculating Agency Cost Level of SEA Countries

Country	Agency Cost Score							Agency Cost Level
	PDI	IDV	UAI	LTO	CPI	Total	Rank	
Indonesia	22	14	52	38	66.50	192.50	5th	Low
Malaysia	0	26	64	59	49.75	198.75	4th	Low
Philippines	6	32	56	73	64.25	231.25	2nd	High
Singapore	26	20	92	28	14.50	180.50	6th	Low
Thailand	36	20	36	68	63.00	223.00	3rd	High
Vietnam	30	20	70	43	69.00	232.00	1st	High
Average Score of Low	16	20	69.33	41.67	43.58	190.58		
Average Score of High	24	24	54	61.33	65.42	228.75		

Notes: PDI = power distance index, IDV = individualism value, UAI = uncertainty avoidance index, LTO = long term orientation, CPI = corruption perception index.

After that, using across countries regression, the earnings quality will be generated based on five accrual models below:

1. Jones (Jones, 1991)

$$ACC_{it} = \beta_0 + \beta_1 \Delta REV_{it} + \beta_2 PPE_{it} + \varepsilon_{it}$$

2. Dechow, et al. (Detecting Earnings Management, 1995)

$$ACC_{it} = \beta_0 + \beta_1 (\Delta REV_{it} - \Delta REC_{it}) + \beta_2 PPE_{it} + \varepsilon_{it}$$

3. Kasznik (On the Association between Voluntary Disclosure and Earnings Management, 1999)

$$ACC_{it} = \beta_0 + \beta_1 (\Delta REV_{it} - \Delta REC_{it}) + \beta_2 PPE_{it} + \beta_3 \Delta CFO_{it} + \varepsilon_{it}$$

4. Dechow, et al. (Earnings management and costs to investors from firms meeting or slightly exceeding benchmarks, 2002)

$$ACC_{it} = \beta_0 + \beta_1 (\Delta REV_{it} - (1 - k) \Delta REC_{it}) + \beta_2 PPE_{it} + \beta_3 ACC_{it-1} + \beta_4 \Delta REV_{it+1} + \varepsilon_{it}$$

5. Dechow & Dichev (The Quality of Accruals and Earnings: The Role of Accrual Estimation Errors, 2002)

$$ACC_{it} = \beta_0 + \beta_1 CFO_{it-1} + \beta_2 CFO_{it}$$

$$+ \beta_3 CFO_{it+1} + \beta_4 (\Delta REV_{it} - \Delta REC_{it}) + \beta_5 PPE_{it} + \varepsilon_{it}$$

where:

ACC = Total net income minus net cash flow operational divided by total asset current year

$\Delta REV$  = Net turnover at time  $t$  minus turnover at time  $t-1$  of a company divided by total asset current year

$\Delta REC$  = Net receivables at time  $t$  minus receivables at time  $t-1$  of a company divided by total current last year

PPE = Net property, plant, and equipment of a company divided by total asset current year

CFO = Net cash flow operational of a company divided by total asset current year

$\Delta CFO$  = Net cash flow operational at time  $t$  minus net cash flow operational at time  $t-1$  of a company divided by total asset current year

K = Slope coefficient from regression  $\Delta REC$  on  $\Delta REV$

However, given that Model 4 and 5 include future year variables i.e.  $\Delta REV_{it+1}$  and  $CFO_{it+1}$  hence this study applies Model 1-3 in main analysis and Model 4

and 5 in sensitivity analysis. Moreover, it is anticipated that heterogeneity problem may exist in the model because of repeated values in variables of similar group i.e. either firm, country, etc. Thus fixed effects model (FEM) will be considerably suitable to run regression because FEM solves all heterogeneity effects that are correlated with regressors. Therefore, two different regression models are used for each accrual model namely: fixed effect model (FEM) and pooled panel data model across countries. In case of pooled model across countries, year effect has to be controlled so cluster standard error for firm is necessary. Absolute abnormal accruals are used because both income-increasing and decreasing discretion are forms of accounting manipulation symmetrically (Tendeloo & Vanstraelen, 2005).

Subsequently, instead of using arbitrary indicator(s) that could lead to bias coefficient estimates, this research use all corporate governance variables discussed earlier in literature review. Following Larcker, et al. (2007), author employs principal component analysis (PCA) amongst four different corporate governance variables to get suitable factors for linear regression. This method is chosen because it is suspected that there is a correlation between corporate governance variables that can arise multicollinearity problem in linear OLS regression. After generating suitable factors for regression, linear regression is run below to know the correlation between abnormal accruals and (1) high agency cost country, (2) corporate governance factors and (3) interaction of high agency cost country and corporate governance factors. I include year dummies and cluster standard error for firms. Also, author use size (Lang & Lundholm, 1993), book-to-market ratio (McNichols, 2000) and leverage ratio (Tendeloo & Vanstraelen, 2005)

as controls because those variables are associated with manager's behaviour.

$$|DACC|_{it} = \alpha_0 + \alpha_1 HIGH_{it} + \sum \gamma \text{Corporate Governance Factors}_{it} + \sum \theta HIGH * \text{Corporate Governance Factors}_{it} + \delta_1 SIZE_{it} + \delta_2 BTM_{it} + \delta_3 LEV_{it} + \epsilon_{it}$$

where:

- |DACC| = Absolute of discretionary accruals from accrual model divided by total asset current year
- HIGH = One if firm is operating in high agency cost country and zero otherwise
- SIZE = Natural logarithm of total asset divided by total asset current year
- BTM = Debt-to-equity ratio of a company at current year
- LEV = Book value divided by market value of a company at current year
- Corporate Governance Factor = Corporate governance factors generated from PCA analysis

## RESULT AND ANALYSIS

### Principal Component Analysis

Table 1 presents the descriptive of corporate governance variables and its correlation matrix, and it shows that at least auditor independency and board independency are correlated.

Table 1 Descriptive of Corporate Governance Variables

VARIABLE (N=538)	MEAN	MEDIAN	SD	MIN	MAX
PANEL A – Descriptive Statistics of Corporate Governance Variables					
BOD	9.6301	9.00	3.7395	2.00	22.00
BOD_IND	0.4275	0.40	0.1827	0.00	0.92
AUD	3.4052	1.00	1.2799	0.00	7.00
AUD_IND	0.7775	1.00	0.3073	0.00	1.00
PANEL B – Correlation Matrix of Corporate Governance Variables					
		BOD	BOD_IND	AUD	AUD_IND
CORRELATION	BOD	1			
	BOD_IND	-0.0306	1		
	AUD	0.2625	0.2475	1	
	AUD_IND	0.2063	0.5310	0.3394	1

Note: BOD = number of board directors employed in a company; BOD\_IND = percentage of independent board director employed in a company; AUD = number of audit committee employed in a company; AUD\_IND = percentage of independent audit committee employed in a company



Table 2 presents the result of principal component analysis of corporate governance variables. It was testified whether factor analysis is appropriate using Kaiser-Meyer-Olkin (KMO) test statistic and Bartlett's test of sphericity. Value of KMO shows 0.562 and *p*-value of Bartlett's test reports 0.000. This means factor analysis is appropriate. Then, following Larcker, et al. (2007) this paper is using principal component analysis to determine the minimum number of factors that account the maximum variance of data. Based on communalities values, each governance variables are suitable for factor analysis because it exceeds 0.50. All factors with eigenvalues greater than 1 are retained, and it results 2 factors explaining 72.68% variance of the data. This number is also suitable after passing criteria of scree plot test. Varimax rotation is used for easy interpretation of outcomes of which governance variable belongs to which factor. Governance variables are defined to each factor exceeding 0.40 in absolute value.<sup>1</sup>

Therefore, author determines two factors of INDEPENDENCY and BOARD SIZE. INDEPENDENCY contains information of percentage of independent board directors and percentage of independent audit committee while BOARD SIZE associates with size of board directors and size of audit committee.

<sup>1</sup> Factors used in this study are the most proper one. Beforehand, I include board meeting governance variable in PCA analysis and I found that this variable cannot be included in all factors hence I include it as regressor in further regression. Then, multicollinearity exists in the regression model so I decide to exclude that variable in this study.

Table 2 Result of Principal Component Analysis

FACTOR	COMPO- NENT LOAD- ING	COMMU- NALITIES
INDEPENDENCY		
BOD_IND	0.8930	0.8060
AUD_IND	0.8050	0.7260
BOARD SIZE		
BOD	0.9020	0.8200
AUD	0.6100	0.5550
KMO Measure of Sampling Adequacy		0.5620
Sig. of Bartlett's Test of Sphericity		0.0000
Cumulative Data Variance Explained		72.68%

Note: Factors are used with eigenvalue is more than 1. Variables belong to a factor where the component loading overweighs 0.40. All variables are defined in Table 1.

### Multivariate Analysis

This section is reporting the multivariate analysis designed to test the hypotheses of this study whether discretionary accruals are associated with (1) high agency cost country, (2) corporate governance factors and (3) interaction of high agency cost country and corporate governance factor.

Table 3 Descriptive Statistics of Variables for Five Accrual Models

VARIABLES	N	MEAN	MEDIAN	SD.	MIN	MAX
ACC	587	-0.0246	-0.0259	0.0604	-0.1887	0.1551
$\Delta$ REV	587	0.0048	0.0058	0.1570	-0.8612	0.6019
PPE	587	0.3721	0.3565	0.2136	0.0087	0.9051
$\Delta$ REV – $\Delta$ REV	587	-0.0018	0.0006	0.1504	-1.0218	0.6277
$\Delta$ CFO	587	0.0042	0.0047	0.0580	-0.1782	0.1930
$\Delta$ REV – (1 – k) $\Delta$ REV	439	0.0311	0.0180	0.1488	-0.7954	0.5986
ACC <sub>it-1</sub>	439	-0.0210	-0.0197	0.0572	-0.1935	0.1613
$\Delta$ REV <sub>it+1</sub>	439	0.0027	0.0068	0.1345	-0.8612	0.6019
CFO <sub>it-1</sub>	439	0.1052	0.0849	0.1064	-0.0890	0.5811
CFO <sub>it</sub>	439	0.1107	0.0914	0.1095	-0.0898	0.5653
CFO <sub>it+1</sub>	439	0.1155	0.0973	0.1156	-0.1118	0.5817

Note: ACC = total net income minus net cash flow operational divided by total asset current year;  $\Delta$ REV = net turnover at time  $t$  minus turnover at time  $t-1$  of a company divided by total asset current year;  $\Delta$ REC = net receivables at time  $t$  minus receivables at time  $t-1$  of a company divided by total current last year PPE = net property, plant, and equipment of a company divided by total asset current year; CFO = net cash flow operational of a company divided by total asset current year;  $\Delta$ CFO = net cash flow operational at time  $t$  minus net cash flow operational at time  $t-1$  of a company divided by total asset current year; K = slope coefficient from regression  $\Delta$ REC on  $\Delta$ REV.

Table 3 presents descriptive statistics of variables for five accrual models. This table presents mean and median values of firm-year observations variables that are used for accrual regression. Author is using FEM and pooled panel data regressions for accrual models, and then include year dummy and

cluster standard error for firm in pooled regression across countries.

Table 4 Descriptive Statistics of Abnormal Accrual Measurements, Corporate Governance and Interaction of Corporate Governance and High Dummy, Control and High Agency Cost Dummy Variables

VARIABLE (N = 538)	MEAN	MEDIAN	SD	MIN	MAX	
PANEL A - Abnormal Accrual Measurements						
FEM_ DACC	Model 1	0.0443	0.0335	0.0388	0.0003	0.1784
	Model 2	0.0442	0.0337	0.0387	< 0.0001	0.1783
	Model 3	0.0408	0.0313	0.0353	< 0.0001	0.1886
POOLED_ DACC	Model 1	0.0434	0.0313	0.0383	0.0001	0.1780
	Model 2	0.0434	0.0315	0.0383	0.0003	0.1781
	Model 3	0.0398	0.0310	0.0343	0.0001	0.1870
PANEL B - Corporate Governance Factors and Interaction Variables						
INDEPENDENCY	< 0.0001	0.1276	1.0000	-3.0119	2.0284	
BOARD SIZE	< 0.0001	-0.0734	1.0000	-2.5544	2.6467	
HIGH * INDEPENDENCY	-0.2871	0	0.6913	-3.0119	1.3740	
HIGH * BOARD SIZE	0.0992	0	0.7814	-2.5544	2.4993	
PANEL C - Control and High Dummy Variables						
SIZE	15.1669	15.3513	1.2321	8.4506	17.9777	
BTM	0.5703	0.4239	0.4619	0.0070	2.5785	
LEV	0.4580	0.3204	0.8405	-0.8675	5.3617	
HIGH	PROPORTION DUMMY = 0		PROPORTION DUMMY = 1			
	N	%	N	%		
	293	54.46	245	45.54		

Note: FEM\_|DACC| = absolute discretionary accruals from FEM across countries, scaled by total asset; POOLED\_|DACC| = absolute discretionary accruals from pooled panel across countries, scaled by total asset; HIGH = one if firm is operating in high agency cost country and zero otherwise; INDEPENDENCY = factor of corporate governance that describes the independency of board directors; BOARD SIZE = factor of corporate governance that describes the size of board directors employed; SIZE = natural logarithm of total asset divided by total asset current year; BTM = debt-to-equity ratio of a company at current year; LEV = book value divided by market value of a company at current year.

Model 1:  $ACC_{it} = \beta_0 + \beta_1 \Delta REV_{it} + \beta_2 PPE_{it} + \epsilon_{it}$  – Jones (Earnings Management During Import Relief Investigations, 1991)

Model 2:  $ACC_{it} = \beta_0 + \beta_1 (\Delta REV_{it} - \Delta REC_{it}) + \beta_2 PPE_{it} + \epsilon_{it}$  – Dechow, et al. (Detecting Earnings Management, 1995)

Model 3:  $ACC_{it} = \beta_0 + \beta_1 (\Delta REV_{it} - \Delta REC_{it}) + \beta_2 PPE_{it} + \beta_3 \Delta CFO_{it} + \epsilon_{it}$  – Kasznik (On the Association between Voluntary Disclosure and Earnings Management, 1999)

After running accrual models, error terms for each model-regression is predicted and use them as proxy of abnormal accruals. Absolute abnormal accruals are plotted as proxy of earnings management because both income-increasing and income-decreasing are forms of accounting manipulation. Absolute abnormal accruals are obtained from Model 1-3 in main analysis and from Model 4 and 5 in sensitivity analysis. Table 4 presents the descriptive statistics of variables for further regressions. Total sample is 538 firm-year observations consisting firm-year observations in low agency countries (HIGH = 0; n = 293) and those operating in high agency countries (HIGH = 1; n = 245), see Panel C. Panel A describes the different measurements of abnormal accruals generated as dependent variables. Panel B reports the descriptive of corporate governance factors and its interactions to be included in the model to answer hypothesis H2 and H3. I run linear regression of high dummy, corporate governance factors, interaction of high dummy and corporate governance factors, and control variables

on different types of absolute abnormal accruals measurements. Author include year dummy and cluster standard error for firm for each regression.

$$|DACC|_{it} = \alpha_0 + \alpha_1 HIGH_{it} + \gamma_1 INDEPENDENCY_{it} + \gamma_2 BOARD SIZE_{it} + \theta_1 HIGH * INDEPENDENCY_{it} + \theta_2 HIGH * BOARD SIZE_{it} + \delta_1 SIZE_{it} + \delta_2 BTM_{it} + \delta_3 LEV_{it} + \epsilon_{it}$$

Table 5 presents the pairwise correlation of variables. It appears that BOARD SIZE and HIGH have negative correlation with abnormal accruals. Also, it appears that SIZE and BTM (LEV) are negatively (positively) correlated with abnormal accruals. These can be evidences to support hypothesis H1 and H2; however, these correlations should be interpreted with caution because firm's characteristics should be controlled in cross-sectional analysis. Moreover, the table shows that VIFs are all below 10 indicating that the model does not have multicollinearity problem.

Table 5 Pairwise Correlation Matrix

		1	2	3	4	5	6	7	8	9	10	11	12	13	14	VIF
1	FEM_ DACC  Model 1	1.000														
2	FEM_ DACC  Model 2	1.000*	1.000													
3	FEM_ DACC  Model 3	0.806*	0.806*	1.000												
4	POOLED_ DACC  Model 1	0.956*	0.958*	0.753*	1.000											
5	POOLED_ DACC  Model 2	0.954*	0.957*	0.752*	1.000*	1.000										
6	POOLED_ DACC  Model 3	0.782*	0.784*	0.942*	0.809*	0.808*	1.000									
7	INDEPENDENCY	-0.026	-0.026	-0.018	-0.018	-0.018	-0.013	1.000								4.47
8	BOARD SIZE	-0.123*	-0.123*	-0.072	-0.105*	-0.104*	-0.067	0.000	1.000							4.14
9	HIGH * INDEPENDENCY	-0.004	-0.003	0.023	0.008	0.009	0.025	0.811*	0.282*	1.000						3.89
10	HIGH * BOARD SIZE	-0.062	-0.062	-0.031	-0.047	-0.047	-0.037	0.250*	0.794*	0.414*	1.000					3.59
11	SIZE	-0.179*	-0.177*	-0.115*	-0.154*	-0.152*	-0.093*	0.308*	0.476*	0.406*	0.388*	1.000				1.77
12	BTM	-0.114*	-0.113*	-0.096*	-0.097*	-0.096*	-0.066	-0.195*	-0.093*	-0.221*	-0.145*	0.172*	1.000			1.23
13	LEV	0.054	0.055	0.097*	0.062	0.064	0.105*	-0.150*	0.257*	-0.049	0.179*	0.115*	-0.066	1.000		1.13
14	HIGH	-0.075	-0.077	-0.094*	-0.109*	-0.109*	-0.137*	-0.577*	0.199*	-0.455*	0.139*	-0.172*	0.068	0.215*	1.000	1.79

Note: All variables are defined in Table 4. \* significantly different from zero at the 5% level.

Table 6-8 report the regression result of analysis designed to test the correlation between abnormal accruals and (1) high agency cost country, (2) corporate governance factors and (3) interaction of high agency cost country and corporate governance factors.

Table 6 Regression Result - Independent Variables from Abnormal Accrual Measurements of Model 1

MODEL 1 (N=538)	FEM_ DACC		POOLED_ DACC	
	Coefficient	t-stat	Coefficient	t-stat
HIGH	-0.0126**	-2.12	-0.0167***	-2.94
INDEPENDENCY	-0.0101**	-2.32	-0.0107**	-2.36
BOARD SIZE	-0.0092**	-2.4	-0.0086**	-2.32
HIGH * INDEPENDENCY	0.0102*	1.91	0.0098*	1.84
HIGH * BOARD SIZE	0.0084**	1.98	0.0092**	2.24
SIZE	-0.0049*	-1.96	-0.0046*	-1.92
BTM	-0.0059	-1.44	-0.0043	-0.98
LEV	0.0048	1.32	0.0052	1.48
CONSTANT	0.1249***	3.32	0.1196***	3.29
F-STAT	2.98		2.94	
PROB > F	0.0014		0.0016	
R <sup>2</sup>	0.0870		0.0884	

Note: FEM\_|DACC| = absolute discretionary accruals from FEM across countries, scaled by total asset; POOLED\_|DACC| = absolute discretionary accruals from pooled panel across countries, scaled by total asset; HIGH = one if firm is operating in high agency cost country and zero otherwise; INDEPENDENCY = factor of corporate governance that describes the independency of board directors; BOARD SIZE = factor of corporate governance that describes the size of board directors employed; SIZE = natural logarithm of total asset divided by total asset current year; BTM = debt-to-equity ratio of a company at current year; LEV = book value divided by market value of a company at current year.

Model 1:  $ACC_{it} = \beta_0 + \beta_1 \Delta REV_{it} + \beta_2 PPE_{it} + \varepsilon_{it}$  - Jones (Earnings Management During Import Relief Investigations, 1991)

\*\*\* significant at 1% level, \*\* significant at 5% level, \* significant 10% level

Table 6 specifically reports regression analysis using two different measurement of absolute abnormal accruals from Model 1 of Jones (1991) using FEM and pooled panel data regressions. It shows that HIGH, INDEPENDENCY, and BOARD SIZE are negatively correlated with abnormal

accruals. HIGH \* INDEPENDENCY and HIGH \* BOARD SIZE are positively correlated with abnormal accruals. Also, it depicts that SIZE has negative correlation with abnormal accruals. This supports hypothesis H1 that firms in low agency cost countries have higher abnormal accruals. This also shows that independency and size of board directors and audit committee are effectively reducing earnings management effort. However, evidences depict that firms in high agency cost countries take advantages of corporate governance structure to conduct earnings management. Furthermore, results identify that bigger firms tend to do earnings management rather than its counterparts.

Table 7 reports result of regression analysis using two different measurement of absolute abnormal accruals from Model 2 of Dechow, et al. (1995) using FEM and pooled panel data regressions. It describes that HIGH, INDEPENDENCY, and BOARD SIZE are negatively correlated with abnormal accruals. HIGH \* INDEPENDENCY and HIGH \* BOARD SIZE are positively correlated with abnormal accruals. Also, it depicts that SIZE has negative correlation with abnormal accruals. These results are similar with Table 6 beforehand generates.

Table 7 Regression Result - Independent Variables from Abnormal Accrual Measurements of Model 2

MODEL 2 (N=538)	FEM_ DACC		POOLED_ DACC	
	Coefficient	t-stat	Coefficient	t-stat
HIGH	-0.0128 **	-2.16	-0.0167 ***	-2.95
INDEPENDENCY	-0.0101 **	-2.35	-0.0108 **	-2.38
BOARD SIZE	-0.0092 **	-2.41	-0.0087 **	-2.33

HIGH * INDEPENDENCY	0.0103 *	1.93	0.0099 *	1.87
HIGH * BOARD SIZE	0.0084 **	1.99	0.0091 **	2.23
SIZE	-0.0048 *	-1.94	-0.0045 *	-1.88
BTM	-0.0058	-1.41	-0.0042	-0.96
LEV	0.0048	1.33	0.0053	1.48
CONSTANT	0.1242 ***	3.29	0.1189 ***	3.24
F-STAT		2.99		2.96
PROB > F		0.0014		0.0015
R <sup>2</sup>		0.0871		0.0887

Note: FEM\_|DACC| = absolute discretionary accruals from FEM across countries, scaled by total asset; POOLED\_|DACC| = absolute discretionary accruals from pooled panel across countries, scaled by total asset; HIGH = one if firm is operating in high agency cost country and zero otherwise; INDEPENDENCY = factor of corporate governance that describes the independency of board directors; BOARD SIZE = factor of corporate governance that describes the size of board directors employed; SIZE = natural logarithm of total asset divided by total asset current year; BTM = debt-to-equity ratio of a company at current year; LEV = book value divided by market value of a company at current year.

Model 2:  $ACC_{it} = \beta_0 + \beta_1 (\Delta REV_{it} - \Delta REC_{it}) + \beta_2 PPE_{it} + \varepsilon_{it}$  - Dechow, et al. (Detecting Earnings Management, 1995)

\*\*\* significant at 1% level, \*\* significant at 5% level, \* significant 10% level

Table 8 reports regression analysis using two different measurement of abnormal accruals from Model 3 of Kasznik (1999) using FEM and pooled panel data regressions. It describes that HIGH, INDEPENDENCY, and BOARD SIZE are negatively correlated with abnormal accruals. HIGH \* INDEPENDENCY is positively correlated with abnormal accruals. Also, it depicts that LEV has positive correlation with abnormal accruals. These findings are similar with what previous results generate. However, evidences depict that firms in high agency cost countries take advantages of corporate governance only with independent board structure to conduct earnings management. Furthermore, results identify that firms with higher leverage conduct more earnings management behaviour than its counterparts.

Table 8 Regression Result - Independent Variables from Abnormal Accrual Measurements of Model 3

MODEL 3 (N=538)	FEM_ DACC		POOLED_ DACC	
	Coefficient	t-stat	Coefficient	t-stat
HIGH	-0.0138**	-2.27	-0.0179***	-3.16
INDEPENDENCY	-0.0102**	-2.55	-0.0102**	-2.57
BOARD SIZE	-0.0071*	-1.90	-0.0061*	-1.77
HIGH * INDEPENDENCY	0.0101*	1.91	0.0089*	1.83
HIGH * BOARD SIZE	0.0069	1.62	0.0064	1.60
SIZE	-0.0031	-1.40	-0.0028	-1.37
BTM	-0.0049	-1.08	-0.0026	-0.59
LEV	0.0058*	1.69	0.0064*	1.95
CONSTANT	0.0962***	2.97	0.0903***	2.95
F-STAT		1.96		2.06
PROB > F		0.0367		0.0275
R <sup>2</sup>		0.0741		0.0831

Note: FEM\_|DACC| = absolute discretionary accruals from FEM across countries, scaled by total asset; POOLED\_|DACC| = absolute discretionary accruals from pooled panel across countries, scaled by total asset; HIGH = one if firm is operating in high agency cost country and zero otherwise; INDEPENDENCY = factor of corporate governance that describes the independency of board directors; BOARD SIZE = factor of corporate governance that describes the size of board directors employed; SIZE = natural logarithm of total asset divided by total asset current year; BTM = debt-to-equity ratio of a company at current year; LEV = book value divided by market value of a company at current year.

Model 3:  $ACC_{it} = \beta_0 + \beta_1 (\Delta REV_{it} - \Delta REC_{it}) + \beta_2 PPE_{it} + \beta_3 \Delta CFO_{it} + \varepsilon_{it}$  - Kasznik (On the Association between Voluntary Disclosure and Earnings Management, 1999)

\*\*\* significant at 1% level, \*\* significant at 5% level, \* significant 10% level

Overall, it can be concluded that (1) firms in high agency cost level have higher earnings quality rather than its counterparts, (2) independency and size of board directors and audit committees are negatively correlated with abnormal accruals (3) the correlation of independency or size (of board directors and audit committees) and abnormal accruals is stronger for firms operating in high agency cost countries. This shows that (1) earnings management is efficient (2) indeed independency and size of board directors and audit committees are effective reducing earnings management behaviour and

(3) firms in countries with higher agency cost level will take advantage corporate governance structure (size and independency of board directors and audit committees) to conduct earnings management. Furthermore, this study also infers that firms with bigger size (bigger leverage) perform less (more) accounting discretion rather than its counterparts.

**Sensitivity Analysis**

This sub-section presents sensitivity analysis of previous regression analysis. Absolute abnormal accruals are

employed as measurements using two alternative accrual models (Dechow, Richardson, & Tuna, 2002; Dechow & Dichev, 2002). Because these models include future variables, 135 firm-year observations (25.09%) of total sample before are dropped out from the analysis. Therefore, in this sensitivity analysis, there are 54.09% of firm-year observations operating in low agency cost countries (HIGH = 0; n = 218) and 45.91% of those operating in high agency cost countries (HIGH = 1; n = 185). Author runs regression including year dummies and I cluster standard error for firms in all regressions.

Table 9 Regression Results of Sensitivity Analysis

	FEM_ DACC			POOLED_ DACC		
	Coefficient		t-stat	Coefficient		t-stat
<b>MODEL 4 (N=403)</b>						
HIGH	-0.0242	***	-3.13	-0.0114	**	-2.47
INDEPENDENCY	-0.0149	***	-2.63	-0.0093	**	-2.49
BOARD SIZE	-0.0113	**	-2.2	-0.0120	**	-2.39
HIGH * INDEPENDENCY	0.0112		1.62	0.0077	*	1.66
HIGH * BOARD SIZE	0.0135	**	2.34	0.0150	***	2.85
SIZE	-0.0054	*	-1.84	-0.0066	***	-3.61
BTM	-0.0074		-1.32	-0.0011		-0.31
LEV	0.0069		1.5	0.0023		0.89
CONSTANT	0.1504	***	3.34	0.1483	***	5.31
F-STAT			2.69			5.23
PROB > F			0.0049			0.0000
R <sup>2</sup>			0.1019			0.1276
<b>MODEL 5 (N=403)</b>						
HIGH	-0.0132	*	-1.72	-0.0151	***	-3.39
INDEPENDENCY	-0.0093	*	-1.96	-0.0091	***	-2.91
BOARD SIZE	-0.0097	**	-2.25	-0.0075	***	-2.84
HIGH * INDEPENDENCY	0.0075		1.12	0.0060		1.45
HIGH * BOARD SIZE	0.0117	**	2.37	0.0084	***	2.88
SIZE	-0.0062		-1.63	-0.0025		-1.2
BTM	-0.0135	***	-2.92	-0.0064	*	-1.88
LEV	0.0020		0.62	0.0041	**	2.16
CONSTANT	0.1432	**	2.29	0.0802	**	2.43
F-STAT			1.85			2.57
PROB > F			0.0573			0.0069
R <sup>2</sup>			0.1345			0.1049
Note: FEM_ DACC  = absolute discretionary accruals from FEM across countries, scaled by total asset; POOLED_ DACC  = absolute discretionary accruals from pooled panel across countries, scaled by total asset; HIGH = one if firm is operating in high agency cost country and zero otherwise; INDEPENDENCY = factor of corporate governance that describes the independency of board directors; BOARD SIZE = factor of corporate governance that describes the size of board directors employed; SIZE = natural logarithm of total asset divided by total asset current year; BTM = debt-to-equity ratio of a company at current year; LEV = book value divided by market value of a company at current year. Model 4: $ACC_{it} = \beta_0 + \beta_1 (\Delta REV_{it} - (1 - k) \Delta REC_{it}) + \beta_2 PPE_{it} + \beta_3 ACC_{it-1} + \beta_4 \Delta REV_{it+1} + \varepsilon_{it}$ Model 5: $ACC_{it} = \beta_0 + \beta_1 CFO_{it-1} + \beta_2 CFO_{it} + \beta_3 CFO_{it+1} + \beta_4 (\Delta REV_{it} - \Delta REC_{it}) + \beta_5 PPE_{it} + \varepsilon_{it}$ *** significant at 1% level, ** significant at 5% level, * significant 10% level						

Table 9 shows the regression result of sensitivity analysis. Overall, evidences are consistent with main analysis. Results show that (1) firms in high agency cost level country have higher earnings quality rather than its counterparts, (2) independency and size of board directors and audit committees are negatively correlated with abnormal accruals and (3) the correlation between board independency (or board size) and abnormal accruals is stronger for firms operating in high agency cost countries. This confirms previous finding in main analysis that (1) earnings management is efficient (2) independency and board size factors are effective reducing earnings management behaviour and (3) firms in countries with higher agency cost level will take advantage of corporate governance structures (in case of independency and size of board directors and audit committees) to conduct earnings management. Furthermore, Sensitivity analysis result shows that size and book-to-market ratio (leverage) are negatively (positively) correlated with abnormal accruals. This means that bigger firms and under-priced firms perform less for accounting discretion rather than its counterparts while firms with higher leverage conduct more earnings management than its counterparts.

## **DISCUSSION AND CONCLUSION**

This study scrutinises the association between abnormal accruals and (1) high agency cost country, (2) corporate governance factors and (3) interaction of high agency cost country and corporate governance factor.

Evidences describe that (1) firms in high agency cost level have higher earnings quality rather than its counterparts, (2)

firms with higher independency and size of board directors and audit committees are negatively correlated with abnormal accruals (3) the correlation of independency or size (of board directors and audit committees) and abnormal accruals is stronger for firms operating in high agency cost countries. This shows that (1) earnings management is efficient (2) indeed independency and size of board directors and audit committees are effective reducing earnings management behaviour and (3) firms in countries with higher agency cost level will take advantage corporate governance structure (size and independency of board directors and audit committees) to conduct earnings management. Furthermore, I also find that firms with bigger size (higher leverage) perform less (more) accounting discretion rather than its counterparts.

This finding contributes the existing literatures that typical earnings management in six SEA countries is efficient, e.g. in Indonesia (Siregar & Utama, 2008). This finding also contributes the general idea of existing literatures that audit committee and board director's independencies are governance means that effectively reduce earnings management (Klein, 2002). Also, evidence shows that size of board directors and audit committees is also effective to decrease earnings management which is not consistent with common view, but somehow similar with Larcker, et al. (2007). Lastly, there are enough evidences showing that corporate governance structure advantages can be an opportunistic driver for firms in countries with high agency cost to conduct earnings management.

Implication and Suggestion for Further Research

Based on results of this study, there

are several implications identified. First, standard setters should be more aware in governing and adjusting regulations based on cultural values and corruption level differences because they can affect the agency cost level as well as the earnings management behaviour. Second, investors may look forward to look at the earnings account for their investment decision.

There are also several limitations of this research that can be developed. First, financial and governance data is not generally available or complete, especially in country such as Vietnam. Second, the sample employed for further research should be extended into bigger sample (firm and year) or even the whole population. Third, model fit is still too low, so the model can be developed through adding governance variables, modifying and identifying other the variables, and looking for more suitable factors for future research.

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