CHAPTER II

THEORETICAL REVIEWS

2.1. Agency Theory

Agency theory is concerned with resolving two problems that can occur in agency relationships. First is agency problem that arises when (a) desires or goals of principal and agent conflict and (b) it is difficult or expensive for principal to verify what agent is actually doing. Problem here is that principal cannot verify that agent has behaved appropriately. Second, it was problem of risk sharing that arises when principal and agent have different attitudes toward risk. Problem here is that principal and agent may prefer different actions because of different risk preferences (Eisenhardt, 1989).

Positivist researchers have focused on identifying situations in which principal and agent are likely to have conflicting goals and then describing governance mechanisms that limit agent's self-serving behavior. Positivist research is less mathematical than principal agent research. Also, positivist researchers have focused almost exclusively on special case of principal-agent relationship between owners and managers of large, public corporations (Berle & Means, 1932 in Eisenhardt, 1989).

Since information systems inform principal about what agent is actually doing, they are likely to curb agent opportunism because agent will realized that he or she cannot deceive principal. For example, Fama (1980 in Eisenhardt, 1989) described information effect of efficient capital and labor markets on managerial opportunism, and Fama (1983 in Eisenhardt, 1989) described information role that boards of directors play in controlling managerial behavior.

2.2. Good Corporate Governance

The corporate governance term was introduced for first time by 1992 Cadbury Committee in report known as Cadbury Report. Report was viewed as a turning point that determines practice of corporate governance around the world. World Bank defines GCG as a set of laws, regulations and principles that should be conducted and all of aspects are able to encourage efficient performance of company sources and to produce long-term economic value for stakeholders or people around company in overall (Emirzon, 2006).

Cadbury Committee defines corporate governance as a system that serves to control and direct organization (Tjager et al., 2003 in Iqbal and Fachriyah, 2004). A wider definition classifies corporate governance into two perspectives namely narrow perspective and wide perspective. Within narrow perspective, corporate governance is defined as an administrational mechanism that controls relationship between company management, commissioner, boards, shareholders and stakeholders. On contrary, within wider perspective corporate governance is defined as how far company has been run in an open and honest manner in order to increase public's trust toward market mechanism, to increase efficiency within resource allocation either in domestic or in foreign scope, to strengthen industrial structure and finally to increase public's welfare and wealth.

All of corporate governance definition above have a common meaning that emphasizes how to control link between all of interested parties that is realized in a single company-controlling system. In other words, basic GCG principles, especially ones being determined by OECD, are consisted of five aspects namely (Daniri, 2005 in Emirzon, 2006):

1. Transparency: it refers to information openness either in decision-making process or in material information distribution and relevant with company's situation.
2. Accountability: it refers to clarity in terms of company's board function, structure, system and responsibility so that company management will be done effectively.
3. Responsibility: it refers to appropriateness within company management toward healthy corporation principles and governing regulations as well.
4. Independency: it refers to a circumstance where company is run professionally without any conflict of interest not in accordance with governing regulations as well as healthy corporation principles.
5. Fairness: it refers to fair and equal treatment in fulfilling stakeholders' right as a result of agreement and governing regulations as well.

Based on the GCG definition above, we can infer that there are five main purpose of Good Corporate Governance namely (Daniri, 2005 in Emirzon, 2006):

1. To protect stakeholders' right and interest.
2. To protect non-shareholders stakeholders' right and interest.
3. To increase company value and stakeholders value.

4. To increase effectiveness and efficiency of Board of Directors and company management.
5. To increase link quality between Board of Directors with company's senioer management.

The main purpose of a good company management is to provide sufficient protection and fair treatment for stakeholders and other interested parties through maximal increase of stakeholders' value, not only as a mere effort to keep company run on right track according to universally governing rules and norms. Then, good company management should be understood and learned by public and other interested parties, so that there will be a trust that their bet in a go-public company is a right choice (Suprayitno, 2004 in Emirzon 2006).

2.3. Earnings Management

According to Dechow and Skinner (2000 in Benkraiem, 2009), earnings management practices are directly linked to accrual based accounting. In fact, choice of moment when revenues and charges are recorded creates a variation that constitutes different between cash vs. accrual based accounting. In long run, this variation will tend to disappear, since earnings must normally tend toward cash flows. In short term, however, it is potentially adjustable (Dechow and Dichev, 2002 in Benkraiem, 2009). Earnings management represents a way of manipulating this variation. This manipulation comprises a set of accounting choices whose objective is to modify firms' reported earnings. It is carried out in compliance with prevailing accounting standards. Researchers in accounting and finance have devoted considerable energy to studying this phenomenon (Stolowy and Breton, 2004 in Benkraiem, 2009).

Earnings management according to Scott (1997) is choice by a manager of accounting policies, or actions affecting earnings, so as to achieve some specific earnings objective. Thus, earnings management includes both accounting policy choice and real actions. First, consider policy choices. It is convenient to divide accounting policy into two categories. One is choice of accounting policies, such as straight-line versus declining-balance amortization, or policies for revenue recognition. Other category is discretionary accruals such as provisions for credit losses, warranty costs and inventory values. Another way to manage earnings are by means of real variables, such as advertising, R&D, maintenance, timing of purchases, and disposal of capital assets.

2.4. Patterns of Earnings Management

There are several pattern of earnings management (Scott, 2007):

1. Taking Bath

   This can take place during periods of organizational stress or reorganization. If a firm must report a loss, management may feel it might as well report a large one. Consequently, it will write-off assets and provide for expected future costs. Because of accrual reversal, this enhances the probability of future reported profits. In effect, recording of large write-off puts future earnings "in the bank".

2. Income Minimization

   This is similar to taking bath, but less extreme. Such a pattern may be chosen by a politically visible firm during periods of high profitability, Policies that suggest income minimization include rapid write-off capital assets and intangibles, expensing of advertising and R&D expenditures, and so on.

3. Income Maximization

   From positive accounting theory, managers may engage in a pattern of maximization of reported net income for bonus purpose, or to attract investor if they company go public.

4. Income Smoothing

   This is perhaps most interesting earnings management patter. From a contracting perspective, risk adverse managers prefer a less variable bonus stream, other things equal. Consequently, manager may smooth reported earnings over time so as to achieve relatively constant compensation.

2.5. The Motivation of Earnings Management

Management conducts earnings management for many reasons (Scott, 2007), namely:

1. Contractual Motivation

   There is an urge to conduct earnings management that appears from characteristics of bonus program where contract between company and manager becomes basis of manager's compensation. Other contractual urge is for sake of debt covenant which is predicted by debt covenant hypothesis. If management comes closer to violation toward covenant, then management tend to conduct earnings management in order to decrease probability of covenant violation within debt covenant.

2. Political Motivation

   There are many companies being politically visible. Usually, these companies are big one and strategic one, because activity of these companies is in touch with many people, namely oil and gas companies. Such companies would like to have an accounting practice and procedure that minimize report net income, especially in high wealth period.

3. Tax Motivation

   Income tax, perhaps, is most visible motivation for conducting earnings management, however tax authority tend to make their accounting regulation calculate taxable income which gives a space for company conduct earnings management.

4. CEO Replacement

   CEOs who have bad performance will try to conduct earnings management in order to maximize company's profit. Thus, this situation can delay or even prevent their discharge. They might be "taking a bath" in order to increase positive future earnings. This motivation is conducted by new CEOs as well, especially if large deletion can be charged into former CEO.

5. Initial Public Offerings

   Based on definition, company that conducts IPO does not have certain market price. Rising question is that how can we evaluate shares of such company? Apparently, financial accounting information that is included in prospectus is beneficial as source of information. Hughes (1986) analytically shows that information such as net income if useful for showing company's value for investors. Clarkson *et al* (1992) found an empirical evidence that market responds positively profit forecast as token of company's value. There is a possibility that companies about to go public may manage its prospectus under an expectation that it will have high share price.

6. To Communicate Information to Investor

   Use of earnings management for communicating information toward investors is in question from standpoint of efficient capital market theory. If earnings management can reveal inside information, then this aspect actually can improve financial report information.

2.6. Board of Commissaries

Board of commissaries as an organ of company has a task and be responsible collectively in conducting monitoring and in giving suggestion to directors and in making sure that company conducts GCG as well. Unfortunately, board of commissaries is not allowed to take any part in taking operational decision. Status of each member of board of commissaries including chief commissary is equal. Task of chief commissary as *primus inter pares* is to coordinate board of commissaries' activity. In order that board of commissaries' task can run effectively, following principles should be fulfilled (KNKG, 2006):

1. Board of commissaries composition must make immediate, accurate and effective decision-taking possible and board should act independently as well.
2. Members of board of commissaries should be professional, which means that they have integrity so that they can perform their function well including making sure that boards have paid attention to interest of all stakeholders.
3. Monitoring and suggestion function of board of commissaries' covers prevention, improvement and temporary discharge.

2.6.1. Composition, Appointment and Discharge of Board of Commissaries Members

1. Numbers of board commissaries members should be adjusted with company's complexity by still paying attention to decision taking.
2. Board of commissaries can be consisted of ones that do not come from affiliated party known as independent commissaries and affiliated commissaries. Terms "affiliated" refers to party that has familial and business relationship with stakeholders, board members and other boards of commissaries members, and company itself. Former members of board

of directions and board of commissaries who are affiliated with company's employee, for certain period of time can be included as affiliated party.

3. Numbers of independent commissaries should be able to ensure that monitoring mechanism can run effectively and is according to law. One of independent commissioners should have financial or accounting background.
4. Board of commissaries members are appointed and discharged by stakeholders' meeting through a transparent process. For companies whose shares are listed in stock exchange, state companies or private companies, fund raising companies, companies whose product and service being consumes by people widely, and companies which impact environmental sustainability, evaluation process of board of commissaries members candidate should be done before stakeholders' meeting takes place through nomination and remuneration committee. Independent commissaries election should pay attention to opinion of minority shareholders that can be communicated through related committee.
5. Discharge of board commissaries members is done by stakeholders' meeting based on a logical reason and after related members is given a chance to defense himself or herself.

2.6.2. Monitoring Function of Board of Commissaries Members

1. Board of Commissaries is not allowed to take any part in taking operation decision. In aspect that board of commissaries take any decision related to

determined aspects within basic budget or law, decision taking is done in function as monitoring party, so operational activity decision still belongs to responsibilities of board of directors. Authority on board of commissaries is still done in function as monitoring and consultative party.

2. Under condition that company call for help of board of commissaries, board of commissaries can give penalty to member of board in form of temporary discharge, under regulation and it should be followed up by stakeholders' meeting.
3. Under condition where there is a vacuum within board of directors or under certain condition a having been stated by law and basic budget, board of commissaries can act as board of directors for temporary.
4. In conducting function, member of board either individually or collectively has right to get an access into and have an information about company in an accurate and complete manner.
5. Board of commissaries should have set of rule and charter so that execution of function can be directed and effective and can also be used as one of means for measuring their performance.
6. Board of commissaries within its function as monitoring party is responsible for communicating monitoring report upon company management done by board of directors, in order to achieve their acquit de charge from stakeholders' meeting.

7. In performing function, board of commissaries can form a committee. Suggestion from committee is brought to board of commissaries in order to take a decision. For companies whose shares are listed in stock exchange, state companies or private companies, fund raising companies, companies whose product and service being consumes by people widely, and companies which impact environmental sustainability, they have to establish at least audit committee, while other committee is established according demand.

2.7. Independent Board Commissaries

Existence of independent commissaries has been determined by Jakarta Stock Exchange through its regulation on July 1st, 2010. It is explained that companies listed in stock exchange should have independent commissaries, minimum requirements for independent commissaries is 30% of all members of board commissaries. Criteria for independent commissary are as follows (FCGI, 2006):

1. Independent commissary should not be a member of management.
2. Independent commissary should not be majority shareholders, or an official that has direct or indirect relationship with majority shareholders.
3. Independent commissaries within last three years should not be employed in his or her capacity as an executive by company or other company in a group of business and not be employed as well in his or her capacity as a commissary after he or she does not fill that position anymore.

4. Independent commissary should not be a professional consultant of company or other company that belongs to same group with company.
5. Independent commissary is not a significant and influential customer or supplier from company or other company that belongs to same group or in other ways has a direct or indirect relationship with related customer or supplier.
6. Independent commissary does not have any contractual with company or other company that belongs to same group other than as commissary of related company.
7. Independent commissary should be free of any interest and business deal or of any other relationship that can, or can be considered fairly as intervention in terms of material with his or her capability as a commissary to act for sake of company's benefit.

2.8. Audit Committee

Committee is a group of people being chosen by bigger group, in order to execute certain operations or to conduct special tasks. In this case, audit committee is beneficial in terms of optimizing monitoring function that previously belongs to full responsibility of director board. PT. Bursa Efek Jakarta circular No: SE-008/BEJ/12-2001 in March 7th, 2011 has set membership of audit committee for external party. Role of audit committee is set through Bapepam circular number SE-03/PM/2002. In circular, Bapepam states that committee should consist of at least three members and chairman of committee should come from independent commissioner of company with 30% in proportion in order to establish a good corporation (Wedari, 2004).

Audit committee should consist of independent commissioners, should be free from daily management activities and should have main responsibilities in assisting commissioner board when board conducts their task especially for cases related to company's accounting policy, internal monitoring and financial reporting system. In general, audit committee should be responsible for three following aspects, namely (FCGI, 2006):

1. Financial Reporting

   Audit committee's responsibility in terms of financial reporting aspect is to ensure that financial report submitted by management has given real illustration of following matters:

   a. Financial condition
   b. Result of the operation
   c. Long term commitment and planning

   Tasks in relation to this aspect are as follows:

   a. Recommending external auditor
   b. Monitoring matters related to external auditor, namely:
      1) Auditor appointment letter
      2) Audit cost estimation
      3) Auditor visitation schedule
      4) Coordination with the internal auditor
      5) Audit results supervision

6) Value of implementation auditor work.

c. Evaluating accounting policy and decisions related to policy

d. Monitoring Financial Statement, including:

1) Interim Financial Statement

2) Annual Financial Statement

3) Auditor's Opinion and Management Letters

Especially for evaluation of accounting policy and decision of a policy, both of these matters can be done effectively by attaining a brief summary about all of accounting policy that underlies financial statement submitted by officials in accounting department.

2. Corporate Governance

Audit committee responsibility in terms of corporate governance aspect is to ensure that company has been managed according to governing rules and regulation, has conducted operation with ethics and has effectively monitored interest clash and fouls done by company's employee.

Tasks in relation to this aspect are as follows:

a. Evaluating company's policy related to its obedience toward rules and regulations, ethics, interest clash and investigation in finding any action and any deceit that corrupts company.

b. Monitoring occurring litigation or postponed litigation as well related to corporate governance cases in which company has been one of involved parties.

c. Inquiring important cases related to interest clash, action that breaks down company and deceit.

d. Being responsible for reporting results of Corporate Governance analysis and other important findings.

3. Corporate Control

Audit committee responsibility in terms of corporate control is to learn matters that potentially risk company along with internal control system and to monitor monitoring process done by internal auditor. Tasks in relation to this aspect should cover monitoring and evaluation toward effectiveness and efficiency of internal monitoring system.

Besides, new definition about internal audit strengthen audit committee's responsibility in corporate control because within definition it is stated that internal audit is an independent activity in providing assurance and consolation in order to attain extra value for improving an organization activities un achieving its goal through a systematic and disciplinary approach in evaluating and improving risk management, monitoring and governance process.

2.9. Concentrated Ownership

Company's ownership structure reflects power and influence distribution among stakeholders over company's operational activities. One of ownership characteristic is ownership concentration and it is divided into concentrated ownership and dispersed ownership. Concentrated ownership is a commonly found phenomena in growing economic such as Indonesia and countries in continental Europe. On the other hand, Anglo Saxon countries such as England and United States of America has a relatively dispersed ownership (La Porta and Silanez, 1999).

Share ownership is said to be concentrated if most of shares are possesed by minority stakeholders, so these stakeholders will have relatively dominant shares in comparison to others. On contrary, share ownership is said to be dispersed if shares are distributed evenly to public and no stakeholder possesses bigger shares in comparison to others (Dallas, 2004).

Ownership concentration can be a management internal disciplinary mechanism and it can be used as a mechanism for improving monitoring effectiveness, because bigger possession make stakeholder to have pretty significant information access in order to balance informational advantage possessed by management. If this idea can be realized, then we can minimize moral hazard action in form of earnings management (Hubert and Langhe, 2002).

Knopf and Teall (1986) examined relationship between S&L ownership structure and risk behavior within application of Financial Institution Reform, Reconvert and Enforcement Act 1989. One of risk measurements was bankruptcy. Results of measurement was that inside stakeholder or insider had a correlation with occurrence of bankruptcy.

La Porta et al. (1998 and 2000) specifically in Indonesia find out that French origin countries group (including Indonesia) possess highest ownership concentration in comparison to other origin countries groups. Even in this group

Indonesian company shows bigger ownership concentration in comparison to other companies and three greatest stakeholders own 58% share in average. They state that weak law enforcement and institutional environment is heavily correlated to ownership concentration.

Result itself was possibly understated as well because they based their analysis on direct ownership instead of ultimate ownership. Then, they tried to improve variable measurement of ownership concentration by using ultimate ownership data through investigation of ownership link until they find who possessed biggest voting rights when they analyzed ownership structures of companies in 27 advanced countries (La Porta et al., 1999).

Claessens et al. (2000) states that there have not been any clear separation between ownership and control within companies registered in Jakarta Stock Exchange. Most of companies is still owned by families and managerial positions are occupied by majority stakeholders. Even though managerial positions are not occupied by majority stakeholders, managers still come from family members. As a result, what will be opinion of majority stakeholders will be opinion of managers as well.

2.10. Culture

Accounting research has for many years focused on influence of cultural values on development of accounting practices. Past studies have provided evidence on following: that accounting practices and disclosure are a function of nation's cultural values (Perera, 1989 in Rahman and Ali, 2002); that cultural heritage affects attitudes towards business related fraud (Watson, 2003 in Rahman and Ali, 2002); and that an organization's culture can predispose a company into considering fraudulent financial reporting (Geriesh, 2003 in Rahman and Ali, 2002). Hofstede (1991) in Rahman and Ali (2002) defines culture as "collective programming of mind which distinguishes members of one group or category of people from another". Among components of national culture are prevalent value systems that are transferred from generation to generation. Values refer to broad preferences for one state of affairs over others. They are acquired knowledge that people use to interpret experiences; direct feelings of good and evil, and affect perceptions of how things are, that eventually affect behavior.

Othman and Zeghal (2006) note that, as with all human activities, accounting rules and practices, as well as capital markets, are affected by culture. Accounting is a socio-technical activity involving an interaction between both human and non-human factions and, because two interact, accounting cannot be culture-free. And as further asserted by Han et al. (2010) and Hussein (1996), there is an increasing awareness among many accounting researchers and standard setters of social and cultural influences on accounting (Geiger and Smith, 2010).

Geiger and Smith, 2010 explained that in fact, culture has been found to influence development of accounting systems (Gray 1988), perceptions of participants in those systems (Doupnik and Tsakumis 2004), and application of financial reporting rules within accounting systems (Tsakumis 2007). With respect to earnings management, Braun and Rodriguez (2008) find a positive relationship between Gray's (1988) culturally derived accounting values of statutory control, uniformity, conservatism, secrecy, and earnings management. Further, Kinnunen and Koskela (2003) identify a positive relationship between earnings management and Hofstede's (1991) cultural value of power distance, which measures extent to which individuals accept human authority inequality. Similarly, Nabar and Boonlert-U-Thai (2007) conclude that Hofstede's cultural values of uncertainty avoidance and masculinity were related to earnings management.

2.11. Hypotheses

1. The Effect of Independent Commissioner Board Proportion toward Earnings Management

According to Healy and Wahlen (1998), earnings management takes place when management uses certain decisions in transaction and financial reporting to change financial reporting as base of company's performance which aims to mislead owner or shareholders. Earnings management can take place because manager has been given authority to choose accounting method that will be used in recording and revealing possessed financial information. Other reason is existence of high information asymmetry between management and parties that do not have sufficient source, support or access to related information in order to monitor manager action (Richardson, 1998). So, result is manager will try to manipulate reported company performance for sake of himself or herself (Morris, 1987).

Therefore, effective monitoring is highly demanded by related parties in company management. One of most important element in GCG concept implementation is commissioner board consisting of independent commissioner. Commissioner board is centre of company's success and survival. (Egon in FCGI, 2008) because commissioner board has a responsibility to monitor management, while management has a responsibility to increase efficiency and competitiveness of company, so commissioner board can monitor any action of management in operating company; this includes management probability to do earnings management. Based on explanation above, researcher would like to propose following hypothesis:

Ha1: Independent commissioner board proportion negatively influences earnings management.

2. The Effect of Commissioner Board Size toward Earnings management

Commissioner board as a part of company has a collective responsibility to monitor and suggest director and to ensure that company implements GCG (KNKG, 2006). Yu (2006) found that commissioner board size significantly negatively affect earnings management that is measure by using modified Jones model in order to obtain management accrual value. This statement signifies that less commissioner board members are, more earnings management is; this is due to fact that small number of commissioner board members makes organization to be probably dominated by management in conducting the role they have to play. Xie et al. (2003) and Oeasnell et al. (2001) found a proof that more number of commissioner board can decrease act of earnings management. Based on explanation above, researcher would like to propose following hypothesis:

Ha2: Commissioner Board size negatively influences earnings management.

3. The Effect of Audit Committee toward Earnings management

Audit committee has a task to monitor management in order to increase effectiveness in creating fair and well-qualified financial reporting, obedience toward governing regulations and sufficient internal monitoring. Principle is that audit committee creates a clean, healthy and responsible business life (Sulistyanto, 2008).

In line with Kep. 29/PM/2004, audit committee is committee established by commissioner board for monitoring company's management. Existence of audit committee is very important for company's management. Audit committee is a new component within company control system. In addition, audit committee is considered as bridge between shareholder and commissioner board to management party in handling control problems. Based on Jakarta Stock Exchange form letter, audit committee membership consists of at least three people including chairman. Member of this committee who comes from commissioner is only one person; this person should be company's independent commissioner and chairman of audit committee all at once. Other members who are not independent commissioners should be coming from independent external party (Nasution and Setiawan, 2007). Existence of audit committee within company is expected to decrease conflict of interest and thus decrease impact of earnings management. Based on above explanation, researcher would like to propose following hypothesis:

H3: Audit committee negatively influences earnings management.

4. The Effect of Concentrated Ownership Toward Earnings Management

Earnings management is management action that aims to influence exposed earnings rate within financial reporting process. The purpose is to increase certain party's wealth, even though in long term (cumulative earnings) there shall not be any earnings difference that can be identified as a profit (Fishcer and Rosenzweig in Iqbal and Fachriyah, 2004).

One of several ways in influencing earnings management done by company's management is using concentrated ownership structure. Concentrated ownership is a common phenomenon in economic of developing countries such as Indonesia and ones in continental Europe. On contrary, in Anglo Saxon countries such as United States of America and United Kingdom, ownership structure is relatively dispersed (La Porta and Silanez, 1999).

Share ownership is said to be concentrated if majority of shares are possessed by minor parties or minor groups, so shareholders have relatively dominant numbers than that of others. Share ownership is said to be dispersed if share ownership is relative-evenly dispersed to public; there is no one who holds bigger numbers than others (Dallas, 2004).

Concentrated ownership structure can be an internal management disciplinary mechanism, as a mechanism that can be used to increase monitoring effectiveness, because dominant possession makes shareholder have a significant information access in order to be equal with informational gap possessed by management. If this matter can be achieved, then management's moral hazard action that takes form of earnings management can be decreased (Hubert and Langhe, 2002). Based on explanation above, researcher would like to propose following hypothesis:

H4: Concentrated ownership structure negatively influences earnings management.

5. The Effect of Culture Toward Earnings Management

Hofstede (2001) asserts that high individualism societies are characterized by self-orientation, autonomy, low-context communication, and emphasis on individual achievement. Schuler and Rogovsky (1998) find that individualism is positively associated with the use of pay-for-performance contracts. Thus personal gain is likely to be an important motivator in high individualism societies. Prior research on earnings management (Beneish, 1999) suggest that managers misstate earnings to maximize their own wealth, often at a significant cost to other stakeholders in firm. Concern for other stakeholders' welfare is indicative of collectivism, not individualism. Accordingly, earnings management is likely to be high individualism societies.

High power distance implies that structures in organizations are centralized and that authority is concentrated in hands of top managers (Hofstede, 2001). High power distance countries are characterized by lack of both leader communication (Offerman and Hellman, 1997) and participative leadership (House et al., 1999). Prior research indicates a high incidence of earnings management when top managers are powerful. For example, Dechow et al. (1996) find that earnings management is prevalent in firms in which chief executive officer also either serves as chairman of board or is firm's founder. Gray (1998) also argue that information sharing is low in high power-distance societies. For these reasons, we expect a positive relationship between power distance and earnings management.

Masculinity indicates a preference for achievement, assertiveness, and material success. In high-masculinity societies, according to Hofstede (2001) desirable managerial qualities include decisiveness and competitiveness. Society places high emphasis on performance, and managers hold ambitious career aspirations and prefer to work for prominent companies and earn high salaries. Masculinity has also been shown to be positively associated with societies' acceptance of aggressive behavior (Hastings and Hastings, 1981) and consumers' desire to keep up appearances (de Mooij, 1998). This suggests that managers in high-masculinity societies are likely to endeavor to report strong profits that beat benchmarks. Accordingly, relationship between masculinity and earnings management is like to be positive.

In Rahman and Ali (2006), Chuah (1995) argues that mind of Malaysian managers is influenced by race, education and type of organisation they work for. Using Hofstede's (1983) four dimensions (individualism, power distance, uncertainty avoidance, and masculinity) in underlying differences in nation's cultural values, Abdullah (1992) provides evidence that Malays are rated lower on individualism, which is partly attributed to fact that Islam emphasis groups and societies rather than individuals (Baydoun and Willet, 1995). In addition, concept of zakat (tax) in Islam promotes development of collectivism in community by providing a mechanism for rich to help poor. Using race and education as surrogate for culture, Haniffa and Cooke (2002) found Chinese to be more individualistic and more secretive in their disclosure partly due to their entrepreneurial skills that have a greater influence on Malaysian economy. They, however, found Malaysian firms dominated by Malay directors have a higher level of voluntary disclosure, which is consistent with Islamic business ethics that encourages transparency in business, thus may have fewer tendencies to manage earnings. Based on explanation above, researcher would like to propose following hypothesis:

H5: Culture influences earnings management.