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3**International Journal of Civil Engineering and Technology (IJCIET) Volume 9, Issue 3, March 2018, pp.** 10–19, **Article ID: IJCIET_09_03_** 002 **Available online at http://** http **://www.iaeme.com/ijciet/issues.asp?JType=IJCIET&VType=9&IType=3 ISSN Print: 0976-6308 and ISSN Online: 0976-6316 © IAEME Publication Scopus Indexed** **THE EFFECT OF**

1**ASSETS EXPROPRIATION THROUGH MANAGERIAL COMPENSATION TO FINANCIAL REPORTING FRAUDULENT: AGENCY THEORY AND EXPROPRIATION VIEWS**

Rr. Sri Handayani, Warsito Kawedar and Fuad Research Scholar and Lecturer in Accounting,

18**Faculty of Economic and Business,** University of **Diponegoro.** Semarang, **Indonesia** **ABSTRACT** **This study** aims **to**

obtain empirical evidence for the

1**effect of** asset **expropriation through managerial compensation to financial reporting fraudulent.**

This research was developed by the agency theory and expropriation theory framework. Research populations are companies listed in Indonesia Stock Exchange 2008-2016 for agriculture, mining and basic industries and chemicals. Selection of research sample using purposive judgment sampling method. Methods of data analysis using multiple linear regressions. The data from this research is unstructured panel data. The source of research data comes from the company's annual report which has been audited and obtained from www.idx.co.id and ultimate ownership information obtained from OSIRIS database. The results of the research information that higher tendency of asset expropriation by the managerial makes higher tendency of financial reporting fraudulent occurrence. Higher the opportunistic behaviour of managerial makes higher tendency of the managerial to present financial statements less reliable and

biased. Key words: asset expropriation, agency conflict, opportunistic behavior, managerial compensation, financial reporting fraudulent. Cite this Article: Rr. Sri Handayani, Warsito Kawedar and Fuad, The

13**Effect of Assets Expropriation Through Managerial Compensation to Financial Reporting Fraudulent: Agency Theory and Expropriation Views.**

6**International Journal of Civil Engineering and Technology, 9(3), 2018, pp.** 10-19. **http://www.iaeme.com/IJCIET/issues.asp?JType=IJCIET&VType=9&IType=3 1. INTRODUCTION The**

purpose in the study is to test and provide empirical evidence of asset expropriation effect through managerial compensation to financial reporting fraudulent. Financial reporting fraudulent can be interpreted as a misrepresentation view of financial statements (Henry et al., 2012). Financial reporting fraudulent was done through reported earning's manipulation (Chen et al., 2011). Financial reporting fraudulent is an attempt to present biased information, thus it was not representing reliable financial information. In recent years, many companies are indicated to perform financial reporting fraudulent by utilizing transactions with related parties. For example, the case of Enron, Adelphia, Tyco, Refco, Hollinger, Rite Aid, Bank Global, Century Bank or PT Kimia Farma. This condition has led decreasing confidence in the financial statements, especially on the quality of earnings (Cheung et al., 2009; Ge et al., 2010). The management conducts fraudulent financial reporting was motivated to maximize the benefits for themselves with both pecuniary and non-pecuniary forms. The benefits of pecuniary are maximized through expropriating the company's assets. Company’s asset expropriation by management aims to increase perquisite by using compensation schemes

24**(Morck and Yeung, 2003; Bertrand and Schoar, 2006;** Urzua, 2009; **Croci,** Gonenc and Ozkan, **2012).**

Agency theory said that asset acquisition by the firm's management is a manifestation of the conflict between manager and shareholder (Gordon et al., 2012). Conflict seems between managers, and shareholders will raise agency costs that will be passed on to shareholders, and Managers will bear fewer agency costs. The pecuniary benefit and non- pecuniary benefit reach the optimum point if the

17**marginal utility derived from** each **additional** cost. It means **equals the marginal utility derived from the**

non-pecuniary item addition and equals the additional income after-tax purchasing power (wealth) is obtained. Meanwhile, the theory of expropriation said that the acquisition of corporate wealth by agents with excessive power was abused of power (Jodice, 1981; Eaton & Gersovitz, 1984, Rajan and Zingales, 1998; Zingales, 2001). The expropriation of company assets by management through compensation policies is caused of the management as an agent has excessive power or privileged access to company resources. Asset expropriation by the controlling rights holders will be followed by interventions to economic and financial policies that would be harmed by the minority's interests, including interventions to expropriated company profits (Jodice, 1981). Expropriation of assets will lead decreasing welfare for the expropriated party (Eaton & Gersovitz, 1984) Previous research by Borner, etc. All (1998) states that financial reporting fraudulent does not involve transactions with related parties.

23**Transactions with related parties are** used **to** exploit assets (Gordon **et al.,** 2004; Kuan **et al.,**

2010; Henry et al., 2012; Vakilifard & Salmanian, 2015; Hasnan et al., 2016). Financial reporting fraud is an efficient transaction to help companies achieve optimized asset utilization and reduce transaction costs (Chien & Hsu, 2010; Elhelaly, 2014). Several previous research outcomes on transactions with related parties focus upon the effect to the transactions on the earning's management, decline in corporate value, low company performance, financial reporting fraudulent and negative stock returns (Cheung et al., 2006;

10**Berkman et al., 2009;** Chen **et al.,** 2009; **Cheung et al., 2009; Ge et al., 2010;** Chalevas, 2011; **Lei & Song, 2011;** Henry **et al.,**

2012). In order to gain a better understanding of financial reporting fraudulent, this study focuses upon the effect of corporate asset expropriation by the management on the tendency of financial reporting fraudulent. This study differs from previous studies. The results from previous research into the effect of asset acquisition through managerial compensation against financial reporting fraud are described within the framework of the theory of agencies.

19**This study contributes to the literature by** focusing on **the effect of** managerial expropriation **on**

financial reporting fraudulent in the Indonesian context. Managerial expropriation will result in lower corporate performance, thereby strengthening in management incentives to make up profit in order to present unbiased information to external parties that have limited access to information. Bias financial information aims to give the impression to external parties that the company's performance is good. 2. LITERATURE REVIEW 2.1. Agency Theory Acquisition of assets through managerial compensation can be explained within the framework of the agency theory. Agency Theory is explained that the firm is the nexus of the contractual relationship between agents and principals. Agent as a second party assigned to run certain activities in the interest of principal or the first party. The first party delegate's authority to a second party to decide on behalf of the principal. This relationship is based on several prepositions as follows (Jensen and Meckling, 1976; Eisenhardt, 1989; LaPorta et al 2000; Alfadhl and Alabdullah, 2013): a. Agents are risk aversion. Agents avoid risk because agents have a high risk of their resources. Agencies cannot afford the risk diversify on their resources. All resources will be invested in a contractual relationship that has agreed with the agent and will be amortized. While the principal can diversify the resources, it has on various forms of investment so that the principal will have a neutral risk. b. Information asymmetry condition, the principal as an outsider did not know the agent's behavior. The agent has a personal interest, such that the agent will act like that jeopardizes the agent's interests. The agents will attempt to maximize their interest with the burden borne on the principal, so it becomes an agency problem. c. Agency conflict will raise agency issues. Two forms of

9**agency problems** are **moral hazard and adverse selection. Moral hazard** is **the**

act of agents who deliberately neglects their duty. Agent is not trying to maximize acting in the interests of principal. Adverse selection is the agent's attempt to mislead the principal by misrepresenting his or her ability. There is an effort from the agent to package his ability so that it looks good for the eyes of the principal. Managers will have a tendency to pick policies that do not harm themselves and can improve their

utility (Jensen, 1994). Jensen and Meckling (1976) describe the principal-agent relationship within shareholder and management behavior framework. Management

27**as an agent who obtains** the delegation of **authority from shareholders to manage**

corporate resources and negotiated on shareholder's interests. Managers must demonstrate performance shareholders benefits. This condition occurs if the output exceeds the opportunity cost of the resources utilized and can maximize shareholder wealth. 2.2. Expropriation Theory Expropriation Theory is one of the theories often used in the economics practice to explain the phenomenon of macro-asset displacement. Expropriation is the transfer from host country assets to be foreign through direct investment. Expropriation is also called nationalization. Expropriation can be done by utilizing the right of control. The objective of it is to intervene in the policy and to revoke the contract. Asset expropriation policy taken by elite's rule to achieve political-economic goals and their tendency in political and economic phenomena (Jodice, 1981). The use of expropriation theory in the microscope is explained by Eaton & Gersovitz (1984), Rajan & Zingales (1998), and Rajan & Zingales (2001). In the production function, output is determined by production factors ie labor, capital and managerial services. Expropriation occurs on capital. Expropriation will most likely be done by those who have capital control. 2.3. Assets Expropriation Through Managerial Compensation Asset expropriation activities are activities to move assets and corporate profits out of corporate entities conducted by holder's rights to gain benefits (Johnson et al. 2000). There is some empirical evidence that the company's managerial with a structure ownership of the pyramid asset expropriation through increased managerial compensation

8**(Kato et al.,** 2002, **Cheung et al., 2005;** Urzua, 2009; Barontini **and Bozzi,**

2011). In some

8**countries like India, Italy, Hong Kong and Korea,**

where most firms have to pyramid ownership structures, there is a tendency of managerial compensation in

8**group affiliated companies** to **have** greater **compensation** rates **than** managerial compensation **in**

on the group affiliated (Urzua, 2009). Asset expropriation activities can be defined as corporate resource exploitation activities conducted by insiders. Who's have control rights in order to obtain personal benefits (Henry et al., 2012). Djankov et al (2005) defines the acquisition of a company's assets as an act by an individual who has control of the company (such as: manager, controlling shareholder) to transfer the company's wealth to oneself without intending to share it with others. Included as a takeover activity of company assets include the theft of company assets, opportunistic behavior, excessive compensation policy and self-serving for financial transactions. 2.4.

15**Financial Reporting** Fraudulent **The US National Commission on Financial Reporting Fraudulent** (1987) defines **financial reporting** fraudulent **as** a deliberate **or**

omission activity that resulting reported information in the financial statements misleading its users materially (Marai and Pavlovic, 2013). Financial reporting fraud occurs if the user of the financial statements has an initial presumption that the financial statement rendered has the intention

12**to deceive** the **users of the financial statements materially. Financial**

reporting

16**fraud can also be defined as** a deliberate act **of** distorting **financial statements by internal** and **external**

parties in order to hide the misuse of assets or to obtain certain benefits (Johnson and Rudesill, 2001; Salehi and Mansoury, 2009). Financial reporting fraud cannot be clearly separated from earning's management (Marai and Pavlovic, 2013). This is based on several reasons as follows: (1) both have the same goal that is to mislead the users of financial statements; (2) earning's management indicated will result in financial reporting fraudulent. It has indicated the companies commit financial reporting fraudulent that previously undertook earning's management (Lee et al, 1999; Perols and Lougee, 2011); (3) the same incentives that companies and managerial compensation maximize or to avoid debt covenants. Real earning's management can be proxied by earning's management that takes into account business transaction's targets and the influence of cash flow components (Roychowdhury, 2006; Swai and Mbogela, 2016). 2.5. Development of Hypotheses In this research, the development of hypotheses to

1**the effect of** managerial **expropriation through managerial compensation** on **financial reporting**

fraud is developed within the conceptual framework of expropriation theory and agency's theory. Agency theory paradigm informed that asset acquisition through managerial compensation occurs because of an agency conflict between manager and shareholder. The manager becomes a party that is unable to diversify the risks. Managers become exposed to high risk. Managers will be opportunistic in order to maximize expected benefits that will be received. Managers take over the assets (expropriate assets) for obtaining additional income by utilizing the policy of compensation schemes (Chang

22**et al,** 2002; **O'Connor et al., 2006;** Jiraporn **et al., 2008).**

While in expropriation theory, managers take over the company's resources because they have inherent control rights. Financial information becomes an object within the responsibility and control of the management. If the management is motivated to take over the company's assets through an indicated compensation scheme, there is an increasing trend that the manager will present a biased financial report (Jodice, 1981; Eaton and Gersovitz, 1984; Henry et al., 2012).

5**The hypothesis** developed **in this study** is **as follows: H1:**

Asset's expropriation through managerial compensation has a positive effect on financial reporting fraudulent.

23**. RESEARCH METHOD The** population **of this research is**

firm-years data from companies listed on Indonesia Stock Exchange in 2008 - 2016 agricultural, mining and basic industries and chemical industries (industrial type 1, 2 and 3. State Ownership Entity-SOE) were excluded from the population. The population was 911 firms-years. The sample that can be used in this study (useable sample) is 308 firms-years. There are 600 from 911 firms years excluded from the sample. The firms-years excluded from the sample consist of 149 firms-years that do not issue annual reports; 217 firms-years have a reporting currency other than rupiah (Rp.) and 237 firms-years have in completed research data (companies do not have a majority shareholder). The variables in this study consist of the dependent variable, independent variables, mediator variables, moderator variables, and control variables. 3.1.

5**Dependent Variable The dependent variable in this** research **is**

financial reporting fraudulent. Financial reporting fraudulent is proxied by real earning's management (Roychodhury, 2006; Marai and Pavlovic, 2013; Swai and Mbogeta, 2016). In this study, real earning's management is measured using one indicator of Roychodhury (2006) that is abnormal

14**cash flow from operating activities.** The abnormal **cash** flows **from** operating **activities**

are expressed as cash flows from actual operating activity's minus cash flows from normal operating activities.

7**CFOt / At-1** = α + **α1 (1 / At-1) + β1 (St / At-1) + β2 (ΔSt / At-1) + εt**

3.2. Independent Variables Independent variable of research is asset's expropriation through managerial compensation. Asset's expropriation through managerial compensation

11**is measured by the** amount of **total** compensation ratios **received by the directors**

4**at the end of the year** to **the** total **book value of the firm's assets at the end of the year.**

3

20**.3. Control Variables** The **control variables** for **this study are firm size,** audit quality **and**

leverage. 1.

9**Firm size is measured by** Ln **of the total** book value **of the**

asset. 2. Audit quality is proxied with a public accountant firm affiliated with Big4. Audit quality is measured by the

7**dummy variable, 1 = if the firm is audited by a**

public accountant affiliated with Big 4 and 0 = for vice versa. 3. Leverage, measured by the total debt ratio

4**of the firm at the end of the year** to **the** total **book value of the** company's **assets** on **the** date from **the year.**

4. Expropriation of Assets by shareholders Asset expropriation by shareholders is proxied with transactions with related parties on the form by tunnelling resources company (TUN). This study used multiple linear regressions as a statistical modeling to explain the effect of shareholder's asset expropriation and the management asset expropriation to financial reporting fraudulent. FRF = β0 – β1TUN + β2Comp + β3LnTA + β4DAUD+ β5LEV + εit (1) The hypothesis is accepted if the p-value is significant on the level of ≤ 5%.

21**4. RESULT AND DISCUSSION 4.1. Descriptive Statistics Table 1 Descriptive**

Statistic FRF CFR/CR Tunnel_Receivable Tunnel_Sales Total_Tunnel Prop_Liabillity Prop_Buying Ex_Managerial Leverage Total Asset Minimum Maximum Mean Standard Deviation 0,0038 7,1635 0,6823 0,7233 0,1443 1 0,6290 0,2331 0 0,9035 0,5922 0,1286 0 1 0,1526 0,2841 0 1,9474 0,1750 0,3174 0 0,9945 0,0979 0,1939 0 1,4046 0,1064 0,2205 0,0003 0,0783 0,0090 0,0197 0,0058 2,9981 0,4553 0.3002 7.648.193.81 4.236.0347.00 5.430.660.118. 7.754.088.353.9 3,00 0.000,00 105,00 83,10 Source: data processed. Table 1. It describes the descriptive statistics of each research variable. Financial Reporting Fraudulent in this study was measured by absolute abnormal cash flow. Average financial reporting fraudulent equal to 0,6823 with minimum value 0,0038 and maximum value 7,1635. Asset expropriation through managerial compensation

25**is measured by the ratio of the** key manager's compensation **to total** assets. **The**

average statistical value of the managerial expropriation variable is 0.9%. This value can be interpreted that the average amount of asset expropriation performed by key managers is 0.9% of total asset value. The minimum

5**value of the** managerial expropriation **variable is 0.** 03% of **the** total asset **value.**

While the maximum value of 7.83% of the total value of the asset. 4.2. Hypothesis Testing The results of statistical tests on the model of research as follows: FRF = β0 - β1TUN + β2Comp + β3LnTA + β4DAUD + β5LEV + εit (1) The F_test value of the model test is 2.095 significant at the 5% level. The value can be interpreted that model is fit. The independent variables for this study, controlled rights to cash flow right, tunnelling, propping, managerial expropriation, log natural of total asset, leverage and audit quality can explain variations of the dependent variable, financial reporting fraudulent. While the coefficient of determination (Adj_R2) of 3.8%. The statistical explanation power of independent variables to the dependent

variable is 3.8%. 4.2.1. The Influence of Asset Expropriation by Management against Financial Reporting Fraudulent The statistical test of research

14**hypothesis stating that** managerial expropriation **has a positive effect on**

financial reporting fraudulent indicates variable coefficient value 10,123 with t value equal to 2,1 and significance of probability value less than 5%. Thus the results of this study can accept the research hypothesis. Table 2 Regression Constant CFR/CR Tunnel_Receivable Tunnel_Sales Total_Tunnel Prop_Liabillity Prop_Buying Ex_Managerial Ln_TA Leverage Qual_Aud F= 2, 095**** Adj R2 = 0,038 Coefficient 3,256 0,049 -0,186 -0,279 0,278 0,586 -0,251 10,123 -0,094 0,105 0,189 t-value Tolerance VIF 2,176 0,230 0,696 1,436 -0,379 0,428 2,335 -1,147 0,348 2,869 1,013 0,218 4,579 2,220** 0,677 1,476 -1,159 0,723 1,383 2,100** 0,594 1,683 -1,829 0,225 4,439 0,722 0,862 1,160 1,942 0,712 1,404 Source: data processed. The results have informed that finer managerial control to corporate asset's then finer manager's asset expropriation through increasing compensation policy, greater managerial tendency to apply moral hazard by presenting biased, fewer reliable financial statements. Increased compensation will be the reason for the managerial

12**to commit financial reporting** fraudulent. **The** results **of** this **research** are **in**

line with Urzúa's (2009) opinion that higher managerial control interest will result in a higher tendency of the managerial asset expropriation to diversify inherent risks.

11**5. CONCLUSION, LIMITATIONS AND SUGGESTIONS This study** aims to examine **the** effect **of**

management’s asset expropriation through the amount of compensations to

5**financial reporting** fraudulent. **The populations** of **this study are companies in**

industrial sectors 1, 2 and 3 that listing

26**on the Indonesia Stock Exchange in** 2008 to 2016. **The** population **of this study**

is 911 firms-years. Selection of sample research using purposive judgment sampling method so that the sample size amounted to 305 firms- years. Methods of data analysis using multiple linear regressions. The results showed that the higher management tendency of asset expropriation makes higher tendency occurrence of financial reporting fraudulent. At the individual level, management compensation as a form of management’s asset expropriation is an opportunistic behavior to gain maximize benefits. Higher the opportunistic behavior of managerial makes higher tendency of the material to present financial statements less reliable and biased. While at the organizational level, managerial compensation seems like as a manager's attempt to exploit the company's resources. The outflow of a company's resources is likely to be carried out by a company who Has Company's resources power. Privileged access to management is utilized to asset expropriation through its authority to determine compensation policies. The outflow of corporate resources taken over by management through the amount of compensations that have been received greater, the distorted profits tend to be presented. The low coefficient of determination becomes the limitation in this study. Other related variables into asset expropriation are an opportunity for future research.

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