Effect of Corporate Governance on Earnings Management: Study on Manufacturing Companies Listed in the Indonesia Stock Exchange

Review of Integrative Business & Economics Research

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ABSTRACT

This research aims to obtain empirical evidence about the effect of corporate governance consisting of managerial ownership, institutional ownership, board size, and audit quality toward earnings management. The sample in this research includes 53 companies listed on the Indonesia Stock Exchange (IDX) from 2016–2018 with a total of 159 data observations that match the criteria using purposive sampling method. This research uses multiple regression analysis to test the hypothesis. Results show that institutional ownership has a positive influence on earnings management. Institutional investors are considered passive investors, thereby rendering them uninvolved in overseeing management. Additionally, some institutional investors only focus on short-term results and thus compel the management to perform earnings management to meet institutional investor expectation. This study offers a reference to other research that examines the same research topic. Its result provides information to investors for them to pay extra attention to corporate governance mechanism and consequently prevent earnings management practice.

Keywords: Earnings Management, Corporate Governance, Indonesia Stock Exchange.

1. INTRODUCTION

The financial report shows a picture of the accounting for operational activities and the company's financial condition in a certain period (Margaretha, 2011). Financial reports aim to present information about the company's financial position, performance, and changes in the company's financial position useful when users of financial statements make decisions. In addition, financial reports are a form of management's responsibility for their performance. By using financial reports, stakeholders can evaluate the company's ability to generate profits (Kartikahadi *et al.*, 2016).

Earnings are used to measure management performance and turn earnings into important information. This earnings information often becomes the target of management's opportunistic actions to maximize its interests. The behavior of managing earnings according to management's wishes is called earnings management (Christiani and Nugrahati, 2014). Subramanyam (2014) states that earnings management is an intervention deliberately carried out by management to determine company profits with the aim of fulfilling personal interests. One example of a case of earnings management is the financial reporting problem of Garuda Indonesia Corp. The problem started when two Garuda commissioners refused to sign Garuda's 2018 financial reporting because they did not agree with the recognized revenue from the Cooperation contract with Mahata Aero Technology Corp.

To reduce opportunistic behavior from management, a governance mechanism is formed to reduce opportunistic behavior. This governance mechanism is hoped to reduce the opportunistic behavior of management and protect stakeholders' interest. This research was conducted to obtain empirical evidence on the influence of corporate governance mechanism measured by managerial ownership, institutional ownership, board size, and audit quality on earnings management. The research problem was on corporate governance which has a significant influence on earnings management.

2. LITERATURE REVIEW

2.1. Agency Theory

According to Jensen and Meckling (1976), agency theory is a contractual relationship between the principal and the agent to perform services on behalf of the former by authorizing the latter to manage the company. In agency theory, the owner of the company leaves the management of the company to an agent who has a better understanding on how to conduct business with the aim of making a profit (Sutedi, 2011). The principal and the agent have different interests, giving rise to a conflict of interest where the investor has an interest in obtaining the results of the invested capital while management has an interest in improving their welfare. This conflict of interest creates agency problems (Annisa and Hapsoro, 2017). The agency problem includes monitoring cost, bonding cost, and residual loss.

2.2. Earnings Management

Earnings management is an act of interference by company management in the financial reporting process with the aim of benefiting oneself by influencing company profits (Prabowo, 2014). Subramanyam (2014) describes several types of earnings management, namely, (1) increasing income where the company increases its profit in one period, thereby suggesting that the company is in good condition; (2) the company's big bath has been written off in one period; (3) the company's income smoothing increases or decreases profits to reduce the level of profit fluctuation. Earnings management occur when there are asymmetry information that arising from moral hazard, which can encourage management to do earnings management (Amin *et.al.*, 2018)

2.3. Managerial Ownership and Earnings Management

Managerial ownership can minimize agency problems by equating the interests of managers with shareholders (Jensen and Meckling, 1976). Increasing management share ownership is hoped to reduce earnings management practices because this share ownership will cause the management to have the same interests as shareholders, thereby possibly reducing agency conflicts; the latter is then hoped to motivate managers to improve financial statement performance (Napitupulu, 2012). From the above explanation, the hypothesis is stated as follows:

H_1 Managerial ownership has a negative influence on earnings management.

2.4. Institutional Ownership and Earnings Management

Institutional ownership refers to company shares owned by institutional investors such as insurance companies, financial institutions, pension funds, and other companies (Yang et al., 2009). Institutional investors can be more effective in monitoring management than individual investors (Aygun *et al.*, 2014). On average, institutional investors have better information than individual investors; a higher level of understanding will decrease the information asymmetry between shareholders and management, making it difficult for management to manage earnings (Al-Fayoumi *et al*., 2010). From the explanation above, the hypothesis is set as follows:

H_2 Institutional ownership has a negative influence on earnings management.

2.5. Board of Commissioners and Earnings Management

A company board can be an important internal monitoring mechanism that has an impact on the level of corporate earnings management (Aygun *et al*., 2014). The role of the board in the company is to oversee management behavior to minimize earnings management actions and trust investors (Firnanti, 2017). The number of boards in the company affects the decision-making process, which will in turn affect corporate governance and company performance (Arifin and Destriana, 2016). From the explanation above, the hypothesis is stated as follows:

H_3 Board of Commissioners has a negative influence on earnings management.

2.6. Audit Quality and Earnings Management

One of the efforts made by companies to reduce earnings management practices is the use of quality auditor services because using quality auditors will increase public trust (Firnanti, 2017). The big KAP (KAP big four) is considered to have a higher quality given their existing good reputation in the community; accordingly, they will carry out audit services carefully (Christiani and Nugrahanti, 2014). From the explanation above, the hypothesis is stated as follows:

H_4 Audit quality has a negative influence on earnings management.

3. METHODOLOGY

The population used in this research includes the manufacturing companies listed in the IDX from 2016 to 2018. The sample selection technique used in this research is purposive sampling method. The sample selection uses purposive sampling method to obtain the sample which matches the purpose of this research. To test the hypothesis, it uses multiple regressions.

3.1. Definition Operation

Earnings management in this study is measured using the modified jones model according to the research conducted by Aygun et al. (2014). The following proxies are used:

$$TAC_{it} = NI_{it} - CFO_{it}$$

$$NDAC_{it} = \beta_1 (1/ TA_{it-1}) + \beta_2 (\Delta REV_{it}/ \Delta REC_{it}) + \beta_3 (PPE_{it}/TA_{it-1}) + \varepsilon_i$$

$$TAC_{it} /TA_{it-1} = \beta_1 (1/ TA_{it-1}) + \beta_2 (\Delta REV_{it}/ TA_{it-1}) + \beta_3 (PPE_{it}/TA_{it-1}) + \varepsilon_{it}$$

$$DAC = (TAC/TA_{it-1}) - NDAC$$

TAC_{it}	= Total Accrual in year t
NI_{it}	= Net Income in year t
CFO_{it}	= Operating Cash Flow in year t
TA_{it-1}	= Total Asset in prior year
ΔREV_{it}	= Change on Revenue in year t
ΔREC_{it}	= Change on receivables in year t
PPE	= *Property, Plant, and Equipment* on year t
ε_{it}	= *Error term*

Managerial ownership is measured using the proportion of shares owned by management. Institutional ownership is measured using the proportion of share ownership by institutional investors, the size of the board of commissioners is measured on the basis of the number of boards in a company. Audit quality uses a dummy variable, where 1 means that the company is audited by big 4 auditor and otherwise. Profitability is measured by Return on Asset, Leverage is measured by Debt-to-Equity ratio, and Firm size is measured by logarithm natural of asset.

The research framework is shown as below:

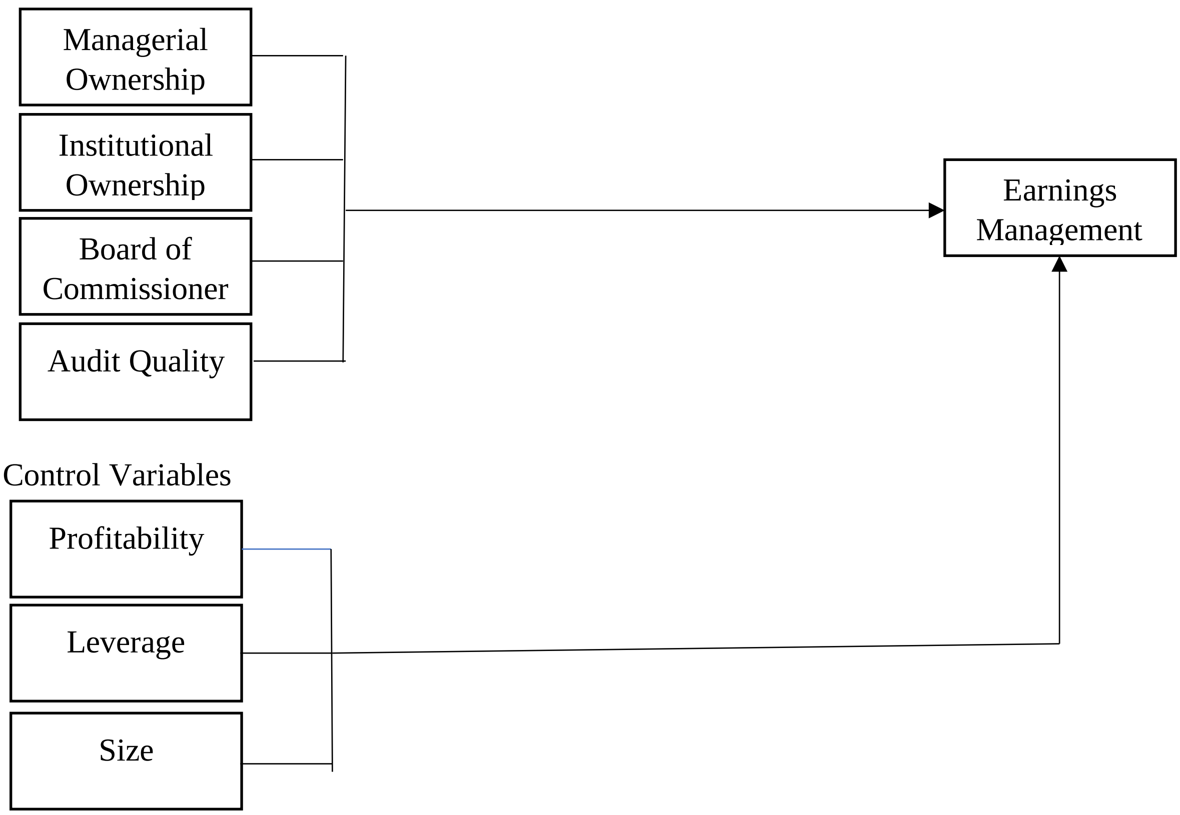

Figure 1.
Research Framework

4. RESULT

The following presents the results of descriptive statistic and hypothesis testing for each variable.

Table 1. Descriptive Statistic

Variable	N	Minimum	Maximum	Mean	Std. Deviation
EM	159	-0.2444600	0.2058800	0.027604494	0.0747686077
MO	159	0.000000000	0.739182222	0.10126566832	0.159048791616
INS	159	0.000000000	0.944760821	0.60390596638	0.256635331633
BS	159	2	12	3,95	1.905
AQ	159	0	1	0.31	0.464
ROA	159	-0.391843500	0,.466601393	0.04162708566	0.090668395034
LEV	159	0.098477010	3.593281393	0.49722459457	0.402180327781
FS	159	25.663544011	33.473727501	28.27827001999	1.656473438012

Table 2. Hypothesis Result

	B	t	Sig
(Constant)	-0.304	-2.243	0.026
MO	0.030	0.612	0.541
INS	0.069	2.334	0.021
BS	-0.001	-0.304	0.762
ROA	0.145	1.892	0.060
LEV	-0.011	-0.718	0.474
FS	0.011	0.233	0.041
AQ	-0.023	-1.474	0.142
R			0.367
Adjusted R^2			0.094
F			0.002

Table 2 shows that the managerial ownership variable (MO) has a significant value of 0.541, where the value is greater than 0.05. Thus, H1 cannot be accepted. This finding means that the independent variable managerial ownership has no effect on the dependent variable of earnings management, the presence of shares owned by management cannot minimize earnings management actions that occur. Management tends to take policies from an investor's view, such as increasing company profits to attract investors and increase share prices (Agustia, 2013).

The test results show that the institutional ownership variable (INS) has a significant value of 0.021, where the value is less than 0.05. Thus, H2 can be accepted or institutional ownership has a positive effect on earnings management. This result means that greater institutional ownership will improve earnings management because institutional investors are considered passive investors and are thus not involved in supervising management. By contrast, some institutional investors focus only on short-term results (Lassoued et al., 2017).

The test results show that the variable size of the board of commissioners (BS) has a significant value of 0.762, where the value is greater than 0.05. Therefore, H3 cannot be accepted or the variable size of the board of commissioners has no effect on earnings management, and the presence of the board of commissioners cannot control management not to perform earnings management practices. Thus, the size of the board of commissioners does not determine the effectiveness of supervision of the management of a company (Agustia, 2013).

The test results show that audit quality (AQ) has a significant value of 0.142, where the value is greater than 0.05. Thus, H4 cannot be accepted or the audit quality variable has no effect on earnings management, Auditors from both big four and non-big four KAP have no complete information related to company financial reports such as management (Yunietha and Palupi, 2017).

5. CONCLUSION

On the basis of the current research, the independent variables of managerial ownership, board size, and audit quality can be concluded to have no effect on earnings management. Meanwhile, the independent variables of institutional ownership have a positive effect on earnings management. Institutional investors are considered passive investors and are thus not involved in overseeing management, and some institutional investors only focus on short-term results. Accordingly, the latter compels the management to perform earnings management to meet institutional investor expectation. The next research is expected to add other corporate governance mechanisms to the research to obtain better result, such as board meeting, board expertise, and audit committee expertise. For earnings management, other measurements can be used to see if they can provide the best result.

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