

1-30-2013

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Recommended Citation

Hermiyetti, Hermiyetti and Manik, Evita Nora (2013) "The Influence of Good Corporate Governance Mechanism on Earnings Management: Empirical Study in Indonesian Stock Exchange Listed Company for Periods of 2006-2010," *The Indonesian Capital Market Review*: Vol. 5 : No. 1 , Article 5.

DOI: 10.21002/icmr.v5i1.1583

Available at: <https://scholarhub.ui.ac.id/icmr/vol5/iss1/5>

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The Influence of Good Corporate Governance Mechanism on Earnings Management: Empirical Study in Indonesian Stock Exchange Listed Company for Periods of 2006-2010

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The purpose of this research is to examine the influence of good corporate governance mechanism about earnings management in companies listed in Indonesian Stock Exchange during 2006 to 2010. The independent variables include the size of commissioner board, independent commissioner board percentage, size of audit committee, and commissioner meeting frequency. The dependent variable is earnings management which is measured by discretionary revenue model (Stubben, 2010). Size of company is used as the control variable in this research. The population of this research is 465 samples from companies listed at Indonesian Stock Exchange during 2006 to 2010. The sampling method used in this research is purposive sampling method. In addition, the data analysis method used is regression analysis and descriptive statistics. The result of this research indicates that the mechanism of good corporate governance which is represented by the size of commissioner board, independent commissioner board percentage, size of audit committee, and commissioner meeting frequency do not have any significant impact on earnings management. However, the result shows that company size gave positive influence toward earning management.

Keywords: *Good corporate governance, size of commissioner board, independent commissioner board percentage, size of audit committee, commissioner meeting frequency, earnings management*

Introduction

Each company is run for profit and enhances shareholder value. In practice, employers do not have the ability to run their own company's operations, hence, the owner authorizes managers to run the operations of the company. Financial report is one of the tools that can be used by owners in monitoring the performance of managers. But the separation between owners and managers within company could raise conflict of interest (Alwie, 2005). Managers have tendency to take their own advantage (moral hazard) at the expense of the principals interests. According to Xie, Davidson, and DaDalt

(2001), when the manager's incentives based on financial performance, it is possible that managers are interested to improve financial performance through earnings management. Behind manager's gain, earnings management could lead to negative effects for users of financial statements because of misleading information. According to Parulian (2004), earnings management can lead to incorrect calculation of securities value that blur the predictive value of securities and reduce investors' ability in decision-making.

Parulian (2004) and Alwie (2005) stated that earnings management behavior by managers could be minimized by practicing good cor-

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porate governance (GCG). According Tjager (2003), the development of corporate governance issues in Indonesia that was previously only marginal now become a central issue since economic crisis that hit Asia. Shareholders and regulators have paid more attention to the importance of the practice of good corporate governance. Currently the basic regulation of corporate governance in Indonesia is the Code of Good Corporate Governance issued by the National Committee on Governance (KNKG) in 2006. According to the Code of Corporate Governance, every company has to ensure the application of the principles of good corporate governance in every aspect of business in the whole range of companies. Principles of good corporate governance include transparency, accountability, responsibility, independence, and fairness. To ensure that corporate governance system is functioning within an organization, there are governance mechanisms that serve as procedures and link between decision makers and controllers. According to the context of control, governance mechanisms divided into two types, the external and internal mechanisms.

External mechanism, according to Syakhroza (2005), is known as the "market mechanism in controlling company" which capital markets, product markets, and labor markets serve as mechanisms of corporate control. The market mechanism will only be effective on perfect market conditions. Meanwhile, Indonesia does not have these characteristics so that alternative mechanisms are needed. According Syakhroza (2005), internal mechanisms can provide solution through governance board instrument. Governance board mechanism, basically, is an instrument that could be functionalized effectively since governance board has a position as an intermediary between shareholders and managers.

Studies about the influence of corporate governance on earnings management have been done before. Klein (2000) examined the relationship between audit committee characteristics and earnings management director and the results showed a negative linear relationship between audit committee independence with

earnings manipulation. But the relationship is positive in which audit committee of companies is less than the number of independent commissioners. Conversely, there is no significant relationship between earnings management with strict rules to have a 100% independent commissioner. Xie, Davidson, and DaDalt (2001) studied about the role of commissioners, audit committee, and executive committee to prevent earnings management and found that commissioner and composition of audit committees affect earnings management within company.

Research about influence of corporate governance on earnings management is also conducted in Indonesia. Ujiyantho and Pramuka (2007) found that independent commissioner existence has positive effect on earnings management, the size of the commissioner does not have a significant influence on earnings management, and together corporate governance mechanisms have a significant effect on earnings management. Nasution and Setiawan (2007) found that corporate governance mechanisms that include independent commissioner composition, commissioner size, and presence of audit committees had significant effect in reducing earnings management practice. Nuryaman (2008) found that the composition of the commissioners had no significant effect on earnings management and the concentration of individual ownership has a significant negative impact on earnings management in manufacturing companies.

Measurement of earnings management in several previous studies used different approaches, namely Jones, modified Jones, Beaver and Engel model. One earnings management measurement model that is not frequently used in previous studies is revenue-based measurement. This revenue-based measurement model is known as discretionary revenue that developed by Stubben (2010). Discretionary revenue model based on existence of accounting policy choices in revenue recognition. These options provide management flexibility in managing revenue recognition in that management has the opportunity to manage reported revenue that also give opportunities for managers practicing earnings management.

This study is different from previous studies for we used discretionary revenue model measuring earnings management. This model used because research shows that the earnings management measurement by the income approach can reduce bias, more specific and more powerful in detecting earnings management. This study investigated corporate governance mechanisms based on board governance that is proportion of independent commissioner, the Audit Committee size and meeting frequency of Board of Commissioners. We conducted this study based on problem whether corporate governance mechanisms affect earnings management. This study aims to obtain empirical evidence that corporate governance mechanisms affect earnings management.

This study is expected to be useful as a reference for companies, readers, and study of capital markets, especially regarding internal mechanism of board governance and its impact on earnings management practices. This study is also expected to be useful for investors as a consideration in making investment decisions.

Literature Review

Agency theory

According to Daniri (2005), agency theory considers that the management, as a conscious agent, will act for its own sake. In contrast, stewardship theory says that essentially, based on philosophical assumptions, humans can be trusted to act responsibly, with integrity and honesty to others. The theory is in contrast with agency theory, in which management as the agent can perform actions that are incompatible with expectations and goals provided by shareholders as principals that give trust and responsibility to managers.

Agency theory has responded broadly and seen that it reflects reality (Daniri, 2005). It is possible that management can take action that is incompatible with shareholders objectives. For example, earnings management actions by management could be detrimental for shareholders who received reports that did not reflect the facts about company's condition. Hence,

supervision function is required to ensure that management of the company is kept in control and to ensure that the management's decision is in line with rules and shareholders objectives.

Good corporate governance practices in Indonesia

Reformation of corporate governance took place in Indonesia after the 1998 economic crisis. Based on Alijoyo and Zaini (2004), since 2000 until now corporate governance evolved from national policy level, company level, up to the initiative of several non-governmental organizations, which has influence on business. The National Committee on Corporate Governance (KNKG) establishment marked GCG reforms in August 1999. In 2004, by the regulation of Ministry of Economics Affair in KEP-49/M.EKON/11/2004, government established National Committee on Governance (KNKG) to revitalize GCG. KNKG has a vision to make Indonesia as one of the countries with best governance implementation in the world. According to the KNKG Chairman, GCG could be driven from two sides, first is from ethics side and second is from regulation side. Encouragement from the ethical side is marked by the issuance of general guidelines for good corporate governance. These guidelines implementation are based on business people awareness in running business that put corporate survival, stakeholder interests, and avoid creating an instant profit. The force of GCG implementation is held through the creation of government regulation for publicly listed companies and to state owned enterprises. The Indonesian Capital Market Supervisory Body (BAP-EPAM) through Letter No. SE-03/PM/2000 requires every public company to have an Audit Committee. This detail is set in the Regulation IX.I.5 in which audit committee shall consist of at least one independent commissioner as chair and two other members from outside company. Stock Exchange requires public companies to have at least 30% of the total independent commissioner and have at least three audit committee members where the presidency is held by an independent commissioner.

Measuring earnings management by discretionary revenue model

Stubben (2010) developed a model of earnings management measurement based on income, known as the discretionary revenue model. This model is based on the choices of accounting policy in terms of revenue recognition. That discretionary income is income that has choice of accounting policy in recognition of the reported income. In practice, the choice of accounting policies provide opportunities to management for practicing earnings management.

Discretionary revenue, in financial statements, cannot be directly calculated and known. Therefore, to estimate discretionary income value, we can use some approach via a formula. In this study we use earnings management measurement based on estimated discretionary revenue using the following formula:

$$\Delta AR_{it} = \alpha + \beta \Delta R_{it} + \varepsilon_{it} \quad (1)$$

According to Stubben (2010), the value of discretionary revenue is estimated by the residuals of the model. This model uses approach where uncollected credit income is discretionary. When its income, the revenue recognition determined by accounting policy choices, is above average, the discretionary income can be predicted better.

Proportion of independent commissioners and earnings management

OECD states that non-executive board (independent commissioners) may act to take decisions independently or as an arbiter in the decision-making that is potentially creates conflicts of interest. In addition, an independent commissioner may reduce agency problems and provide advice to managers. Independent commissioners can support the implementation of good corporate governance within the companies through the controlling function.

Based on studies conducted by Xie et al. (2001), Chtourou (2001), and Carcello (2006), it can be said that the independent commission-

er, either by their percentage or by existence, has negative effect on earnings management practice. This indicates that through the existence of independent commissioner practice, earnings management could be reduced.

H₁: The percentage of independent commissioner negatively affect earnings management

The size of the audit committee and earnings management

The audit committee is a committee that is formed to assist the commissioner in overseeing company both in terms of financial and corporate governance implementation. One of the supervision is to avoid earnings management practice that could harm users of financial statements because the information received does not match reality.

Xie (2001), Chtourou (2001), and Carcello (2006) investigated the relationship between audit committee and earnings management. The result of the study shows that the audit committee with financial background is proven to reduce earnings management practices.

H₂: The size of the audit committee has a negative influence on earnings management

Number of board meetings and earnings management

Board of commissioners coordinates to control management in operating company. One form of coordination can be seen from the official meeting of the board of commissioners. Xie et al. (2001) found that meeting frequency of the Board of commissioners has a negative influence on earnings management. This indicates that the more often the board of commissioners holds meetings, the smaller the earnings management level within companies.

H₃: The number of board of commissioners has a negative influence on earnings management

Research Method

Population, sample, and sampling technique

The population of this study is the listed companies in the Indonesian Stock Exchange during 2006-2010 except financial industry companies. The financial industry is not included in this study because it has special characteristics that are different from other industries. This study uses purposive sampling as sample selection method. Sample selection is based on the following criteria: i) companies must be listed in the Stock Exchange from 2006 to 2010 consistently; ii) the company's annual reports and financial statements for the period of 2006, 2007, 2008, 2009, and 2010 are consistently accessible to researchers; and iii) GCG data required is available in the company's annual report for the period of 2006, 2007, 2008, 2009, and 2010. The data used is the secondary data that is taken from the company's annual report and financial data from the Indonesia Stock Exchange (BEI) and the Indonesian Capital Market Directory (ICMD). To obtain the required data, we use research archive method.

Operationalization of variables

The examined variables in this research consist of independent variables, dependent variable, and control variable. The independent variables include size of commissioner board, independent commissioner board percentage, size of audit committee, and commissioner meeting frequency. The dependent variable is earnings management which is measured by discretionary revenue model (Stubben, 2010). Size of the company is used as the control variable in this research.

The measurement of each variable is:

- Independent variables:

- Percentage of independent commissioner, the composition of the independent commissioner of the total board of commissioners;
- The size of audit committee, the number of the company's audit committee member;
- Frequency of board meeting, the number of

board meetings in one year

- Company size, as a control variable, the natural logarithm of total assets at year end.

Dependent variable:

- Earnings management, proxied by discretionary revenue with the model developed by Stubben (2010). The formulation of the model are:

$$\Delta AR_{it} = \alpha + \beta \Delta R_{it} + \varepsilon_{it} \quad (2)$$

In accordance with the model:

ΔAR_{it} : account receivable change in the years i

ΔR_{it} : revenue change in the years i

ε_{it} : residual model in the years i

Discretionary revenue as the proxy earning management is the residual of the model

Result and Discussion

Object description of research

Based on IDX data, the total companies listed on the Stock Exchange during 2006-2010 are 450 listed companies and companies that meet sampling criteria are 93 companies. Thus, the amount of observation data used in this study consisted of 465 data during the study five years period from 2006-2010. During research was held, it was found that there were 25 outliers data so that the net number of used samples are 440 observations.

Descriptive statistics

Statistical value in the initial data processing has not produced normally distributed data. According to Gujarati (2006) and Levine (2008), the functional form of regression by transformation data into log-linear form or natural logarithm form can be used to overcome them. In addition, data outliers were excluded from the sample because it has value beyond the average value of the data used (Levine, 2008). Table 1 presents the descriptive statistical results of the study.

Table 1. Descriptive statistics

	N	Minimum	Maximum	Mean	Std. deviation
<i>ln</i> Δ AR	440	16,95	28,23	24,3761	1,99427
<i>ln</i> Δ REV	440	17,69	31,08	26,2019	2,13467
DISCREV	440	-3,5812	3,4616	0.000000	1,2644237
<i>ln</i> KI	440	-1,61	0,00	-0,9135	0,26253
<i>ln</i> KA	440	0,69	1,95	1,1613	0,18465
<i>ln</i> FM	440	0,00	3,50	1,6372	0,65683
SIZE	440	20,16	32,36	28,5271	1,60255
Valid N (listwise)	440				

Table 2. Regression analysis of first model (discretionary revenue)

Variable	Coefficient	t-stat	Sig.
Constant	5.446	7.320	.000
<i>ln</i> Δ REV	.722	25.526	.000*
N	440		
R ²	0.598		
F-statistic	651.577		
Prob. F-stat	0.000 *		

Variable dependent
ln Δ AR = Account receivable changes year *i*

Variable independent
ln Δ REV = Revenue changes year *i*

*Significant at 5% confidence level

Test of classical assumptions in first model (discretionary revenue)

Normality test

Based on normality test using the Kolmogorov-Smirnov test on discretionary revenue model data, it can be seen that the significance value is <0.05 which is valued at 0.000. Thus, there is an indication that the research data is not normal. After we used functional form of the model, test of Kolmogorov-Smirnov shows that the value of significance was greater than 0.05 which is equal to 0.876. Hence, it can be concluded that the data in this model has no normality problem.

Autocorrelation test

The table of critical values Durbin-Watson (DW) shows that for $n = 440$, $k = 1$, and $e = 5\%$, the value of $dl = 1.84$ and $du = 1.85$. Based on the test, it is known that the value of $d = 1.878$. Because the DW value is greater than du (1.85) and less than $4-du$ (2.15), we can interpret that the data has no autocorrelation problem.

Linearity test

Linearity test in this study uses Glejser test. Based on Glejser test known that discretionary revenue variable has a value below the significance probability of 0.000 to 0.05, which can be interpreted that the discretionary revenue data does have no linearity problem.

The classical model assumptions test

Normality test

Based on normality test performed by using the Kolmogorov-Smirnov test on discretionary revenue model data, it can be seen that the significance value <0.05 , which is valued at 0.000. Thus, there is an indication that research data is not normal. After we used functional form of the model, test of Kolmogorov-Smirnov shows that the value of significance was greater than 0.05, which is equal to 0.925. Hence, it can be concluded that the data in this model has no normality problem.

Table 3. Regression analysis of second model

Variable	Coefficient	t-stat	Sig.
Constant	-4.924	-4.488	0.000
lnIC	0.147	0.646	0.519
lnAC	-0.331	-0.918	0.359
lnMF	0.090	0.973	0.331
SIZE	0.186	4.536	0.000*
N	440		
R ²	0,055		
F-statistic	6,278		
Prob. F-stat	0,000*		

Variable dependent

DISCREV (*Discretionary Revenue*) = Proxy of Earnings Management (Stubben, 2010)

Variable independent

AC= Audit committee size

IC= Percentage of independent commissioner

MF=Meeting frequency of the board of commissioner

SIZE=Company size= Natural logarithm of asset

*Significant at 5% confidence level

Multicollinearity test

There is no tolerance values below 0.10 (tolerance values ranged from 0.786 to 0.974). Moreover, there is no VIF values above 10 (VIF values ranged from 1.027 to 1.271). Hence, we can conclude that data have no multicollinearity problem.

Autocorrelation test

Tables of critical values Durbin-Watson (DW) shows that for $n = 440$, $k = 4$, and $e = 5\%$, the value $dl = 1.83$ and $du = 1.86$. Based on the test, it is known that the value of $d = 1.946$. Since the DW value is greater than du (1.86) and less than $4-du$ (2.14), it can be interpreted that the data has no autocorrelation problem.

Linearity test

Linearity test in this study using Glejser Test. Based on Glejser test, it is known that discretionary revenue variable has a value below the significance probability of 0.000 to 0.05, which then can be interpreted that the discretionary revenue data does not have linearity problem.

Regression analysis

Based on statistic test, it was found that the calculated F value is 651.577 and significant at the 5% significance level. Similarly, the ob-

tained t -stat is 25.526 and significant at the 5% significance level. Both of the tests showed that receivables changes as an independent variable affects income changes value and the effect is significant. This indicates there is a correlation between accounts receivable change with income change. Income changes can be used to predict future receivable changes. This is because if present revenue is not directly earned by the company, the revenue is recognized as a receivable and the accounts will affect changes of present receivable and change in future accounts receivable when it has been received. This is related to income that is not influence the choice of accounting policy for recognition of revenue cycle changes associated with changes in accounts receivable.

R^2 or the coefficient of determination in the regression models demonstrated the ability of income change to predict receivable changes. Based on regression result, the determination coefficient was 0.598, indicating that 59.8% change in accounts receivable can be explained by income changes and for the remaining 40.2% by factors other than income changes. There is a possibility that receivable changes that cannot be predicted by changes in revenue related to the accounting policies selection in revenue recognition. The choice gives an opportunity for management to use policy that can meet management goals. This is related to earnings management practices which management attempt to take advantage from accounting policy

Table 4. Summary of research findings

	Expected sign	Coefficient	Significance	Description
H ₁	(-)	0,147	0,519	Accepted
H ₂	(-)	-0,331	0,359	Accepted, but not significant
H ₃	(-)	0,090	0,331	Rejected

choices to generate recognized revenue in accordance with management's targets.

Every residual of the model demonstrates the value of discretionary revenue for each observation data. Value of discretionary revenue indicates an estimated value of earnings management. Discretionary revenue shows management's attempt to exploit the accounting policy choices in revenue recognition in the financial statements.

Based on the regression test, we found that the 5% significance level, calculated F -value is $6.278 > F$ table. Because the calculated F -value is greater than F -table, it can be interpreted that the independent variables jointly affect the dependent variable. The significance level result is $0.000 < 0.05$. From the results of F -test, it can be concluded that independent variables, that are percentage of the independent commissioner (IC), audit committee size (AC), frequency of the board of commissioners (MF), and company size ($SIZE$), jointly have significant effect on earnings management that measured by discretionary revenue ($DISCREV$).

The coefficient of determination is used to measure how far the ability of the model in explaining dependent variable. In this study, we use R^2 as the coefficient of determination value. Based on the test results, we obtained that R^2 value is equal to 0.055. This means that 5.5% of discretionary revenue ($DISCREV$) variation as a proxy of earnings management can be explained by independent commissioner percentage, audit committee size, meetings frequency of commissioners, and company size. While the other 94.5% can be explained by factors other than board of governance variables such as internal and external mechanisms of the market conditions, economic conditions, and other factors. This possibility occurred because board of governance implementation in Indonesian companies is to meet the minimum regulation only, and less attention to the effectiveness of board governance mechanisms in monitoring

activities. And also, according to Tjager (2003), lack of commissioner's independence is a special challenge in monitoring good corporate governance implementation. Commissioners have tendency to refract their independence, where very strong role of commissioners and directors that have majority stock have weakened the position of independent commissioner in decision-making (Tjager, 2003).

As presented in Table 4, we can see that variable percentage of independent commissioner does not proven to decrease earnings management levels. Percentage of independent commissioners has no significant effect on earnings management practices, which is evident from the statistical test results of counted t -value $0.646 < t$ -table 1.96. It can also be seen from the significance value of 0.519, which is greater than the specified significance level of 0.05. This can be explained that the existence of independent commissioner is only for meeting government regulations, so that majority shareholders have greater control in company. As a result, the existence of independent commissioner is only complies the existing regulations and is not intended for the enforcement of good corporate governance (Gideon, 2005; Sylvia and Siddharta, 2005, in Ujiyantho, 2007). These findings support the research conducted by Nuryaman (2008) and Peasnell et al. (2000). According to Nuryaman (2008), some of the reasons why board of commissioners' composition had no effect on earnings management are: (1) empirical evidence shows that average commissioner composition is relatively low, so that independent commissioner collectively has no power to influence board decisions, and (2) it is possible that board of commissioners does not have competence in accounting and finance.

Audit committee size had no significant effect to earnings management practices, which is evident from the counted t -value of $-0.918 > t$ -table -1.96. It can also be seen from the significance value of 0.359, which is greater than the

specified significance level of 0.05. The possibility of this was due to the interaction between audit committees and company management in conducting earnings management to improve the performance of the company's management effectiveness and to achieve the maximum income (Peasnell, 2000). These findings support the research of Peasnell et al. (2000). This study cannot support research of Nasution (2007), Xie, et al. (2001), and Carcello et al. (2006). The results of this study cannot support the theory that the greater audit committee size will reduce earnings management practices due to increased corporate control. This is possible because the audit committee can interact with company management to improve the effectiveness of management performance through earnings management (Peasnell, 2000). In addition, according Peasnell (2000), the interaction between the audit committee and management can be done to maximize the company's revenue.

Board of commissioners' meeting frequency had no significant effect on earnings management. The results of regression test shows that at the significance level of 5%, the counted t -value is $0.973 < t$ -table 1.96. It can also be proven from the significance value of 0.331, which is greater than the specified significance level of 0.05. This could be occurred because it is possible that frequency of meetings is not the main factor in controlling company's effectiveness, but the effectiveness of the discussion and company's condition understanding by the board of commissioner do. The results of this study do not support research of Xie et al. (2001). Variable frequency of commissioners' meeting failed to prove the hypothesis in this study. Most likely, this is caused by the average of commissioners meeting, which is still too low at 5.15, and there are some companies that only held board meeting once a year, so formal communication cannot reduce earnings management practices within company.

Firm size is used as a control variable in this study. Test result proved that at significance level of 5%, the counted t -value of $4.536 > t$ table 1.96. Because the counted t -value is bigger than t -table, it can be interpreted that company's size

has a significant influence on earnings management practices. It can also be proven from the significance value of 0.000, which is smaller than the specified significance level of 0.05. From the results we can conclude that the larger the company, the higher the tendency for earnings management practice. This results support research of Rahmawati (2007) that the larger the company, the greater the level of earnings management. This could be occurred because the larger the company, the more complex business activities carried on by the company. It can support the manager to manage the company's earnings for supervision and control of large and complex company is more difficult.

Conclusion

Based on the test results and discussions of the influence of independent commissioners percentage (IC), audit committee size (AC), the meetings' frequency of commissioners (MF), and company size to earnings management, it is known that good corporate governance through board governance mechanisms are not proven to have significant influence to discretionary revenue as the proxy of earnings management. These three board governance mechanisms do not show a significant effect on earnings management in companies listed on the Stock Exchange in the 2006-2010 study periods.

Due to time limitations, this study only examines the influence of corporate governance mechanism via board governance mechanisms (internal), and did not examine the application of other corporate governance mechanisms, namely external mechanism or market mechanism. Also, the selection of a relatively short time results low-power test so that the accuracy of the information is still relatively small.

Based on some existing limitations, the researchers suggest for future studies to use a more broadly variable of corporate governance mechanism, the outside board governance mechanism, to obtain more accurate results of corporate governance mechanism. More over, a longer study period can also be taken to study about the effect of corporate governance mechanisms in the long run.

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