THE EFFECT OF CORPORATE GOVERNANCE ON EARNINGS MANAGEMENT POST FINANCIAL CRISIS IN INDONESIA

by Agrianti Komalasari

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ABSTRACT

This research about the effect of corporate governance on accrual and real earnings management in Indonesia after the financial crisis 2007-2008. Earnings management is a deliberate act, and it covers all kinds of manipulations that may affect of financial statements either through the amount of income or other accounting items. In addition to the accrual discretionary quality, earnings management is also measured by using the real activity of the company.

The population in this study are manufacturing companies that publish in Indonesia. Financial statement data obtained taken in 2007-2015. The results of his research is the one hypothesis which states that the composition of independent commissioners affecting the accrual income management in Indonesia after the financial crisis 2007-2008 can not be rejected. The second hypothesis which states that the composition of independent commissioners affecting real profit management in Indonesia after the financial crisis of 2007-2008 can not be denied. Likewise, the third hypothesis states that audit committee influence to accrual profit management in Indonesia after the financial crisis 2007-2008 can not be rejected. The four hypotheses that the audit committee influences the real profit management in Indonesia after the 2007-2008 financial crisis can not be denied.

This study provides empirical evidence that the regulation of corporate governance after the monetary crisis of 2007-2008 has consequences that affect the behavior of decreases the earnings management accrual and increases the real earnings management on manufacturing companies that are sampled in Indonesia stock exchanges.

Key Words: Independent Commisioners, Audit Committee, Riel Earnings Management, Accrual Earnings Management, Financial Crisis.

1.1. BACK GROUND

This study is elevating issues of the influence on corporate governance toward management of accrual earnings management and real earnings management in Indonesia post financial crisis of 2007-2008. Kurniawan (2010) described that in USA there was monetary crisis which intiated from the bankcruptcy of Fannie Mae and Freddie Mac housing credit on 7 September 2007 since provided debt guarantee of USD 5,3 in USA. The government of USA one way the other must spent tax earnings as much as 200 milyar dolar due to bankruptcy of the firm that provided debt to high risk debtor.

On 15 September 2008, the larger bank ofinvestment in USA, Lehman Brothers, had submitted bankrupt status petition. In 2007 Lehman reported the amount of sales of 57 dollarsand last March had still stated by Business Week magazine as one of 50 leading companies in 2008 invaluable asset of Lehman was not more than 2 billion dollars. Other company investment such as Merril Lynch, at the end of the day was taken over by its competitor which was Bank of America. Alan Greenspan, former head of US Central Bank, calledthis world financial crisis occurred is as once in 100 years. The bankruptcy of Lehman Brothers is recorded as the largest bankruptcy in the US corporation history. The largest insurance Company, AIG, is also in the edge of fall (Kurniawan, 2010).

Vichitsarawong *et al* (2010) performed a study on financial crisis impact and post-crisis impact in four East Asia countries as follows, Hong Kong, Singapura, Malaysia, and Thailand. After the crisis, those four Asean countries performed a remedy of corporate governance in their companies. One of the important mechanisms of company governance is to monitor the integrity of financial report system.This Financial Crisis is the activity of global capital market. The development of stock exchange index in some of the world stock exchanges have not shown any out performance and it is corrected declining up to unpredicted level. If it is compared to early 2008, Shanghai stock exchange index declines to 64 percent, Kuala Lumpur composite index 34 percent. As well as composite index of Indonesia stock exchangen (IDX) on 16 Sepetember 2008 touches the lowest level of 1,719.254, corrected 39.3 percent computed as from the highest level of IHSG on 9 January 2008 at the level of 2,830.230. The financial crisis of 2007–2008 shows clear pictures that many companies report indirect impact of the monetary in USA toward IHSG in Indonesia. Suharyono (2015) stated that one of the impacts of the crisis emerge fro, deleveraging activity, such as foreign investment that has difficulty of liquidity and must withdraw its fund back that invented before in Indonesia. Manufacturer company that published in Indonesia most of them are multi national companies that possible to make effort to perform earnings management so that there will be no direct impact to the company from financial crisis happened in 2007-2008. Earnings management is purposely action, and it covers all kinds of manipulation that may influence financial reporting both in the amount of earnings or or accountant items. Suharyono (2015) states that when the monetary crisis occurs foreign investor tends to withdraw their investment from Indonesia.

Study result of Dechow *et al*. (1996) shows important motivation to manipulate earnings is the desire to increase cost effective external financing. Apart from that the manipulation of earnings is also a way of avoiding the limitation of loan agreement but there is no systematic evidence of manager to prove manager has manipulated earnings to get bigger income bonus. Apart from discretionaryaccrual, earnings management is measured by using the company real activity.

Fama and Jensen (1983) states that board of directors receive authority of internal control from the stock holder. Therefore, board directors are appointed to protect the stock holders interest, in this matter ownership and decision control. Argumentation there is separation of owner control and decision control. Debate on corporate governanceon public company emphasizes independent positive contribution of the member of board of directors to provide management act for the sake of the stock holders. While the earlier empirical study was performed by Beasley (1996) supports the earnings management hypothesis which is negatively related to the propotion of board of directors of external company.

Generally the responsibilities of audit committee are connected to their financial and accounting experties, and supervising company internal audit function. Specifically, the duty of audit committee according to Kelly and Dimovski (2007) is reviewing customer annual report, and interim report, studying every issues of financial that significant to the management party and the quality of audit and performing the considerations related to the preparation of compiling the financial report of the company. Apart from that the audit committee performs observation as well with the auditor during the implementation ofexternal audit, such as examine the policy of important accounting, alternative accounting handling, adjustment of accounting, internal controlling issues, and each activities that potential to the occurrence of corruption.

1.2. FORMULATION OF PROBLEMS

Sivaramakrishnan and Yu (2008) study the influence of adequate governance structure on accrual quality, earnings persistency and the capability of earnings predictions. The result indicates that if adequate corporate governance, high earnings quality, company with adequate corporate governance tends to have high capability to predict earnings, adequate corporate governance is a determinator of earnings quality.

There are some motivations of company to perform real earnings management. The study by Graham *et al* (2005) that indicates the readiness of a manager to changediscretionary expenses as well as other real decisions to achieve the objective of financial report. Gunny (2010) states that there is relation between real earnings management and company performance after its period. The result of the study of Zang (2012)and Cohen *et al* (2008) indicates that there is yoyo between real activity manipulation and accrual earnings management. Badertscher (2011)states that usage of earnings alternative management with accrual methods, real activity and non GAAP breaching motivated by extra assessment of company equity.

Earnings management is inpurpose action, and it covers all kinds of manipulations that may influence both financial report on the earnings amount and other accounting items. Apart from discretionary accrual quality, earnings management also measured by using company real activities. The study of Penelitian Roychowdhury (2006) has the objective of examining earnings management through real activities engineering that begin from normal operating practice, that further is motivated by manager to meet certain target. Based on that the formulation of problems proposed in this study is how corporate governance influences accrual and real earnings management in Indonesia after financial crisis of 2007-2008 in Indonesia.

REFERENCES AND HYPOTHESIS DEVELOPMENT

2.1. REFERENCES

2.1.1. AGENCY THEORY

Jensen (2005) states that conflict between management and company owner, rising cost of agency such as monitoring cost as cost to monitor the behavior of management so that there is no opportunity that harm the owner of the company. Jensen and Meckling (1976) decribes that one of the methods to minimize cost of monitoring is by considering funding and the third party, is lender. By loan contract, in general will bind the behavior of management in governing the company. Cost of binding involving wages of management is possible to determine how large is the wages required they want to receive. Cost of residual is an agency cost that emerges due to manager.Manager awares of this problem will attempt an effort to make an earnings report that brings a good image compared to benchmark used by the user. When the effort to achieve earnings target based on accounting standard is difficult to be achieve, accounting discretionary is performed to achieve the target mentioned. Second target is market based incentives.The tendency of manager to create information that company pushed by market force eventually.

2.2. DEVELOPMENT OF HYPOTHESIS

2.2.1. INDEPENDENT COMMISIONER

Manager is motivated by reputation and contractingto raise the value of company, this drives the information invention to the market by reason of the more information revealed will lower the attention ofinvestor toward adverse selection. This will increase investor trust on the company, and has impact on the increase of stock market price. Sivaramakrishnan and Yu (2008), investigates the influence of adequate governance toward accrual quality, earnings persistency, the ability to predict earnings. Its result indicates that if corporate governance is adequate, company with adequate corporate governance tends to have high accrual quality, persistence of earnings, high capability to predict earnings, adequate corporate governance is a deteminator of earnings quality.

There are several company motives to perform real earnings management. Study by Graham *et al* (2005) that indicates the availability of manager to change discretionary expenses as well as other real decisions to achieve the objective of financial report. The result of the study of Zang (2012) and Cohen *et al* (2008) shows there is yoyo between manipulation of real activity and accrual earnings management. Badertscher (2011) states that there is alternative earnings management usage by using accrual method, ral activity and breach of non GAAP which motivated by extra assessment on company equity.Apart from discretionary accrual quality, earnings management is also measured by using company real activity. Based on the mentioned above matter main hypothesis is exposed in this study as follows: Haniffa and Cooke (2002) state that there is a role of the board of commissioners independently toward the performance of the company, and the increase of financial information. The study examines the relation between corporate governance and earnings management which has already performed by Klein (2002), Anderson *et al* (2004), Zéghal *et al* (2011) they find the existence of negative relation between independent board and earnings management activitiy. Large board measurement may increase the bargaining position of the board with CEO.

Therefore, large board measurement can be more effective in monitoring management. Vichitsarawong *et al* (2010) conducts a study on financial crisis affection an the post-crisisperiod in four countries East Asia such as Hong Kong, Singapura, Malaysia, and Thailand. After the crisis, the four South Asia perform an improvement of corporate governance in their company. One of important mechanisms of company governances is to monitor the integrity system of financial report. Therefore it is suspected that the amount of large independent commissioner proves effectively to monitor the performance of management and efficiently work together to solve monetary crisis of 2007-2008 that the level of earnings management will get even lower. Based on this hypothesis raised is:

Ha_1: The composition of independent commisioneer has influence on accrual earnings management in Indonesia post financial crisis of 2007-2008.

Ha_2: The composition of independent commisioneer has influence on real earnings management in Indonesia post financial crisis of 2007-2008.

2.2.2. AUDIT COMMITTEE

The use of audit committee is an important part of internal monitoring system of board of directors according to the result of study performed by Fama (1980), Fama and Jensen (1980), and Bradbury (2006). Audit committee in this research is using proxy of comparison ratio of independent audit committee with total company audit company. Klein (2002) finds negative relation between measurement of independent board and earnings management activity.

Carcello *et al* (2006) investigates relation between expertise of audit committee in the field of finance and earnings management. The result indicates corporate governance of company and financial experts act as complimentary toward one to another. Apart from that, Carcello (2006)finds an evident that there is declining of abnormal accrual after an accounting expert joins with audit committee. Chapple *et al* (2009) investigates misuse of asset with the effectivity of audit committee in Australia andNew Zealand. The result indicates that the proportion of audit committee that independent audit inversely propotional to the misuse of company asset. The results of Chapple *et al* (2009) proves that reduction of misused asset if audit committee is a financial expert. Indonesia is one of the country impacted by previous crisis monetary has obliged companies to implement structure of corporate governance with one of important mechanisms of company corporate governance in order to monitor integrity system of financial report. One of corporate governance structures is audit committee, suspected that due to an audit committee competency in financial therefor company can minimize the issue of earnings management after the financial crisis occurred. Based on that matter the hypothesis is as follows:

Ha_3: The expertise of Audit Committee has influence on accrual earnings management in Indonesia post financial crisis of 2007-2008.

Ha_4: The expertise of Audit Committee has influence on real earnings management in Indonesia post financial crisis of 2007-2008.

RESEARCH METHOD

3.1. DATA RESOURCES, POPULATION AND SAMPLE

Population in this study is manufacturing companies in Indonesia. Financial report data is obtained from database BVD OSIRIS collected in 2007-2014. Data for the year 2007 is used to meet variable that requires data *log*-1. Observation year period is 2008- 2014.

3.2. RESEARCH MODEL

This study uses proxied variable independent audit committee. This study uses proxy for competence of independent audit committee which measured from independent audit committee that has financial expert competency and in total audit committee scale. Independent commissioner is proxied by composition comparison of independent commissioner toward the amount of board of commissioners. Control variabel in this research are four such as company size by using total proxy for log of asset, profitability of company which proxied by return on assets (ROA), operations cash flow and gearing ratio.

3.3. DEPENDENT VARIABEL

3.3.1. Measurement of Acrual Earnings Management.

There are several suggested models to estimate nondiscretionary or normal accrual and discretionary accrual. The measurement of abnormal accrual model Jones (1991) uses more to earnings accrual. Yet, when observation amount per year limited industry, the estimation is provided but unreliable. As proxy for earnings management model of DeFond and Park (2001).

$$AWCA_t = WC_t - (WC_{t-1}/S_{t-1}) \times S_t)$$

The explanation is as follows:

t	= year of t,
$AWCA_t$	= normal working accrual capital in year t.
WC_t	= non cash accrual working capital in year t.
Computed as from	= (cash flow-asset and short term and long term investment) – (current asset−mature long term debt)
WC_{t-1}	= working capital at the end year of t-1
S_t	= sales in the year of t
S_{t-1}	= sales in the year of t−1.

AWCA is scaled by total asset of the year mentioned. The absolute value of AWCA is used for the main objective of measuring earnings management regardless of whether increases or decreases earnings management mentioned. AWCA is scaled by total asset as control to the size of company.

3.3.2. Measurement Riel Earnings Management

Roychowdhury (2006) has developed model which used by Cohen and Zarowin (2010), and Cohen *et al* (2011) is a model developed by Dechow *et al* (2000).

Cash flow from operations activities

$$CFO_t/A_{t-1}=\alpha_0+ \alpha_1(1/A_{t-1})+\alpha_2(S_t/A_{t-1})+\alpha_3(\Delta S_t /A_{t-1})+\varepsilon_t$$

with the explanation as follows:

CFO_t = Cash flow of operations activity is in t
A_{t-1} = log total asset
S_t = Sales in t
ΔS_t = Change in sales from t-1 ke t, $\Delta S_t=S_t-S_{t-1}$

Discretionary production

$$PROD_t/A_{t-1}=\alpha_0+\alpha_1(1/A_{t-1})+\alpha_2(S_t/A_{t-1})+\alpha_3(\Delta S_t /A_{t-1})+\alpha4(\Delta S_{t-1}/A_{t-1})+\varepsilon_t$$

with explanation as follows:

$PROD_t$= production cost in t($COGS_t+\Delta INV_t$)
A_{t-1} = log total aset
S_t = sales in t
ΔS_t = change in sales in t-1

$$DISEXP_t/A_{t-1}=\alpha_0+\alpha_1(1/A_{t-1})+\alpha_2(S_{t-1}/A_{t-1})+\varepsilon_t$$

Discretionary cost is third proxy from real earnings management according to Roychowdhury (2006). With the explanation as follows:

$DISEXP_t$ = discretionary cost,
A_{t-1} = log total asset,
S_{t-1} = sales in t-1

3.3.3. Model of Earnings Management Research

Model used for proxy of accrual earnings management are:

$$AWCA_{it}=\beta_0+\beta_1Board_{it}+ \beta_2AC_{it}+\beta_3ROa_{it}+\beta_4SIZE_{it}+\beta_5LEV_{it}+B_6CFO_{it}+\varepsilon_{it}$$

Model used for proxy of real earnings management is:

$$REM_{it}=\beta_0+\beta_1Board_{it}+ \beta_2AC_{it}+\beta_3ROa_{it}+\beta_4SIZE_{it}+\beta_5LEV_{it}+B_6CFO_{it}+\varepsilon_{it}$$

Table 3.1. Definition Variableused

Variabel and Code	Description	Formula
$AWCA_{it}$	Abnormal accrual working capital in year t is is scaled by total asset using model	$AWCA_t=WC_t-(WC_{t-1}/S_{t-1})\times S_t)$
$Board_{it}$	Board of commisioner, proxied by 3 proxies are the amount of independent board is scaled by total of board, duality of positions of board member in the structure of corporate governance is a dummy variabel that equals 0 if positions are dualand 1 otherwise.	

AC_{it}	Audit committee that proxied is percentage of independent audit committee toward total of audit committee, percentage of audit committee of financial expert with total of audit committee.	
Profitability(ROA_{it})	Profitability is proxied by return on assets (ROA)	Revenue of operations divided by total asset.
Size ($Size_{it}$)	Computed as fromDihitung natural logarithmof total asset	Log (assets)
Leverage (LEV_{it})	Computed as from total debt divided by total asset (gearing ratio)	Total debt/asset
Cash flow (CFO_{it})	Operations cash flow	
REM_{it}	REM real earnings management derived from CFO value, production, Discretionary cost.	

3.4. HYPOTHESIS TESTING AND RESEARCH MODEL

To examine hypothesis multiple regression test must be performed for previous accrual earnings management and real earnings management to examine the mistake of regression model used by BLUE testing of assumption in the form of linearity test, heteroscedasticity test, autocorelation test also normality test.

ANALYSIS AND DISCUSSION

In this chapter hypothesis testing result will be elaborated along with result of research. First part presents selecting procedure data and sample of characteristic, as well as descriptivestatistic variables used in this study. This testing uses company analysis level.

4.1. DATA COLLECTION

Procedure of sample collection shows in Table 4.1 sample collected is 50listed in IDX with 9 years observations, that the total of observation obtained is 450 observations. Outlierexpenditure process is performed if the sample has value exceeding average 3 times deviation standard for each of research variable. Accrual and Real Earnings Management for listed companies in IDX.

Tabel 4.1. Descriptive Statistic for Research Variable of Listed Companies in IDX.

	REM	AWCA	BOARD	CFO	AC	ROA	LEV	SIZE
Mean	0,040	2.076	0.34	1,988	0.000	0.065	0.983	0.585
Median	0,042	2.188	0.1677	0.000	0.000	1.000	0.302	11.032
Maximum	1.612	2.570	0.568	2,98	1.000	1.000	3.354	19.828
Minimum	-1.001	1.006	0.000	0.000	0.000	0.000	-1.002	6.893

Tabel 4.1 presents descriptive statistic for real earnings management (REM), accrual earnings management (DA), commissioner board (BOARD), audit committee (AC), CFO, return on assets (ROA), leverage (LEV) and size (SIZE) during period of 2007-2015 from companies listed in IDX. Tabel 4.1 provides overview on central tendency condition differences, data distributions and data dissemination. From table 4.1it is seen that accrual earnings of listed companies in IDX have an average value of 0,076. Real earnings management average of listed companies in IDX is 0,045. Average value of proportion of independent commissioner to the board of commissioner for sample of listed companies in IDX is 0,34.

Table 4.2. Result of Regression Model of Accrual Earnings Management Testing.

Model of Testing $AWCA_t = \beta_0+\beta_1 Board_{it}+\beta_2 AC_{it}+ \beta_3 ROA_{it}+\beta_4 SIZE_{it}+\beta_5 LEV+\beta_6 CFO+\varepsilon_{it}$			
Independent Variable: Disretionary accrual (DA) Independent Variable	Exp. Tanda	Coefficient	Significancy
Intercept	?	***0,007	0,000
Proportion of Commissioner Board (BOARD)	-	***0,065	0,000
Audit Committee (AC)	-	*0,054	0,092
ROA	-	-0,005	0,132
SIZE	-	0,000	0,184
LEVERAGE	+	*0,004	0,040
CFO	-	*-0,108	0,070
Prob(F-Statistic)		0.000000	
Adjusted`R-squared		0,1438	
*** Significant at a 1% level ** Signficant at a 5% level * Significant at a 10% level			
Table Description: This table presents estimation for accrual earnings management model for listed companies in IDX. Independent Variabel: disretionary accrual (DA); its independent variable: board of commissioner (Board), audit committee (AC), control variable: ROA, size, CFO and leverage.			

Hypothesis one that states the composition of independent commissioner has influence on accrual earnings management in Indonesia post financial crisis of 2007-2008 can not be rejected. As well as hypothesis three that states that audit committee has influence on accrual earnings management in Indonesia post financial crisis of 2007-2008in can not be rejected.

Table 4.3. Result of Regression Model of Real Earnings Management Testing

Model of Testing $REM_t = \beta_0+\beta_1 Board_{it}+\beta_2 AC_{it}+ \beta_3 ROA_{it}+\beta_4 SIZE_{it}+\beta_5 LEV+\beta_6 CFO+\varepsilon_{it}$			
Dependent Variable: Real Earnings management (REM) IndependentVariable	Exp. Mark	Coefficient	Significancy
Intercept	?	**0,075	0,005
Proportion of Board of Commissioner (BOARD)	-	**0,086	0,045
Audit Committee (AC)	-	*0,046	0,080
ROA	-	-0,002	0,171
SIZE	-	0,000	0,485
LEVERAGE	+	*0,025	0,089
CFO	-	*-0,008	0,065
Prob(F-Statistic)		0.000000	
Adjusted`R-squared		0,1242	
*** Significant at level of 1% ** Signfikan at level of 5% * Significant at level of 10%			
Table description: This table presents estimation for real earnings management model for listed companies in IDX. Dependent Variable :disretionary accrual(DA);its independent variable: board of commissioner (Board), audit committee (AC), control variable: ROA, size, CFO and leverage.			

Hypothesis two states that composition of independent commissioner has influence on real earnings management in Indonesia post financial crisis of 2007-2008 can not be rejected. Hypothesis four states that audit committee has influence on real earnings management in Indonesia post financial crisis of 2007-2008 can not be rejected.

Discussion:

This research result both H_1-H_4 supports the result of research by Graham *et al* (2005) that indicates the availability of manager for to change discretionary expenses as well as other real decisions to achieve the objective of financial report. Result of research of Zang (2012) and Cohen *et al* (2008) indicates that there is yoyo between manipulation of real activity with accrual earnings management. Other supporting research is the result of research of Badertscher (2011) states that there is usage of earnings management alternative by using accrual method, real activity, and breach of non GAAP which motivated by the extra assessment of company's equity.

In general is in line with the research of Vichitsarawong *et al* (2010) on the impact on financial crisis and post-crisis period in four countries in East Asia, such as Hong Kong, Singapura, Malaysia, and Thailand. In Indonesia also after the crisis betterment of corporate governance 2007-2008 has performed and has impact on global capital market and has no impact on IDXwhich in this research is indicated due to regulation betterment in board of commissioner and audit committee in public company in IDX.

CONCLUSION

5.1. Conclusion

The objectives of this study is to provide empirical evidence on the influence of corporate governance toward accrual and real earnings management in Indonesia post financial crisis of 2007-2008. This study uses data OSIRIS BVD 2015. Data uses observation year of 2007-2015. Sample can be observed as much as 450 samples. The result of research is hypothesis one states that the compostion of independent commissioner has influence on accrual earnings management in Indonesia post financial crisis of of 2007-2008 can not be rejected. As well as hypothesis three which states that audit committee has influence on accrual earnings management in Indonesia post financial crisis of 2007-2008 can not be rejected.

Hypothesis two states that the composition of independent commissioner has influence on real earnings management in Indonesia post financial crisis of 2007-2008 can not be rejected. Hypohesis four states that audit committee has influence on real earnings management in Indonesia post financial crisis of 2007-2008 can not be rejected.

5.2. Contributions and Implications

The difference of this research with previous research is this research uses sample of companies that are in Indonesia using corporate governance two tier model. This study of Marra *et al*. (2011) and Zéghal *et al*. (2011) collect sample from companies in a country that uses corporate governance one tier model.

This research has proven that the regulation of corporate governancepost monetary crisis of 2007-2008 will have consequency that influences different earnings management behavior in IDX. Other empirical contribution is this research uses two models of accrual and real earnings management.

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