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## Article

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Contemporary Economics

## Provided in Cooperation with:

University of Finance and Management, Warsaw

*Suggested Citation:* Putri, Aprillya Vernanda; Prasetyo, Khusnul (2020) : The effect of good corporate governance mechanism on earnings management in Lq-45 companies, Contemporary Economics, ISSN 2300-8814, University of Finance and Management in Warsaw, Faculty of Management and Finance, Warsaw, Vol. 14, Iss. 4, pp. 545-554,  
<https://doi.org/10.5709/ce.1897-9254.426>

This Version is available at:

<https://hdl.handle.net/10419/297549>

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Primary submission: 15.08.2019 | Final acceptance: 10.01.2020

# The Effect of Good Corporate Governance Mechanism on Earnings Management in Lq-45 Companies

Aprillya Vernanda Putri and Khusnul Prasetyo

## ABSTRACT

This study aims to determine the effect of good corporate governance mechanisms consisting of board size, the board of directors, the independence of the board of commissioners, the size of the audit committee, the expertise of the audit committee and the type of auditor on earnings management in companies indexed by LQ-45 for the 2016-2018 period. This study uses multiple linear regression analysis techniques. The results of the analysis in this study indicate that the expertise of the audit committee is able to reduce the level of earnings management in the company. However, this research is unsuccessful in showing that the size of the board of directors, the independence of the board of commissioners, the size of the audit committee and the type of auditor are able to influence earnings management. These results imply the importance of an expert audit committee to be able to improve the quality of financial reporting, which is indicated by low earnings management.

## KEY WORDS:

Good corporate governance, earnings management, company LQ-45.

## JEL Classification: H83, O16, M42.

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## 1. Introduction

The financial crisis that occurred in Asia in 1997 was considered to be the result of weaknesses in the company's good corporate governance (GCG) practices (Muda et al., 2018). Along with the emergence of various other cases of manipulation of financial statements in the following years, various countries began to develop corporate governance mechanisms to ensure transparency practices in the financial reporting process within the company (Kamran & Shah, 2014). Based on this case, questions arise about the effectiveness of GCG implementation which is used to minimize earnings management practices. Conflicts of interest between the owner (principal) and management (agent) can be minimized by a monitoring mechanism that can balance the interests of the two parties.

According to Schipper (1989) earnings management occurs when there is intervention in the financial reporting process with the aim of obtaining personal gain. Management makes various engineering efforts by using certain techniques so that the appearance of financial reporting looks better, higher or lower in profit. The type of earnings management that is most widely used is accrual earnings management, where management implements policies on the selection of accounting methods and provisions to influence earnings that do not have a direct effect on cash flow (Healy & Wahlen, 1999; Dechow, 1995). Research on earnings management has begun to be widely carried out in Asia (Agustia et al., 2019; Agustia et al., 2020; Abdul et al., 2020)

According to Jensen and Meckling (1976), agency problems can occur because of differences in interests between principals and company agents. The principal is motivated to improve his welfare through the profitability of the company, while the agent is motivated to maximize the fulfillment of

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his economic and psychological needs through obtaining investment, credit, and compensation contracts obtained from the company (Salno & Baridwan, 2000). With these different goals, it provides an impetus for agents to manipulate the performance they do in financial reports to fulfill their wishes. Based on stakeholder theory, a company should emphasize its accountability more broadly and not only limited to financial performance (Yahya et al., 2017). All stakeholders have the right to be treated fairly by the company, where managers (agents) must manage the organization for the benefit of stakeholders (Muda et al., 2018).

Good Corporate Governance (GCG) is a mechanism to direct and control a company so that the company's operations run according to the expectations of stakeholders. By implementing GCG consistently, companies can defend shareholder interests, increase company value in the stock market, protect information transparency, reduce conflicts of interest and increase auditor independence (Leuz et al., 2003; Sari et al., 2018; Mahrani & Soewarno, 2018). This study will analyze the GCG mechanism carried out on the board of directors as company manager, the board of commissioners as the party that oversees company policy, and the organ audit committee which assists the implementation of the board of commissioners' duties in overseeing the financial reporting system (Siallagan & Machfoedz, 2006). In addition, this study will also analyze the type of auditor, which describes how well the company's auditors detect and report material misstatements in financial statements (Gul et al., 2009).

This study uses 119 observations of companies included in the LQ-45 index on the Indonesian stock exchange. The object of this study uses a company registered as an LQ-45 company because the authors consider that the company is an object that has a high level of liquidity and is the most attractive to investors. Profit from the LQ-45 company becomes an attraction for investing in the company, this increases the possibility of earnings management within the company. The results of this study indicate that audit committee expertise is negatively related to earnings management. Where the existence of an expert audit committee is able to reduce the level of earnings management in the company. However, this study did not succeed

in showing that the size of the board of directors, the independence of the board of commissioners, the size of the audit committee and the type of auditor were able to influence earnings management. This result implies that an expert audit committee is able to carry out the monitoring of the reporting process properly as indicated by the low level of earnings management within the company.

The remainder of this paper is structured as follows. Section 2 literature reviews and develops the research hypotheses. Section 3 describes the sample, variables, and research design. Section 4 specifies the empirical result. Section 5 summarizes the paper and presents concluding remarks.

## 2. Literature Review

### 2.1. *The Effect of Board Size on Earnings Management*

Based on The Indonesia Corporate Governance Manual, the board of directors is a part of the company that has full authority and responsibility to manage the company for the benefit of the company in accordance with the company's goals and objectives. The board of directors has an important role in avoiding profit management practices (Kapoor & Goel, 2019). Jensen and Meckling (1976) stated that a small number of boards of directors is more effective in supporting the activities of the Chief Executive Officer (CEO) than a board of directors with a large size. This happens because boards of directors with a larger size tend to concentrate on maintaining their own good name so that the CEO tends to have more power to control the company. In contrast to this, Yermack (1996) concluded that board size is inversely related to earnings management. A smaller number of members of the board of directors will be associated with higher earnings management. The better the quality of the board of directors, it will be associated with discretionary accruals lower. Based on the explanation above, the hypothesis is:

H<sub>1</sub> : Board of director size affects earnings management

### 2.2. *Effect of Independent Commissioners on Earnings Management*

According to Financial Services Authority Regula-

tion Number 33 / POJK.04 / 2004 the board of commissioners is part of the issuer or public company in charge of conducting general and / or specific supervision in accordance with the articles of association and providing advice to the Board of Directors. Daghsni (2016) states that the independence of the board of commissioners is one of the most important determinants of board effectiveness in reducing managerial and earnings management policies. Therefore, in order to increase the effectiveness and activity of the board in its supervision, agency theory suggests involving an independent board of commissioners in the company. Earnings management occurs less frequently when the audit committee is more independent (Bukit & Iskandar, 2009).

Dechow et al. (1995) found that earnings management practices are associated with companies that have an inadequate level of board independence. Likewise, with Cheng and Courtenay (2006) who emphasized that the level of independence of the board of commissioners is directly related to the quality of financial reporting. Based on this explanation, the hypothesis is:

$H_2$  : Independent board of commissioner size affects earnings management.

### 2.3. Effect of Audit Committee Size on Earnings Management

The third characteristic of GCG is the size of the audit committee, according to POJK Number 5 / POJK.04 / 2015 the audit committee is a committee formed and responsible to the Board of Commissioners in helping carry out the duties and functions of the Board of Commissioners. Companies can minimize the form of fraud committed by managers in the financial reporting process through supervision by an independent third party, namely the audit committee (Wardhani & Joseph, 2010). The more members of the audit committee will be able to improve performance, this is because there are more members who carry out supervisory duties (Miko & Kamardin, 2015). Based on this explanation, the hypothesis is:

$H_3$ : Audit committee size affects earnings management.

### 2.4. Effect of Audit Committee Expertise on Earnings Management

The audit committee is responsible for monitoring the

financial reporting process and ensuring the credibility of financial reports. It is important for audit committee members to have a certain level of financial expertise (Mishra & Malhotra, 2016). In the Financial Services Authority Regulation Number 55 / POJK.04 / 2015, it is stated that at least in an audit committee there is one member of the audit committee who has an accounting or financial background. These advantages in financial expertise can help audit committee members to become more familiar with financial and operational reports that enable them to carry out their supervisory duties effectively (Ayemere & Elijah, 2015). The audit committee will be faced with a variety of complex accounting problems (DeFond, 2005). So that the financial accounting expertise will make it easier for the audit committee to carry out its duties. Based on this explanation, the hypothesis is:

$H_4$ : Audit committee expertise affects earnings management.

### 2.5. Effect of Auditor Type on Earnings Management

In accordance with the perspective of agency theory regarding agency problems, another independent party is needed to oversee the reporting of the agent. The company's financial statements will be audited by the auditor to provide assurance that the financial statements are free from material misstatement and protect the interests of the principal (Healy & Wahlen, 1999). A quality auditor has significant effects on market-based and accounting-based financial statements (Hasibuan et al., 2017). Auditors High quality will tend to be conservative with the accounting methods used and will report various findings of errors and irregularities that are revealed during the audit work. The higher the value of Ethics, Commitment, Independence, Competence and Experience would have an impact on the increasing skepticism Professionals (Kusumawati et al., 2017). Lawrence et al. (2010) stated that Big Four audit firms have large resources, as well as sound financial and operational systems, therefore they can provide better services for the company. According to DeAngelo (1981), the competence of big four audit firms will be better than non-big four because the investment spent is greater in technology and audit staff training. Based on the explanation above, a hypothesis is built:

$H_5$ : Auditor type affects earnings management

### 3. Methods

#### 3.1. Sample and Data Source

This study uses a sample of LQ-45 companies listed on the Indonesia Stock Exchange for the period 2016-2018. The LQ-45 company is a company that is included in the criteria for companies that have the highest market capitalization and transaction value, have good financial conditions and growth prospects, and are listed on the Indonesia Stock Exchange for at least 3 months. The observations in this study were 119 companies. Table 1 shows the sample selection from this study. The data in this study were obtained through financial reports and company annual reports which were downloaded through the Indonesia Stock Exchange website.

### 4. Variable Measurement

#### 4.1. Dependent Variable

The dependent variable in this study is earnings management (EM). In this study, earnings management will be proxied by measuring using discretionary accruals. Discretionary accruals are the recognition of which are a management policy choice (Dechow et al., 1995). The model for measuring earnings management in this study uses the modified Jones model. The following are the stages of calculating total accruals to measure earnings management using the modified Jones model (Yasser & Soliman, 2018):

Stage 1 (Calculating total accruals):

$TA_{it} = NI_{it}$  (net profit of company  $i$  in year  $t$ ) -  $CFI_{it}$  (company cash flow in year  $t$ )

Step 2 Calculating the accrual value with a simple linear regression equation:

$$TA_{it} = \alpha_0 (1 / A_{it-1}) + \alpha_1 (\Delta Rev_{it} / A_{it-1}) + \alpha_2 (PPE_{it} / A_{it-1}) + e$$

Step 3 Perform nondiscretionary accruals (NDA) calculation:

$$NDA_{it} = \alpha_0 (1 / A_{it-1}) + \alpha_1 (Rev_{it} / A_{it-1} - \Delta Rec_{it} / A_{it-1}) + \alpha_2 (PPE_{it} / A_{it-1})$$

Stage 4 Perform discretionary accruals calculation:

$$DA_{it} = TA_{it} - NDA_{it}$$

Description:

$TA_{it}$  = Total accruals of company  $i$  in year  $t$

$A_{it-1}$  = total assets of company  $i$  in year  $t$

$\Delta Rev_{it}$  = Change in company  $i$  revenue in year  $t$  minus revenue in year  $t-1$

$\Delta Rec_{it}$  = Change in net receivables of company  $i$  in year  $t$  minus receivables net year  $t-1$

$PPE_{it}$  = value of fixed assets (gross property, plant, and equipment) company  $i$  in year  $t$

$e$  = Error company  $i$  in year  $t$

$NDA_{it}$  = Nondiscretionary accruals company  $i$  in year  $t$

$\alpha$  = fitted coefficient obtained from the results regression in the first stage calculation

$DA_{it}$  = discretionary accruals company  $i$  in year  $t$

#### 4.2. Independent Variable

The independent variable in this study is the good corporate governance (GCG) mechanism. The mechanism used by the author in this study is an internal mechanism consisting of the board of directors, the board of commissioners, the audit committee and the type of auditor for the Board of Directors (DIR) measured numerically by using the number of members of the board of directors in a company (Patrick et al., 2015). Independent commissioners (INDCOM) are measured by the percentage of the number of independent commissioners divided by the total number of the company's commissioners. Audit committee size (AUDCOM) is measured numerically by the number of audit committee members (Patrick et al., 2015). Audit committees with accounting and financial expertise have the ability to deal with more complex company problems and can detect the occurrence of earnings management (DeFond, 2005). The variable of audit committee expertise (EXPAUDCOM) is measured by calculating the proportion of the number of audit committee members who have financial or accounting expertise to the total number of audit committee members. The auditor type variable (BIG4) is a dummy variable, with a value of 1 for companies using Big Four audit firm and a value of 0 for companies using non-Big Four audit firm (Becker et al., 1998).

#### 4.3. Control Variable

This study uses the variable profitability (ROA) and

**Table 1.** List of Sample

Criteria	2016	2017	2018
LQ-45 companies listed on the Indonesia Stock Exchange in 2016-2018	45	45	45
Financial companies listed as LQ-45 companies in 2016-2018	(5)	(5)	(6)
Total Sample	40	40	39

leverage (LEV) as control variables. Profitability is the level of net profit obtained by the issuer in carrying out its operations (Gunawan & Purnamawati, 2015). In this study, the proxy used to measure profitability is Return on Assets (ROA). ROA is a measure of the company's ability to generate profits with the total assets owned by the company. Large firms engage less in earnings management conduct compared to their counterparts (Putra et al., 2018). According to Sudana (2011) leverage arises because companies in their operational activities use assets and other sources of funds which cause fixed expenses for the company. The leverage ratio used in this study is a comparison between total debt and total company assets. The ratio of total debt to total assets is called the debt ratio (Sudana, 2011).

## 5. Methodology

The hypothesis testing in this study uses multiple linear regression analysis. This analysis is a value forecasting tool to test whether or not there is a causal and functional relationship between the independent variable and the dependent variable.

The individual parameter significant test (t) is used to test the effect of each independent variable in partially explaining the dependent variable. The level of significance used in this study is 0.05, which means that if the significance value is  $> 0.05$ , the hypothesis is rejected and if the significance value is  $< 0.05$ , the hypothesis is accepted. The regression model used in this study is as follows:

$$EM = \alpha + \beta_1 DIR + \beta_2 INDCOM + \beta_3 AUDCOM + \beta_4 EXPAUDCOM + \beta_5 BIG4 + \beta_6 ROA + \beta_7 LEV + e$$

## 6. Empirical Result

### 6.1. Descriptive Statistics

Table 2 shows a statistical description of the variables that presents the minimum value, maximum value, average value and standard deviation of each variable used in this study.

Based on Table 2, it shows that the LQ-45 company's earnings management practice (EM) for the 2016-2018 period has an average (mean) of 0.55919 and a standard deviation of 0.87328. The size of the board of directors (DIR) has a mean (mean) of 6.52 with a standard deviation of 1,650. The size of the board of directors ranges from 3 to 11 people.

The independent board of commissioners has a mean (mean) of 0.4014 and a standard deviation of 0.12033. The maximum value is 0.83 while the minimum value is 0.17. The size of the audit committee (AUDCOM) has a mean (mean) of 3.43 or as many as 3 members per company with a standard deviation of 0.728. This shows that LQ-45 company members have on average 3 members of the audit committee in accordance with POJK No. 55 / POJK.04 / 2015 which states that the members of the audit committee consist of at least 3 members who come from independent commissioners and parties outside the company.

The audit committee's expertise has a mean (mean) of 0.6583 and a standard deviation of 0.23451. The type of auditor has an average (mean) of 0.73 with a standard deviation of 0.447, which means that 73% of companies from the entire study population use KAP audit services Big Four. Profitability as a control variable has an average (mean) of 0.0837 with a standard deviation of 0.08722. Variable Leverage, which is measured using the Debt to Equity Ratio, has an average (mean) of

0.490991 with a standard deviation of 0.22283.

### **6.2. Effect of Board of Directors Size on Earnings Management**

Table 3 shows the results of hypothesis testing in the study. The variable of board of directors size (DIR) shows that the hypothesis H1 is rejected because the probability value of the variable is 0.723. This means that there is no significant influence between the size of the board of directors on earnings management. Whether the number of members of the board of directors is large or not cannot prevent the agent from carrying out earnings management. Because according to Wheelen and Hunger (2012), in its implementation some boards of directors are active and others are passive. So that this behavior can reduce the significant effect of board size on earnings management. Boards should not just reflect size but rather the skills and expertise of individuals appointed to the board (Egbunike & Odum, 2018). The absence of observed influence in the size of the board of directors in LQ-45 firms is in line with the research results of Azeez et al. (2019) which states that the size of the board of directors has no significant effect on earnings management.

### **6.3. Effect of Earnings Management Board of Commissioners on Earning Management**

Table 3 shows that the hypothesis H2 is rejected where the value of the variable probability INDCOM of 0.967. This means that there is no significant influence between the proportion of independent commissioners on earnings management because. The existence of an independent board of commissioners cannot prevent the behavior from agent practicing earnings management. This shows that the size of the composition of the independent board of commissioners cannot guarantee that there is good oversight of manipulation in financial statements. The results of this study are in line with the research by Muda et al. (2018) which states that the proportion of independent commissioners has no effect on earnings management. In terms of the independence of the audit committee which is not significant to earnings management consistent with Laily's research (2017).

### **6.4. Effect of Audit Committee Size on Earnings Management**

Based on Table 3. The variable of audit committee size

shows that the hypothesis H3 is rejected because the probability value of the variable is 0.666. This means that there is no significant influence between the size of the audit committee on earnings management. The size of the audit committee is not able to protect the interests of shareholders from earnings management carried out by the agent. This study is consistent with the results of the study by Muda et al. (2018) which states that the size of the audit committee has no effect on earnings management. The size of the audit committee does not represent the effectiveness of monitoring the financial statements. The quality of monitoring will depend on the quality of the members, meeting frequency or other factors not explained in this study.

### **6.5. The Effect of Audit Committee Expertise on Earnings Management**

Table 3 shows that the hypothesis H4 is accepted because the probability value of the variable is 0.045 with a negative regression coefficient of -0.035. This means that there is a negative influence between the expertise of the audit committee on earnings management. The existence of an audit committee with expertise in accounting and finance can reduce the possibility of earnings management practices. This research is in line with the results of research by Ayemere and Elijah (2015) which state that the expertise of the audit committee in accounting and finance is needed in preventing agents from carrying out earnings management. Audit committees who have this expertise can be more competent to assess accounting problems that occur (Albersmann & Hohenfels, 2017).

### **6.6. The Effect of Auditor Type on Earnings Management**

The results of this study indicate that the type of auditor has no significant effect on earnings management. In table 3, the variable type of auditor shows that H5 is rejected because the probability value of the variable is 0.327. The results of this study are consistent with the results of research by Yasser and Soliman (2018) which state that the KAP big four cannot hinder the practice of earnings management by the agent. The level of protection for stakeholders in a country will be related to a lower level of discretionary accruals. Weak regulation in developing countries exposes auditors to low litigation risk. The existence of this makes the effectiveness

**Table 2.** Descriptive Statistics

	<b>n</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>SD.</b>
DIR	107	3	11	6.52	1.650
INDCOM	107	0.17	0.83	0.4014	0.12033
AUDCOM	107	3	6	3.43	0.728
EXPAUDCOM	107	0.00	1.00	0.6583	0.2345
BIG4	107	0	1	0.73	0.447
ML	107	0.0022	0.1803	0.4947	0.04274
ROA	107	(0.0572)	0.4157	0.0837	0.08722
LEV	107	0.0610	1.3862	0.49099	0.22283

**Table 3.** Multiple Linear Regression Test Results

<b>Variable</b>	<b>Coefficient</b>	<b>Sign. t</b>	<b>Conclusions</b>
DIR	-0001	0723	Not Significant
INDCOM	0001	0967	Not Significant
AUDCOM	0002	0666	Not Significant
EXPAUDCOM	-0035	0045	Significant Negative
BIG4	-0010	0327	Not Significant
ROA	-0.0004	0993	Not Significant
LEV	0047	0:17	SignificantPositive
Constant	0054	0101	
Significance of Simultaneous (f)		Sig = 0.020	
correlation coefficient test and determination (R2)		Sig = 0091	



of auditors very dependent on the national audit environment.

## 7. Conclusion

This study examines the GCG mechanism on earnings management practices in the company. Based on the results of the research that has been done, it can be concluded that one of the mechanisms, namely the proportion of audit committee expertise, has a significant negative effect on earnings management for non-financial companies listed as LQ-45 companies. The higher the proportion of accounting and finance experts in the audit committee membership, the higher the supervision of management's financial reporting. This can be indicated by a lower level of earnings management. This study also shows that other GCG mechanisms such as board size, independent board proportion, audit committee size and auditor type are not related to the existence of earnings management in LQ 45 companies. The results of this study imply the importance of having an audit committee from an accounting background and finance to suppress earnings management practices within the company.

This study measures the expertise of the audit committee based on the educational background of an economics degree. To increase the specificity in terms of economic and accounting expertise, further research can use other proxies such as ownership of certification or the presence of certain strategic positions in the field of financial accounting. In addition, further research can also be carried out with a wider sample, namely not only companies listed on the LQ 45 index. This can be done to increase the generalizability of research results.

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## Acknowledgement

This paper is derived from Aprillya Vernanda Putri's Undergraduate Thesis at the Department of Accountancy, Faculty of Economics and Business, Universitas Airlangga, Surabaya, Indonesia. We are also grateful for the comments and insights from Eka Sari Ayuningtyas and Dyah Ayu Larasati