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THE EFFECT OF BOARD OF DIRECTOR COMPOSITION AND AUDIT COMMITTEE EXPERTISE ON THE REAL EARNINGS MANAGEMENT IN INDONESIA

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ABSTRACT

The objective of this research was to prove that the implementation of good corporate governance will have an effect on the real activities manipulation which was done by the management. The implementations of good governance used by this research are board of director composition and audit committee expertise. This research was conducted in Indonesia by using 306 firm years' observations. The result of this research showed a different result from previous researches. This research showed that the implementation of good corporate governance in the form of board director composition and audit committee expertise do not impact the practice of real activities manipulation. Or, in other words some of the good corporate governance tool could not mitigate the real activities manipulation in the company.

1. Introduction

Earnings management occurs when managers use judgment in financial reporting in order to make stakeholders have improper assumptions about economic performance of the company or to influence the result of contract which depends on accounting numbersreported (Healy &Wahlen, 1999). Earnings management practices are not always detrimental to company because several methods used for certain situations are proven to provide benefits and improve performance of the company. On the other hand, earnings management will negatively impact the company when it is implemented on the basis of managerial opportunism. If there is a way to mitigate this managerial opportunism then the earnings management which harms the company can be reduced as well. (Tangjitprom, 2013). Corporate governance mechanism is one of alternative ways to reduce earnings management practices as it provides transparent structures to avoid earnings management and improve market. (Ajina et al, 2013).

This research highlights the theme of corporate governance and its impact on real earnings management level in Southeast Asia. The corporate governance mechanism used in this research was the corporate governance structure in the form of board of director and audit committee. More specifically, this research focuses on board of director composition and audit committee expertise in corporate governance mechanisms as they have vital roles in mitigating earnings management.

Previous studies on the composition of independent commissioners in the board of directors showed that it potentially reduce earnings management level. For instance, research conducted by Lai and Tam (2007) found that the independence of the board of directors in Chinese companies could reduce the tendency of managers to do earnings smoothing. In line with it, research conducted by Ajina, Bouchareb and Souid (2013) revealed the same result that the independence of the board of directors has negative implications on earnings management. In a nutshell, the more independent the board of directors, the more level of earnings management will decrease. In contrast with the two previous studies, research conducted by Gulzar (2011) showed different result that the independence of the board of directors do not have any significant effect on earnings management. In agreement with it, research conducted by Chalevas and Tzovas (2010) also found that corporate governance mechanisms in general do not have any effect on earnings manipulation.

In relation to it, previous studies on the audit committee indicated that the independence of audit committees may improve the quality of financial reports (Valminck&Sarens, 2013). In addition to Lin, Hutchinson, and Percy (2013) also found that the quality and independence of audit committees decrease the level of abnormal accruals or the measurement of earnings management. Other studies showed that audit committee expertise results in better internal control (Krishnan, 2005) and markets also react more positively to companies with more qualified audit committees in accounting (Defond, Han, & Hu, 2005). In other words, the expertise of audit committee in finance create better internal control resulting in higher quality of financial reports. This is consistent with research done by Bedard, Chtourou, and Courteau (2004) which revealed that educational background or experience in finance owned by the audit committee negatively affect the practice of earnings management because by having comprehension on accounting/finance, the audit committee can directly oversee the process of preparing financial reports transparently and produce high quality financial reports. The better financial reports, the lower earnings management level.

This study focuses on the influence of the board of director composition and the expertise of audit committees on real earnings management level. It is expected that the higher the proportion of independent commissioners in the board of directors and the higher the level of expertise of the audit committee will mitigate the level of real earnings management. Real earnings management was selected as a dependent variable because previous studies on earnings management used more abnormal accruals than real activities manipulation. The selected samples were manufacturing companies listed on the Indonesia Stock Exchange (BEI). Indonesia has an emerging economy, especially in terms of its capital markets. However, earnings management is still a problematic issue facing investors. The protection of investor in Indonesia or other countries in Southeast Asia has not been ideal enough, especially for minority investors. Even in advanced countries which have good capital market rules and financial report regulation, the cases of fraud involving earnings management practices still occur. Moreover, in Indonesia, a developing country withmoderately inadequate rules and regulations of capital markets. For instance, several cases involving companies which proved to inflame the profit to attract funds from investors include PT Kimia FarmaTbk, PT Indofarma, PT Lippo and some other companies alleged to have implemented the practice of earnings management in Indonesia. This research describes that the possibility by improving the effectiveness of corporate governance system, the internal control of company in generating good financial reports will be better so that investors will be more protected from harmful earning management practices.

2. Literature Review and Hypothesis Development

2.1 Agency Theory

In this research, agency theory proposed by Jensen and Meckling (1976) is used. Tricker (2009) states that agency theory views corporate governance practices through agency dilemma perspective. The theory considers that corporate governance relations as contracts between principals (shareholders) and agents (managers or directors). The most common agency problem is about information asymmetry between the principal and the agent. Directors or managers are believed to understand every single thing happens in the company while the shareholders must rely on the information provided by the directors. The information provided is in the form of financial reports. Managers who are opportunistic or utility maximize in nature tend to manipulate financial reports to obtain different result which is inadequate to the real condition.

One of solutions for reducing the manipulated practicesis a good monitoring system from the principal. Corporate governance mechanism is considered as one of ideal monitoring systems to mitigate the opportunistic nature of managers. Baysinger and Hoskisson (1990) argue that under agency theory, corporate governance mechanisms through the board of directors will have the legal authority to hire, dismiss and compensate management and play an important role in safeguarding capital investment. Therefore, governance mechanismis an essential element in good corporate governance.

2.2 *The Effect of Board of Director Composition on Real Earnings Management*

Fama and Jensen (1983) state that board of directors has a role as the top control mechanism to do the monitoring towards top management. The members of board of directors from outside of the company are supposed to be more independent because they do not have any relationship with the top management so that they will do their monitoring job with more objectivity than the others. Independent members of board of directors are expected to help mitigating the fraud practice by the management.

Previous studies have examined the relationship between the composition of board of commissioners and fraudulent practices that harm the company, such as negative or aggressive profit management. For example,a research conducted by Beasley in 1996found that the more involvement of independent members in the board of commissioners, the lower level of fraud in the financial reports. In addition, a study done by Gulzar in 2011 also revealed that the composition of the board of commissioners negatively affects the accrual based earnings management. Generally, the whole corporate governance mechanism is negatively related to the level of earnings management in Chinese companies.

This indicates that through strengthening the corporate governance system, investors will be better protected from negative earnings management practices. Based on the description and different result of previous research above, the hypothesis of this research can be formulated as follow:

H1: Board of director composition negatively affects real earnings management

2.3 *The Effect of Audit Committee Expertise on Real Earnings Management*

Although research conducted by Beasley's in 1996 showed that audit committees do not significantly influence trends for managers to commit fraud in financial reporting, subsequent studies reveal different result. A study done by Bedard, Chtourou, and Courteau in 2004 found that there is a negative relationship between financial expertise and audit committee governance to aggressive earnings management. Krishnan's research in 2005 provided evidence that independent audit committees with fewer skills are involved in internal control issues. Good internal controls will result in better quality of financial reports, better financial reports quality also indicate better earnings quality.

Yang and Krishnan's research (2005) also proved that there is a negative relationship between the independence of the audit committee and the audit committee tenure to quarterly earnings management. This further strengthens the evidence that a skilled audit committee will result in better corporate governance mechanisms. Better corporate governance mechanisms will produce quality of financial reports, especially better quality profits. In other words, it will result lower levels of earnings management than companies with poor governance mechanisms. Based on the descriptions, the hypothesis is:

H2: Audit committee expertise negatively affects real earnings management.

3. Research Method

3.1 Data and Sample

Data of this research were obtained from Indonesian Stock Exchange (www.idx.co.id). The data were in the form of annual report of publicly listed companies in Indonesian Stock Exchange from 2014-2016. The sampling technique was used purposive sampling. The criteria of the sample namely:

1. Manufacturing companies which are listed in IDX from 2016-2018.
2. The company fiscal year has to end on December 31st.
3. The company has to use rupiah as the reporting currency.

3.2 Variables Definitions and Measurements

Dependent variable of this research is real earnings management. Roychowdury (2006) and Cohen, Dey, and Lys (2008) stated that a few measurements for real earnings management, namely abnormal cash flow from operation. Abnormal cash flow from operationis calculated from actual cash flow from operation minus "**normal cash flow**" which calculated in this formula:

$CFO_{it} / A_{it-1} = \alpha_0 (1 / A_{it-1}) + \alpha_1 (S_t / A_{t-1}) + \alpha_2 (\Delta S_t / TA_{t-1}) + \varepsilon_t$ (1)

A_t is total asset in the end of period t and S_t is sales in period t, $\Delta S_t$is the sales in this year (S_t) minus the sales from last year (S_{t-1}). Cohen et al (2008) also formulated the step to calculate **normal production cost**:

$PROD_t/A_{t-1} = \alpha_0(1/TA_{it-1}) + \alpha_1(S_t/A_{it-1}) + \alpha_2(\Delta S_t/A_{it-1}) + \alpha_3(\Delta S_{t-1}/A_{it-1}) + \varepsilon_t$ (2)

PROD is total cost of goods sold minus the increase in inventory.

By simplifying a few of assumptions from Dechow et al., (1998) that discretionary expenses are supposed to be estimated with a linear equation from contemporaneous sales and to solve the problem if managers increase sales on purpose to increase the reported income so **discretionary expenses**is measured by the sales from last period/year. Cohen et al., (2008) stated that the formula to estimate normal discretionary expensesis:

$DISEXP_t/A_{t-1} = \alpha_0(1/A_{t-1}) + \alpha_1(S_{t-1}/A_{t-1}) + \varepsilon_t$ (3)

Based on Cohen et al., (2008), this research used a comprehensive set of measurement of real earnings management by combining the three individual measurements which was called REM_Index. REM_Index is a standardized total from individual component of real earnings management. The formula for REM_Index is minus standardized Abn_CFO + standardized Abn_Prod – standardized Abn_Discexp.

Boards Structure (IND) was measured by a ratio and calculated by dividing the total number of independent members of board of directors with the total number of members in board of directors.

Audit Committee Expertise (EXPRT) was measured by a ratio and calculated by dividing the number of audit committee members who have degree in accounting or finance with the total number of audit committee members.

Control Variable

Control variables used in this research, namely:

Company Size (Size). Company size is measured by using total asset. The formula for this measurement is; size = log (total aset book value).

Return on Assets (ROA). Return on Asset (ROA) is a ratio shows the return of asset which used in a company. This ratio is focusing on calculating the efficiency of asset usage in order to generate income. The lower the ROA, the more motivated the managers to manipulate earnings. ROA is formulated:

$$ROA = \frac{Earning\ After\ Interest\ and\ Tax}{Total\ Asset}$$

Leverage. Leverageis a risk which can be seen from the ratio between total asset and total liabilities. The formula to calculate leverage is:

$$Leverage = \frac{total\ liabilities}{total\ assets}$$

3.3 Research Model

$REM = a + b_1IND + b_2EXPERT + b_3FIRMSIZE + b_4LEV + b_5ROA + \varepsilon$

Explanation:

REM = Real Earnings Management, which consists of three individual measurements such as abnormal cash flow from operation, abnormal discretionary expenses, and abnormal production cost. These three individual measurements will be generated

into an index which is called RM_Index (-standardized Abn_CFO+ standardized Abn_Prod – standardized Abn_Discexp)
IND= The total number of independent members of board directors divided with total members of board directors.
EXPERT= The total number of audit committee members with financial or accounting degree divided with total number of audit committee members.
FIRMSIZE= Company Size, which is measured by log natural of total asset.
LEV= Company leverage, which is measured by ratio of total liabilities divided by total asset.
ROA= Return on Asset Ratio

4. Results and Discussion

4.1 Research Data

Initial data are 306 firm years. Those data were obtained from Indonesian Stock Exchange. And those data are tested by using the multiple regression analysis. The residuals from the was normally distributed which is shown by the one sample KS test result in the table 1 below.

Tabel 1. Residuals Normality Test

Kolmogorov-Smirnov Z	Sig.	Note
1,073	0,199	Normally Distributed

The independent variables from this research also not correlated with each other which were shown by the result from the table 2 below.

Tabel 2. Multicollinearity Test

Variabel	VIF	Note
***Board of Director Composition* (IND)**	1,050	No Multicollinearity
***Audit Committee Expertise* (EXPERT)**	1,007	No Multicollinearity

4.2 Hypothesis Test

Based on the test results of Glejser test, it was found that the significance of each variable was less than 0.05. This result implied that the research model was experiencing the problem of heteroscedasticity. The model was also experiencing the autocorrelation problem. Therefore, there are limitations in interpreting the results of this study.

Table 3. Hypothesis Test with Multiple Regression Analysis

Variable	T count	Sig.	Note
Board of Director Composition (IND)	-0,358	0.720	H1 not supported
Audit Committee Expertise (EXPERT)	2,588	0.010	H2 not supported

The result of multiple regression analysis in table 3 above indicated that t count from the board of director composition variables was lesser than t table, which are -0,358. The t count from audit committee expertise variable was higher than t table which is 2,588, however the positive sign was contradicting the hypothesis which said audit committee expertise will negatively affect the real earnings management. Therefore, H1 and H2 are not supported.

4.3 Discussion

This research examines the effect of corporate governance and the real earnings management practice in Indonesia. Financial reporting process is identified as a negotiation process between management and auditor (Antle&Nelbuff, 1991). This finding is consistent with the evidences from financial reporting mistakes and auditing adjustments through years (e.g., Kinney & Martin, 1994 and Nelson et al., 2002). Therefore, it was hypothesized that good corporate governance could mitigate the earnings management practice by management. The corporate governance practice in this research wasproxied by board of director composition and audit committee expertise. The earnings management practice was proxied by the real activities manipulation or real earnings management.

From the hypothesis testing, the result showed that the director board composition and audit committee expertise do not affect real earnings management in Indonesia. The result is different from Bradburry, et al., (2004) which found that board of directors which consist of more independent members will deliver more quality in accounting process and income. It is shown by the decreasing number of earnings management. This result is also different from Bedard, et al., (2004) which found out that a more expert audit committee will mitigate the aggressive earnings management practice by management.

Corporate governance is supposed to increase the quality of financial reporting because by having good corporate governance means that the controlling role will be done more effectively. More effective controlling role could mitigate the opportunistic earnings management practice by the managers. Generally, most of the previous research indicated that good corporate governance system especially in the term of audit committee could be a constraint for manager to do the earnings management.

However, the result of this research showed that corporate governance system does not negatively affect real earnings management. It is indicating that good corporate governance could not be a constraint for manager to do earnings management. This result is in accordance with Chi et al., (2011) which found that a good quality of auditing as a part of corporate governance practice are indirectly increasing the real earnings management practice. It could happen because the manager will strive to find the new way to do the earnings management when the corporate governance quality is increasing. Accrual earnings management is considered too risky and is easily discovered, so that managers strive to do the real activities manipulation which is more difficult to be detected.

5. Conclusion

Based on the result of the test, the first hypotheses which stated that the board of director composition affects real earnings management negatively are not supported. Furthermore, the second hypotheses which stated that audit committee expertise affects real earnings management negatively are also not supported. It can be concluded that the board of director composition and audit committee expertise do not affect the real earnings management. The good corporate governance practice is supposed to increase the quality of accounting process and income but it cannot be proved in this research.

There are some limitations of this research, they are: First, this research uses only two proxies to measure corporate governance, namely: board of director composition and audit committee expertise. Second, this research is only using three years as research period. Third, his research can only be conducted in Indonesia because of the limitation of database. Finally, most of the measurement of control variable are using total asset, it could increase the risk of heteroscedastisity in this research. Therefore, this research suggest for future researcher, it is expected to: first, add other proxies of corporate governance, such as: ownership structure. Second, add more period of time. Third, use international accounting context with more than one country if the database is available. Finally, use different proxies to measure the control variable so that the heteroscedasticity problem could be eliminated.

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