



Are Corporate Governance Mechanisms, Corporate Strategy and Corporate Financial Characteristics Related to Earnings Management?

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ABSTRACT

Objective – This study aims to examine the effect of corporate governance and several factors of corporate financial characteristics on earnings management. Corporate governance mechanisms such as an independent board, board size, and audit committee size are expected to be able to limit the ability of management to carry out earnings management. Meanwhile, a company's financial characteristics such as corporate strategy, company age, operating cash flow, company growth, profitability, company size and leverage are predicted to affect earnings management.

Methodology/Technique – Many previous studies have involved the examination of corporate governance mechanisms and corporate financial characteristics of earnings management however, the results of those studies give rise to inconsistencies. Hence, this study seeks to re-examine the existence of corporate governance mechanisms and corporate financial characteristics of earnings management. The sample in this research is non-financial companies listed on the Indonesian Stock Exchange between 2016 and 2018.

Findings – This data in this study is analysed using statistical methods such as multiple regression linear. The results of this study indicate that one mechanism of corporate governance, the size of the audit committee, has a positive effect on earnings management, while the financial characteristics of companies such as company size and operating cash flow negatively affect earnings management.

Novelty – Other corporate financial characteristics such as corporate strategy, company age, operating cash flow and profitability have a positive effect on earnings management. Meanwhile, the other variables such as board size, leverage and company growth do not have an influence on earnings management.

Type of Paper: Empirical.

JEL Classification: G3, G34, G39.

Keywords: Earnings Management; Corporate Strategy; Audit Committee Size; Company Age; Operating Cash Flows.

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1. Introduction

Financial statements are typically prepared by the management of a company and are used to demonstrate the company's performance. Financial statements include important information such as the company's profit and loss.

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Profit is one of the most important concerns for stakeholders hence, company management aims to maximize the company's profit in order to satisfy its stakeholders. According to Aygun et. al. (2014), earnings management can be considered legal if the company can adjust earnings disclosed in the Generally Accepted Accounting Principles (GAAP) guidelines, for example changing the approach to a current asset such as inventory valuation or depreciation. On the other hand, earnings management is considered fraudulent if it does not comply with GAAP standards such as accelerating revenue recognition and delaying cost recognition (Yang et. al., 2009).

One way that a company can control the occurrence of earnings management practices and minimize agency conflicts is to implement good corporate governance. Corporate Governance (CG) is one of the key elements that connects the company management, board of commissioners, shareholders and other stakeholders. With the existence of CG, business management will involve the interests of stakeholders as well as the use of resources which will result in more effective and efficient company performance.

Previous studies have examined the effect of firm size, firm leverage, and firm corporate strategy. Meanwhile, this study examines the effect of an independent board, board size, audit committee size (Abata & Migiro, 2016), company age, company growth, profitability (Alexander & Hengky, 2019), and operational cash flow (Alzoubi, 2016). The object of this study is non-financial companies listed on the Indonesian Stock Exchange. This research was conducted between 2016 and 2018.

This research contributes to existing knowledge and literature on the role of corporate governance mechanisms and corporate financial characteristics of earnings management. This research also contributes to the users of financial statements such as investors and creditors related to the decision making on the provision of capital funds to consider the existence of corporate governance mechanisms and the characteristics of corporate finance on earnings management.

2. Literature Review

2.1 Agency Theory

Agency theory explains the principal and agent relationship. Agency theory explains that both parties act in accordance with their respective interests. The agent seeks to maximize profits for himself. Meanwhile, the principal wants to achieve maximum returns and dividends. The difference in interests between these 2 parties can lead to a conflict of interest. The conflict of interest will cause agency problems resulting from information asymmetry (Eisenhardt, 1989). This information asymmetry is caused by differences in information between the principal and the agent because the agent acts directly in the company's activities, while the principal only oversees. This arrangement allows agents to take some of the rights of the owner for the welfare of himself. The difference in information possessed by this agent will provide greater opportunities in carrying out earnings management practices (Wiyadi et. al., 2015).

2.2 Earnings Management

According to Subramanyam (2014, p.108) earnings management is a result of managing the numbers contained in the company's financial statements that are intentionally made by the company's management. There are several patterns of earnings management practices carried out according to Scott (2012, p.425). The first pattern is known as big bath earnings management. This is used by managers to increase profits in the future period by reporting a large amount of loss in the current period. This strategy recognizes the costs in future periods as a loss in the current period. The second pattern is income minimizations. This action is taken by management to reduce pressure on political costs or tax motivation. The next pattern is income maximizations. This is done to achieve a bigger bonus or for the purpose of a debt agreement. The next pattern is income smoothing. This pattern is carried out so that reported earnings become more stable and

reduce the occurrence of profit fluctuations that are too large, because investors will be more interested in companies with stable earnings movements.

2.3 Company Size and Earnings Management

Large companies tend to require more funds than smaller companies. Thus, large companies will be more motivated to practice earnings management. According to Gonzalez and Meca (2014) and Swastika (2013), company size has an effect on earnings management. Meanwhile, according to Bassiouny (2016), there is no relationship between company size and earnings management. Hence, the following research hypothesis is proposed:

Ha1: Firm size has an influence on earnings management.

2.4 Firm Leverage and Earnings Management

The higher the leverage ratio in a company, the more likely earnings management will be used to avoid debt agreements (Wiyadi et. al., 2015). According to Sosiawan (2012) and Bassiouny (2016), there is a positive relationship between firm leverage and earnings management. Hence, the following research hypothesis is proposed:

Ha2: Firm leverage has an influence on earnings management.

2.5 Company Age and Earnings Management

Over time, companies realize their strengths and weaknesses and learn to do things better when they discover new techniques to standardize, coordinate and speed up the production process whilst minimizing costs and improving quality (Ericson & Pakes, 1995). Hence, it can be concluded that the longer a company exists, the better the company's management will be and the less likely it will be to engage in earnings management. According to Debnath (2017), the age of the company has a positive influence on earnings management. Meanwhile, according to Gul et. al. (2009), Bhuiyan et. al. (2014) and Alzoubi (2016), the company's age has a negative influence on earnings management. Hence, the following research hypothesis is proposed:

Ha3: The age of an company has an influence on earnings management.

2.6 Independent Board and Earnings Management

An independent board has the responsibility to oversee management in a company to be able to provide protection to shareholders. Thus, an independent board reduces the likelihood of earnings management practices (Abata & Migiro, 2016). The existence of an independent board is intended to be able to avoid the possibility of an imbalance of information and also the actions of deviant management. According to Susanto (2016), Abata and Migiro (2016) and Liu et. al. (2013), there is a positive relationship between the presence of an independent board and earnings management. Hence, the following research hypothesis is proposed:

Ha4: AN independent board has an influence on earnings management.

2.7 Board Size and Earnings Management

The smaller a company's board is, the better the company's performance will be (Gulzar & Wang, 2011). The decisions of the board of directors is also likely to prioritize the welfare of its shareholders and generally

minimize the practice of earnings management. Research by Gonzalez and Meca (2014), Nasution and Setiawan (2007) and Chekili (2002) conclude that there is a positive relationship between board size and earnings management. Hence, the following research hypothesis is proposed:

Ha5: Board size has an influence on earnings management.

2.8 Size of the Audit Committee and Earnings Management

The size of the audit committee is the existence of an audit committee owned by a company. Audit committee variables in research are usually measured using the number of audit committee members in the company. Based on Bapepam regulation No.IX.I.5, an audit committee must consist of at least 3 people. Hence, the following research hypothesis is proposed:

Ha6: The size of the audit committee has an influence on earnings management.

2.9 Corporate Strategy Firm and Earnings Management

According to Wheelen and Hunger (2012, p.254), firm corporate strategy is the choice of direction for a company as a whole in managing its business portfolio or products. In a large corporate business, corporate strategy focuses on managing various product lines and business units to maximize the value of a company. Overall, corporate strategy is related to 3 main problems faced by companies, namely directional strategy, portfolio analysis, parenting strategy. According to Uwuigbe et. al. (2015), firm corporate strategy has a positive influence on earnings management. The more strategies that the company applies, the more likely earnings management practices will be. Hence, the following research hypothesis is proposed:

Ha7: Firm corporate strategy has an influence on earnings management.

2.10 Operational Cash Flow and Earnings Management

Cash flow from operating activities include the effect of cash transactions related to income and expenses. The operating activity category is the most important (Weygandt et. al., 2015, p.646). Operational cash flow is cash from the results of the company's operational activities that can affect the company's profit or loss where cash comes from all types of activities except investment and funding activities. According to Alzoubi (2016) and Chen et. al. (2015), operational cash flow has a positive effect on earnings management. Hence, the following research hypothesis is proposed:

Ha8: Operational cash flow has an influence on earnings management.

2.11 Company Growth and Earnings Management

Company growth can be based on sales and is calculated from sales growth that occurs in the company during a certain period. According to Swai (2016), company growth has a negative effect on earnings management. Hence, the following research hypothesis is proposed:

Ha9: A company's growth has an influence on earnings management.

2.12 Profitability and Earnings management

According to Alexander and Hengky (2017), profitability ratios are ratios that measure a company's ability to earn profits for a certain period. Profitability is an indicator of how to measure the performance of

management to manage the company's wealth so that it can generate profit for the company (Sudarmadji & Sularto, 2007). According to Alexander and Hengky (2017), there is a positive influence between profitability and earnings management. Hence, the following research hypothesis is proposed:

Ha10: Profitability has an influence on earnings management.

3. Research Methods

This study examines non-financial companies listed on the Indonesian Stock Exchange between 2016 and 2018 period. The sample selection method used in this study was purposive sampling with the following criteria:

1. Non-financial companies that were consistently listed on the Indonesian Stock Exchange during the 2016-2018 period;
2. Companies that present financial statements that end on December 31;
3. Companies that present financial statements in Rupiah;
4. Non-financial companies with incomplete annual financial statement data; and
5. Companies that have not consistently revealed the number of audit committees.

In this study, earnings management variables were measured using discretionary accruals (DACC) which were adapted from measurements of the modified Jones model (1991) from previous researchers in Uwuigbe et. al. (2015). In Abata and Migiro's research (2016), the regression equation is used to find company-specific parameters used in the non-discretionary accruals equation. The equation is as follows:

$$TA/At-1 = \beta_1 (1/At-1) + \beta_2 (\Delta REV_t - \Delta REC_t / At-1) + \beta_3 (PPE/At-1) + \epsilon_t$$

Information:

TA = Total Accruals (Net income - Cash from operating activities); At-1 = Total Assets at the beginning of the year; ΔREV_t = Changes in sales from year t-1 to t; ΔREC_t = Changes in trade receivables from year t-1 to t; PPE_t = Gross Plant, Property, and Equipment; $\beta_1, \beta_2, \beta_3$ = company specific parameters; ϵ = Residual (discretionary accrual).

3.1 Company Size

Company size is a value that indicates the size of the company. According to Uwuigbe et. al. (2015), this variable is measured using the following equation:

$$FSIZE = \text{the log of total assets}$$

3.2 Firm Leverage

The leverage ratio also shows the risks faced by the company. The greater the risk faced by the company, the uncertainty to generate profits in the future will also increase.

$$LEV = \text{Total debt} / \text{Total assets}$$

3.3 Company Age

The company's age shows that the company still exists and is able to compete in its economic activities (Alexander & Hengky, 2017).

AGE = the year the company incorporated

3.4 Independent Board

An independent board is defined as the existence of an independent board's responsibility in avoiding fraud or errors in the presentation of financial statements within a company.

BI = Proportion of non-executive boards/Total number of members of the board of directors

3.5 Board Size

The size of the board of directors is the number of directors in a company. In this study, board size is measured using the number of directors in a company (Uwuigbe et. al., 2014).

BSIZE = Number of board members in the company

3.6 Size of the Audit Committee

The audit committee is a neutral and independent body and does not have an interest in management.

ACS = Number of members of the audit committee

3.7 Corporate Strategy Firm

The company's strategy can be calculated using asset growth. Asset growth is the growth rate of assets owned by the company during a given period (Debnath, 2017).

CSTRAT = $\frac{\text{Total Assett}-\text{Total Assett-1}}{\text{Total Assett-1}}$

3.8 Operational Cash Flow

Operational cash flow is cash from the results of the company's operational activities so that it can affect the profits or losses of companies whose cash comes from all types of activities except investment and funding activities.

CFO = Operating cash flow/Total Assets at the beginning of the period

3.9 Company Growth

Growth is a value that shows how much the company has grown from when the company was established until the present (Alexander & Hengky, 2017).

Growth = Market Capitalization/Total Equity

3.10 Profitability

Profitability ratios are used to measure a company's ability to earn profits over a certain period (Alexander & Hengky, 2017). Profitability also illustrates the good and bad performance of the company during a certain period.

$$\text{ROA} = \text{Net Income} / \text{Beginning Total Assets}$$

3.11 Hypothesis Testing

Hypothesis testing is done by using multiple regression analysis. Following are the multiple regression equation models used in this study:

$$\text{DACCit} = \beta_0 + \beta_1\text{FSIZE} + \beta_2\text{LEV} + \beta_3\text{AGE} + \beta_4\text{BI} + \beta_5\text{BSIZE} + \beta_6\text{ACS} + \beta_7\text{CSTRAT} + \beta_8\text{CFO} + \beta_9\text{GROWTH} + \beta_{10}\text{ROA} + \varepsilon$$

Note: DACC = Discretionary Accrual; β_0 = constant; β_1 - β_{10} = Variable Coefficient; FSIZE = Company Size; LEV = Firm Leverage; AGE = Company Age; BI = Independent Board; BSIZE = Board Size; ACS = Audit Committee Size; CSTRAT = Firm Corporate Strategy; CFO = Operational Cash Flow; GROWTH = Company Growth; ROA = Profitability; ε = Error.

4. Research Results

The following are the descriptive statistical test results of this study.

Table 4.1 Descriptive Statistics Test Results

| Variable | N | Minimum | Maximum | Mean | Std. Deviation |
|----------|-----|--------------|------------|-------------|----------------|
| EM | 969 | -3,773240 | 6,225000 | 0,00000005 | 0,298546811 |
| FSIZE | 969 | 9,718045 | 14,537455 | 12,37772797 | 0,758940515 |
| LEV | 969 | 0,006362 | 19,970141 | 0,60983809 | 1,309592947 |
| AGE | 969 | 3 | 107 | 32,87 | 14,625 |
| BI | 969 | 0,000000 | 1,00000 | 0,4046073 | 0,10892107 |
| BSIZE | 969 | 2 | 18 | 4,13 | 1,898 |
| ACS | 969 | 1 | 6 | 3,03 | 0,386 |
| CSTRAT | 969 | -0,854541 | 169,828726 | 0,44947663 | 7,077160744 |
| CFO | 969 | -3,612877 | 2,806697 | 0,04825677 | 0,212635680 |
| GROWTH | 969 | -1951,376121 | 82,444425 | 0,12515259 | 63,333767431 |
| ROA | 969 | -2,901088 | 2,683245 | 0,03256513 | 0,202372954 |

Source: SPSS Data Processing Results 25

Table 4.1 shows the descriptive statistics of each variable in this study. The data used in the study were 969 companies. Earnings management has an average value of 0.00000005 which shows that on average, non-financial companies in Indonesia manage income-increasing earnings management. Variable corporate governance mechanisms such as company size have an average value of 12.377. Firm leverage has an average value of 0.609. The age of the company has an average value of 32.87. The independent board has an average value of 0.404. Board size has an average value of 4.13. Firm corporate strategy has an average value of 0.449. Financial characteristics of the company such as the size of the audit committee has an average value of 3.03. Operating cash flow has an average value of 0.048. The growth of the company has an average

value of 0.125. Profitability has an average value of 0.0325. The following are the results of the hypothesis testing:

Table 4.2 Hypothesis Testing

| Model | B | Sig. | Conclusion |
|------------|----------|-------|------------------|
| (Constant) | 0,242 | 0,000 | |
| FSIZE | -0,024 | 0,000 | Ha1 accepted |
| LEV | 0,003 | 0,075 | Ha2 not accepted |
| AGE | 0,001 | 0,001 | Ha4 accepted |
| BI | 0,029 | 0,223 | Ha5 not accepted |
| BSIZE | 0,002 | 0,308 | Ha6 not accepted |
| ACS | 0,019 | 0,007 | Ha7 accepted |
| CSTRAT | 0,005 | 0,000 | Ha3 accepted |
| CFO | -0,895 | 0,000 | Ha8 accepted |
| GROWTH | 0,000054 | 0,170 | Ha9 not accepted |
| ROA | 0,870 | 0,000 | Ha10 accepted |

Adjusted R2 = 0.929; F = sig. 0.0000

Company size has a significance value of 0.000 meaning the alternative hypothesis is accepted. Thus, firm size has a negative influence on earnings management. Large companies will get more attention from the public, so they will be more careful in preparing their financial reports. This will reduce earnings management practices because the company aims to maintain its reputation in the eyes of the public. Firm leverage has no effect on earnings management because the significance value is more than 0.05. If a company's debt policy is high, then the company will be more strictly monitored and receive more attention from third parties, for example shareholders. Thus, debt policy will not affect earnings management. Company age has a significance value of 0.008 meaning this variable has a positive influence on earnings management. The longer the company is established, the company will increasingly want to maintain its reputation in the eyes of the public by presenting financial reports that reflect good company performance. Thus, the company will increasingly conduct earnings management.

The independent board variable has no influence on earnings management. This research is in line with Swastika's research (2013). A large or small independent board will not reduce earnings management practices because the appointment of an independent board in the GMS is conducted by the majority shareholder, so there is a difference in understanding with the owner's decision so the company can replace the independent board, therefore the independent board is not truly independent. Board size has no influence on earnings management. Many or at least the number of the board of commissioners of a company has no influence on earnings management because the performance of the board of commissioners of a company is less than optimal. Audit committee size has a significance value of 0.007 meaning this variable has a positive influence on earnings management. Supervision of a weak audit committee causes company management to conduct earnings management.

Firm corporate strategy has a significance value of 0.000 meaning this variable has a positive influence on earnings management. If the company's strategy in managing its business portfolio or products rises, the company's activity to manage earnings will also increase. Operational cash flow has a significance value of 0.000 meaning this variable has a negative influence on earnings management. One way in which a company's performance is measured is through operational cash flow. Through operational cash flow can be

seen the company's operations in generating cash which is used to pay off loans and make new investments. Hence, this acts as a signal for investors to assess the company's performance. If the company wants the amount of operating cash flow to appear large, then the company's management has the potential to manage earnings. Company growth does not have an individual effect on earnings management. The magnitude of company growth seen by market capitalization will not determine the magnitude of earnings management practices because the market does not look at market prices from financial statements alone. Profitability has a significance value of 0.000 meaning this variable has a positive influence on earnings management. Managers in a company will be involved in earnings management practices because they want to receive higher profits so they can get bonuses.

5. Conclusions

Based on the results of this study it can be concluded that the size of the company, an independent board, and operational cash flow have a negative effect on earnings management. Meanwhile, firm corporate strategy, company age, audit committee size, and profitability have a positive effect on earnings management. Meanwhile, firm leverage, board size, and company growth have no influence on earnings management. Audit committee has a positive effect on earnings management. In conducting this research, there are several limitations including: The research period used in this study was only three years, namely from 2016 to 2018; and the data used in the study is not normally distributed and there is still heteroscedasticity. To reduce the limitations that exist in this study, the researcher it is recommended that future research: Increase the period of the year used for research; and uses additional data used to overcome abnormal data and heteroscedasticity issues.

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