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The Effects of Good Corporate Governance and Audit Quality on Earnings Management

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Abstract: A number of previous empirical studies have attempted to reveal the existence of earnings management. However, a research that focuses on how to alleviate the earnings management practices committed by managers is still insufficiently available. This study is aimed to examine the effects of Good Corporate Governance (GCG) and audit quality on earnings management. The presence of Board of Commissioner and Audit Committee in Indonesian Manufacturing Public Listed Companies serves as the proxy of GCG. On the other hand, KAP (public accounting firm) size, dichotomous variables and an assumption that big four auditors perform higher audit quality compared to non-big four auditor serve as the proxy of the audit quality. To echo the prior research, earnings management is measured by employing discretionary accruals modified by Jone (1995). 151 manufacturing listed companies were determined as the population and 86 public listed companies were eventually opted for the sample. Purposive sampling method was employed and regression was performed to analyze the data. The results showed that (1) accounting firms size does not yield significant effects on earnings management. It indicates that neither big four nor non-big four can significantly detect the existence of earnings management undertaken by manager through the audit they administer; (2) Board of Commissioner and Audit Committee also do not generate significant effects on earnings management. It indicates that good corporate governance proxied by the existence of Board Commissioner and Audit Committee do not necessarily alleviate the earnings management practices.

Keywords: Earnings management, audit quality, good corporate governance

INTRODUCTION

Financial reporting is one of means to assess the performance of a company. Such a report is also employed as a tool to communicate the company's performance, including both financial and non-financial information, to external elements such as investors or shareholder, creditors, government and other related stakeholders. However, the financial reporting often becomes a questionable book for investors as it is a product yielded by the management implying that they have the capability to intervene to it. This is so, for Indonesian Statement of Accounting Standards stipulates that a company is obliged to make accrual-based financial reports, except

cash-flow accounting. Such a policy appears as the implementation of Framework for the Preparation and Presentation of Financial Reporting (KDPPLK) Paragraph 22 expounding on concepts of accrual-based earnings. It avers that the effects of transactions and other events are recognized at the time of the event (and not when cash or cash equivalents are received or paid) and recorded in the accounting records and reported in the financial statements for that period.

The primary implication of such a compulsory notion is that accrual-based financial reporting can yield a better measurement of a company's underlying performance, compared to cash-based earnings. Under such a circumstance, a manager is plausibly reckoned to have an ample chance to commit earnings management. Such a type of management is caused by discretionary accruals in which the manager has discretion to decide what accounting methods to apply. It is supported by Radzi, *et al* (2011) stating that the use of accrual accounting enables the manager to make some adjustment pertaining to cash flows which is projected to reflect a better performance of the company. On the other hand, Scott (2009) defines earnings management as a choice made by the manager with regard to accounting policies or as a decision made by the manager which can affect the earnings for the purpose of achieving particular objectives pertaining to earnings reporting. Furthermore, Scott (2009) mentions that a decision made by the manager in relation to the earnings management is motivated by bonus plans, debt covenants, and political costs. The manager is motivated to manipulate the earnings to accomplish the attainment targets which have been previously planned. Such attainments are inextricably linked with bonuses the manager will earn and attempts to minimize the risk of violating the debt covenants as well as to reduce any political costs that possibly arise due to government's intervention.

Scott (2009), moreover, adds that a manager, based on the perspective of financial reporting, might utilize earnings management to meet the expected earnings in order to maintain the company's good reputation and prevent market reaction to negative stock prices which can eventually lead to the failure of meeting the investors' expectations. Accordingly, for this reason, the manager is apt to manipulate the financial reporting so that it offers a more attractive sight to the investors. Wardani and Kusuma (2012) report that a manager can possibly proceed with two ways of committing earnings management: accrual-based earnings management in which the accrual manipulation does not generate any effects on the cash flow and real earnings management which can affect the cash flow. As a result, when the manager employs the accrual

manipulation, a measure of the earnings is no longer a reliable indicator of the company's performance. Therefore, the fact that identifying such a manipulation of profits is tremendously obscure makes issues concerning earnings management worth investigating.

Previous studies have provided empirical evidence of earnings management practices. A study conducted by Schiper (1989) is referred as the one which initially considers real activities manipulation as a part of earnings management practices. Roychowdury (2006) reveals that a company reports positively small profits by employing several techniques as giving discount prices to boost the sale, attempting overproduction to reduce fixed cost of each unit resulting in some decrease of COGS and reducing discretionary expenses to avoid losses reported in the financial report as well as losses in the financial statements and a negative earnings change. Furthermore, Gunny (2005) provides empirical evidence to prove that real activities of management have significantly economic consequences for the company's performance in the future.

However, the previous studies reviewed merely focus on how the managers commit earnings management and what economic consequences can result from such practices. Therefore, a study focusing on how to alleviate such practices is insufficiently available. In so doing, financial reporting audit by external and independent auditors can be one of several ways to be done. The audit can closely connect the investors and their interests to the company's financial report, for the investors, compared to the manager, gain more difficult access to all information related to the company. This notion is regarded as agency theory.

LITERATURE REVIEW AND HYPOTHESES

Agency theory expounds on the relationship between the investors or shareholders as principals and the managers as agents. The manager is a person contracted by the investor to serve their interests. As a result, the management is responsible to the investor concerning their work or performance. Furthermore, Jensen and Meckling (1976) spell out agency relationship as "a contract under which one or more person (the principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent". Therefore, an auditor is necessary to perform the service which entails examining the financial report of the company attempted to mediate between the principal and the agent. Moreover, it is also projected to provide assurances that the report is credible and acceptable so

that the investor will not be in any doubt as to whether they can make sound decisions based on the report.

It is hence premised that the audit quality correlates with the earnings management practices by the manager. The quality is defined as to what extent an auditor can reveal error and fraud committed by the management. DeAngelo (1981) regards the audit quality as joint probability in which an auditor is able to detect both error and fraud. The result of a study carried out by Becker, *et al* (1998) demonstrates that a company that has its accounts audited by big six performs a lower tendency of committing earnings management compared to those by non-big six. This study employs big six and non-big six as the proxy for the audit quality and discretionary accruals as the proxy for the earnings management. Moreover, to gauge the discretionary accruals, a model by Jones (1991) is utilized. On the other hand, in the present research, KAP (public accounting firm) big four and KAP non-big four are employed as the proxy for the audit quality. Moreover, to gauge the discretionary accruals, a modified version of Jones' model (1995) is employed as it is regarded to have better predictions compared to those made by previous models.

The audit done by KAP big four is construed as of better quality than the one by KAP non-big four. Such a statement is based on several reasons. First, KAP big four has a better system and it also has more available resources to use which lead to less time it requires to conduct the audit. Moreover, the auditors working in KAP big four demonstrate a higher level of expertise as it always makes attempts to develop and upgrade its auditors. This is supported by a study conducted by Dinuka and Zulaikha (2014) who prove that KAP size has negative and significant effects on earnings management. However, it is contrary to a study carried out by Radzi, *et al* (2011), the results of which show that KAP size does not correlate with earnings management. Considering such inconsistencies in the above findings, the present research seeks to further investigate the matter. Based on the above considerations, a hypothesis is formulated as follows:

H₁ : Audit quality has a significant effect on earnings management

An issue pertaining to Good Corporate Governance (GCG) has always ignited various discussions indicating that this topic is always interesting. GCG is a principal that both directs and controls a company with regard to its responsibility to investors and stakeholders. KNKG

(2006) explains that GCG is one of backbones of a market economy and inextricably linked with trustworthiness of the company that applies it as well as the economic climate in a country. The application of GCG encourages a positively competitive and conducive business climate to take place. Board of Commissioners and Audit Committee are salient components of a company that can support and assure that the employment of GCG runs well. Furthermore, KNKG (2006) outlines that the Board of Commissioners as the organ of the company is responsible to collectively supervise and advice board of directors as well as to ensure that the company runs the GCG well.

The existence of an independent commissioner in the composition of the Board of Commissioners is presumed to have a significant effect on earnings management. The existence of the independent commissioner is expected to play an important role in ensuring the implementation of good GCG practices so that they will alleviate the practice of earnings management by a manager. The results of a study conducted by Hasan and Ahmed (2012) show that the presence of independent commissioners has a significant negative effect on earnings management. This indicates that the supervisory function undertaken by the independent commissioner may reduce the opportunistic attitude of management to manipulate the financial statements through earnings management practices. Based on the above description, a hypothesis is spelled out as follows:

H₂: The composition of Board of Commissioners significantly affects earnings management

The Audit Committee is one of the company's organs other than the Board of Commissioners. KNKG (2006) asserts that the Audit Committee has the duty of assisting the Board of Commissioners to ensure that: (i) the financial statements are fairly presented in accordance with generally accepted accounting principles, (ii) the internal control structure of the company is well implemented, (iii) both external and internal audit are administered by referring to widely-recognized audit standards, and (iv) a follow-up to audit findings is conducted by the management.

The existence of Audit Committee is essential to protect the interests of shareholders. If the Audit Committee performs its role well, which is monitoring management activities in preparing the financial reporting, the quality of the financial reporting will significantly improve. Accordingly, the existence of this Audit Committee will have a negative effect on earnings

management. It means that such a committee can allay the manager's opportunistic attitude to commit earnings management. The results of a study conducted by Hasan and Ahmed (2012) show that the presence of independent commissioners has a significant negative effect on earnings management. Accordingly, a hypothesis is outlined as follows:

H3: Audit Committee significantly affects earnings management

METHODS

This research is categorized as explanatory research, for it focuses on the disclosure of causal relationships between independent variables and dependent variables. The data used in this study is secondary data obtained from the website of Indonesia Stock Exchange in the form of audited financial statements in 2016. All manufacturing companies listed on the Indonesia Stock Exchange in 2016 were opted for the population of this study. There were 151 companies. The unit of analysis employed in this research was the financial reporting of the manufacturing companies. Purposive sampling was employed as the sampling method in which the researcher has determined certain characteristics to attain particular objectives before embarking on the research exploration.

The characteristics employed to govern the research are outlined as: (1) the manufacturing companies are listed on Indonesia Stock Exchange in 2016; (2) they publish their audited financial reporting; (3) they have complete financial reports. The sampling can be seen in Table 1 below:

Table 1. Research Sampling

Description	Total
Manufacturing companies listed on Indonesia Stock Exchange in 2016	151
Those that do not publish their audited financial reporting	(40)
Incomplete financial reporting	(25)
Total	86

The independent variable employed in this study was audit quality entailing the audit quality itself and Good Corporate Governance (GCG). Dummy variable was employed to measure the audit quality. It scores 1 if the company is audited by KAP big four and 0 by KAP non- big four. With regard to GCG, the composition of Board of Commissioners and Audit Committee was chosen as the proxy. An independent commissioner should be present in the

Board of Commissioners. Moreover, a ratio scale was employed to determine the composition of the Board of Commissioners and the Audit Committee by calculating the number of them in each company. Modified Jones model (1995) was employed to reveal the earnings management. It is displayed as follows:

$$TACC_i = NI_i - OCF_i \dots \dots \dots (i)$$

$$TACC_{it}/A_{it-1} = \alpha_t [1/A_{it-1}] + \alpha_{1i} [(\Delta REV - \Delta REC)/A_{it-1}] + \alpha_{2i} [PPE_{it}/A_{it-1}] + \varepsilon_{it} \dots (ii)$$

$$DA_{it} = TACC_{it}/A_{it-1} - \alpha_t [1/A_{it-1}] + \alpha_{1i} [(\Delta REV - \Delta REC)/A_{it-1}] + \alpha_{2i} [PPE_{it}/A_{it-1}] \dots (iii)$$

TACC is the total amount of accruals. ΔRev is change. ΔRec is the change of receivables and PPE is plan, property and equipment. Multiple regression was employed to analyze the data in which it is intended to test how independent variables influence dependent variables. The equation is formulated as follows:

$$Y = a + b_1X_1 + b_2X_2 + b_3X_3 + e$$

Y is discretionary accrual. A is Constanta and b1 is the coefficient of audit quality variable. Moreover, b2 is the coefficient for the Board of Commissioners and b3 is the coefficient for the Audit Committee.

RESULTS

The first hypothesis asserting that the audit quality conducted by KAP big four and KAP non-big four yields a significant effect on earnings management was found to be unproven. This can be seen in Table 1 displaying that *sig t > p value* (0,566 > 0.05) which means that the first hypothesis is rejected. In addition, the second hypothesis of the study states that the composition of the Board of Commissioners significantly affects earnings management. However, this hypothesis was found to be unproven. This can be seen in Table 1 which shows that *sig t > p value* (-0.645 > 0.05) which means that the second hypothesis is also rejected. The final hypothesis also cannot prove the significant influence of the Audit Committee on earnings management. This can be seen in Table 1 displaying that *sig t > p value* (-0.090 > 0.05). It means that the Audit Committee did not yield any significant effects on earnings management.

Table 1. Regresion of Hypotheses 1, 2 and 3

Variabel independen	B	t hitung	Sig
KAP size (X ₁)	1.041E26	.576	.566
Board of Commissioners (X ₂)	-3.769E24	-.090	.928
Audit Committee (X ₃)	-2.163E26	-.645	.521
Dependent Variable : <i>Earnings management</i>			
R square	: 0,008		
F	:0,225		

DISCUSSION

Based on the results of the analysis, this study cannot prove the significant effects of audit quality proclaimed by KAP big four and KAP non-big four on earnings management. It means that neither KAP big four nor KAP non-big four can be proved to significantly detect the earnings management through the audit of the financial reporting they conducted. This indicates that audit quality is not only determined by KAP size and KAP affiliated with big for is not necessarily capable to detect any fraud committed by the management. It can plausibly occur when such fraudulent practices are on a massive scale so that it imposes serious setbacks for the auditor to disclose the fraud. In addition to such a reason, it also might be attributed to how KAP selected the samples during the audit they performed. That the present study cannot prove the hypotheses might be affected by a possibility that KAP opted for wrong samples. The results of this study attest those conducted by Radzi *et al* (2011) that also cannot prove the significant influence of KAP size on earnings management.

The second hypothesis which states that the composition of the Board of Commissioners has a significant effect on earnings management was also found to be unproven. It suggests that the existence of independent commissioners cannot prevent the behavior of managers from committing earnings management. This indicates that Good Corporate Governance practices have not been maximally implemented in which the independent commissioner in charge of supervising the management is not able to prevent or alleviate earnings management practices undertaken by the company. Moreover, a weak internal control system is also responsible for the weak implementation of GCG in the company. Therefore, the results of this study do not support those of a research conducted by Hasan and Ahmed (2012) which proves that the existence of independent commissioners reduces the earnings management activities undertaken by managers.

The third hypothesis asserting that Audit Committee significantly influences earnings management was also not proven. The Audit Committee is responsible for ensuring the reliability and fairness of the financial reporting. The existence of Audit Committee is expected to allay the opportunist attitude of managers to commit earnings management in order to meet their personal desires. Such a result indicates that the existence of Audit Committee in the company is not necessarily able to prevent the earnings management practices. This may plausibly happen if the Audit Committee do not run their functions properly or they are not independent as required by the regulations issued by BAPEPAM-LK. It is likely that the company will only provide Audit Committee to comply with the new rules issued by BAPEPAM-LK namely the Decision of the Chairman of the Capital Market and Financial Institution Supervisory Agency Number: Kep-643 / BI / 2012 on the Establishment and Implementation Guidelines of the Audit Committee. The results of this study do not attest those conducted by Radzzi, *et al* (2012) discovering that Audit Committee can reduce earnings management practices committed by the managers.

CONCLUSION

This research cannot prove the influence of audit quality and Good Corporate Governance (GCG) on earnings management. This indicates that the audit of financial reporting conducted by KAP big four is not necessarily better than the one by KAP non big four. In addition, massive and rampant earnings management practices and sampling techniques employed in the audit might cause the unproven research hypothesis. The composition of the Board of Commissioners and Audit Committee is also not proven to decrease earnings management practices committed by the managers. This might happen due to the functions of GCG which are not well performed and the weakness of the company's control system.

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