The Effect of Board of Commissioners and Audit Committee Independence and External Auditor Brand Name on Earnings Management (Empirical Evidence from Indonesia)

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ABSTRACT

Managers can manipulate earnings in order to maximize their own interests or to signal their private information, thus influencing the informativeness of earnings. Accounting earnings are more reliable and more informative when managers' opportunistic behavior is controlled through a variety of monitoring systems. Corporate governance mechanism can constrain earnings management. The objective of this study was to examine the effect of three corporate governance variables on earnings management practice of Indonesian public listed companies. Therefore, this study focused on the role of corporate governance structure (independent board of commissioner and audit, and auditor size) to reduce companies earnings management. Therefore, the study was aimed to reveal whether the independent board of commissioners affect earnings management, the independent of audit committee affect earnings management, and auditor size affect earnings management. The population of this study was all of Indonesian listed companies for the period 2008-2009. This study used purposive sampling technique with some criteria. The final sample consists of 124 firm-years observations, 47 firms for 2008 and 77 firms for 2009 period. Final sample is only 124 observations due to many companies did not have complete corporate governance data. Data analysis implemented was multiple tests. The results of data analysis show result of an empirical evidence that independent board of commissioner negatively affects. There is another empirical evidence that hypothesis of a negative effect of ratio of independent audit committee on firm's earnings management is not supported.

الملــــــخص

يمكن التلاعب بالأرباح وذلك من أجل تعظيم مصالحهم الخاصة أو الإشارة إلى معلوماتهم الخاصة ، وبالتالي التأثير على المعلوماتية للأرباح المحاسبية أكثر موثوقية وأكثر فائدة عندما يتم التحكم في سلوك المديرين الإنتهازيين من خلال مجموعة متنوعة من أنظمة المراقبة يمكن لآلية حوكمة الشركات أن تقيد إدارة الأرباح حيث كان الهدف من الدراسة هو دراسة تأثير ثلاثة متغيرات للحوكمة على ممارسة إدارة الأرباح للشركات المدرجة بالبورصة، لذلك ركزت هذه الدراسة على هيكل حوكمة الشركات متمثلة في استقلالية المفوضين والمراجع وحجم المراجع في الحد من إدارة أرباح الشركات حيث هدفت الدراسة إلى الكشف عما إذا كان مجلس المفوضين المستقل له تأثير على إدارة الأرباح أيضا عما إذا كان إستقلال الجنة التدقيق لها تأثير وإذا ما كان هناك تأثير لحجم المراجع على إدارة الأرباح. مجتمع الدراسة شمل جميع الشركات الإندونيسية المدرجة بالبورصة للفترة من 2008-2009 واستخدمت الدراسة اسلوب أخذ العينات الهادف مع بعض المعايير وكانت العينة النهائية 124 شركة ملحوظة (متوفرة) جزء منها 2008 وعددها 47 شركة ، 2009 ان عددها 77 شركة ويرجع ذلك لعدم وجود بيانات حكومية للعديد من الشركات وتم تحليل البيانات من خلال إختبارات متعددة وأظهرت النتائج بأن مجلس المفوضين المستقل له تأثير سلبي لى إدارة الأرباح وكانت داعمة لها ولكنها لم تكن داعمة لإستقلالية لجنة المراجع وحجم المرااجع.

INTRODUCTION

One of the most important functions of corporate governance is to ensure the quality of the financial reporting process (Osma and Noguer, 2007). The issue of corporate governance has become more important due to the highly publicized financial reporting frauds at Enron, Worldcom, Xerox, and Parmalat. Accounting accruals gives managers a great deal of discretion in determining the earnings a firm reports in any given period because of information asymmetry between managers and shareholders. Managers can manipulate earnings in order to maximize their own interests or to signal their private information, thus influencing the informativeness of earnings (Cornett et al., 2009).

Earnings management can be defined as the alteration of a firms' reported economic performance by insiders (managers) either to mislead some stakeholders or to influence contractual outcomes (Healey and Wahlen, 1999). Accounting earnings are more reliable and more informative when managers' opportunistic behavior is controlled through a variety of monitoring systems (Piot and Janin, 2009). Positive accounting theory argues that earnings management occurs due to three hypotheses (Watts and Zimmerman, 1986): a) the bonus plan hypothesis, b) the debt covenant hypothesis, and c) the political cost hypothesis

Previous corporate governance research showed empirical evidence that corporate governance mechanism can constrain earnings management (for example: Klein, 2002; Peasnell et al., 2005; Piot and Janin, 2007; Osma and Noguer, 2007; Cornett et al., 2009). However, much of these studies were conducted in Anglo-Saxon countries. Whether these results can be generalized able to developing countries such as Indonesia is still an empirical question.

Indonesia has different corporate governance structure from its Anglo-Saxon countries. companies incorporated under the Indonesian Company Law has two boards (thus called the two-tiers board system) (Kurniawan and Indriantoro, 2000): (i) Board of Commissioners (*Komisaris*) that performs the supervisory and advisory roles, and (ii) Board of Directors (*Direksi*) that performs the management/executive role. Indonesian has a unique agency problem phenomenon that can make different results with previous corporate governance research. The majority of public firms in Indonesia are controlled by families. The agency problem in Indonesian case is between majority and minority shareholders.

Said (2010) has examined the role of Indonesian corporate governance structure in enhancing the value-relevance of accounting information. The results of his study show that corporate governance structure (board of commissioner and audit committee) enhances the value-relevance of accounting information. Different with Said (2010), this study focuses on the role of corporate governance structure in constraining opportunistic earnings management.

Prior studies have also found an association between poor corporate governance and weaker financial controls and higher levels of financial statement fraud (Klein, 2002). The duties of the Board of Commissioners are (Kurniawan and Indriantoro, 2000): 1) to supervise the performance of the Board of Directors and policies made by the board, and 2) to provide advice to the Board of Directors. The Komisaris is required by the Company Law to carry out, in good faith and with full responsibility, its duties in the best interests of the company. Audit Committee Under the Corporate Governance Framework proposed by the National Committee for Corporate Governance, it was recommended that the Board of Commissioners of an enterprise establish an Audit Committee whose duties include: 1) promoting corporate discipline and a controlled environment to prevent fraud and abuse, 2) improving the quality of financial disclosure and reporting, 3) reviewing the scope, accuracy and cost effectiveness of the external audit and the independence and objectivity of the of the external auditors, and 4) reviewing internal control systems and day to day performance of the company's internal auditors.

Hence, this study focuses on the role of corporate governance structure (independent board of commissioner and audit, and auditor size) to reduce companies earnings management. Therefore, the study was aimed to reveal whether the independent board of commissioners affect earnings management, the independent of audit committee affect earnings management, and auditor size affect earnings management.

According to Fama and Jensen (1983), independent members make BOC more effective in monitoring managers and exercising control on behalf of shareholders. They have greater incentives than inside members to be effective monitors of management in order to preserve their reputational capital. Osma and Noguer (2007), Chen et al. (2007), Jiang et al. (2008), and Cornett et al. (2009) all found a negative relationship between board of commissioner independence and earnings management. The audit committee has been shown to constrain earnings management practices, particularly when it is highly independent (Piot and Janin, 2007). Klein (2002) finds that audit committee independence reduces earnings management (measured by abnormal accruals) in absolute value. Bédard et al. (2004) find that the likelihood of aggressive earnings management (i.e. markedly positive or negative abnormal accruals) decreases if the audit committee composed entirely of independent directors. Becker et al. (1998) argue that high-quality auditors (in their case Big 4 auditors) are able to detect earnings management because of their superior knowledge, and act to curb opportunistic earnings management to protect their reputation.

As discussed above, there were three hypotheses developed as follow: 1) **H1:** Independent Board of Commissioner negatively affects firm's earnings management, 2) **H2:** Independent Audit Committee negatively affects firm's earnings management and 3) **H3:** Auditor size negatively affects firm's earnings management

METHODOLOGY

The research was conducted in Indonesia. The objective of this study was to examine the effect of three corporate governance variables on earnings management practice of Indonesian public listed companies. The population of this study was all of Indonesian listed companies for the period 2008-2009. This study used purposive sampling technique with some criteria. The final sample consists of 124 firm-years observations, 47 firms for 2008 and 77 firms for 2009 period. Final sample is only 124 observations due to many companies did not have complete corporate governance data. Based on research hypotheses as explained above, this study proposes the research model. Independent variables are three components of corporate governance structure (independence of board of commissioner, independence of audit committee, and auditor size). Meanwhile dependent variable is earnings management (measured by discretionary accrual). This study proposes hypothesis that corporate governance can constrain earnings management. Therefore, independent variables negatively affect dependent variable.

FINDING & DISCUSSION

Descriptive Statistics

Descriptive statistics of the variables of the study are described in the table 1.

Table 1. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Ratio Independent BOC	124	20.00%	80.00%	41.5682%	11.43420%
Ratio Independent AC	124	33.33%	100.00%	59.8925%	21.80718%
Auditor Size	124	0	1	.53	.501
Earnings Management	124	-2.2627	1.7451	-.029952	.5225134
Valid N (listwise)	124				

Table 1 shows that minimum of ratio of Independent Board of Commissioner (BOC) member to total BOC number is 20% with mean 41.56%. This means Indonesian public listed companies has fullfiled the requirement of having at least one independent of BOC member. In addition, minimum of ratio of Independent Audit Committe (AC) member to total AC member is 33.33% with its mean is 59.89%. This descriptive statistics also provides an empirical evidence that the requirement to have at least one independent AC member also has been fullfilled (National Committee for Corporate Governance, 2006).

Furthermore, table also describes that mean of earnings management (as proxied by discretionary accrual) is -0.2995 with standard deviation of 0.5225. This result provides empirical evidence that sample companies engage income decreasing earnings management practice (Scott, 2003).

Correlation Matrix

Table 2 presents correlation matrix among research variables. As shown in Table 2, correlation coefficient between ratio independent BOC and earnings management is negative and significant (-0.377). This means that there is a negative relationship between these two variables. The higher the ratio of independent BOC, the lower the extent of earnings management practices conducted by companies.

Table 2. Correlation Matrix

		Ratio Independent BOC	Ratio Independent AC	Auditor Size	Earnings Management
Ratio Independent BOC	Pearson Correlation	1	.518**	.023	-.377**
	Sig. (2-tailed)		.000	.803	.000
	N	124	124	124	124
Ratio Independent AC	Pearson Correlation	.518**	1	.082	-.329**
	Sig. (2-tailed)	.000		.364	.000
	N	124	124	124	124
Auditor Size	Pearson Correlation	.023	.082	1	-.031
	Sig. (2-tailed)	.803	.364		.729
	N	124	124	124	124
Earnings Management	Pearson Correlation	-.377**	-.329**	-.031	1
	Sig. (2-tailed)	.000	.000	.729	
	N	124	124	124	124

It is also illustrated that correlation coefficient between ratio independent AC and earnings management is negative and significant (-0.329). This means that the higher the ratio of independent AC, the lower the extent of earnings management practices conducted by companies. Meanwhile, the coefficient correlation between auditor size and earnings management is negative (-0.031) but not statistically significant (p-value=0.729). Therefore, there is no relationship between auditor size and earnings management variables found in this study.

Test of Regression Assumptions

Before hypotheses testing, this section presents the results of classical regression assumptions as a requirement in ordinary least squares (OLS) regression. The results of classical regression assumptions analysis consists of multicollinearity, autocorrelation, and heterocedasticy (Gujarati, 2003).

Multicollinearity Test

Multicollinearity means there is perfect correlation among independent variables. OLS regression assumes that the correlation among independent variables should not high. To examine multicollinearity problem, this study uses Variance Inflation Factor (VIF) analysis. VIF score must less than 10 for regression model that does not have multicollinearity problem (Gujarati, 2003). Result in Table 3 shows that the highest of VIF is 1.367 (less than the criteria of 10). In conclusion, there is no multicollinearity problem in the regression model used in this study.

Table 3. Result of Multicollinearity Test

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	.774	.174		4.440	.000		
	Ratio Independent BOC	-.013	.004	-.283	-2.901	.004	.732	1.367
	Ratio Independent AC	-.004	.002	-.182	-1.867	.064	.727	1.375
	Auditor Size	-.010	.087	-.010	-.120	.904	.993	1.007

a. Dependent Variable: Earnings Management

Autocorrelation Test

One assumption in OLS regression is that there is no autocorrelation. No autocorellation means the error terms (residuals) are uncorrelated. To examine no autocorellation assumption, this study will use Durbin-Watson (DW) test which compare DW score with DW table. There is no indication of autocorrelation problem if the results of regression show DW score is located in DU<DW< 4-DU region (Gujarati, 2003).

With sample 124 (n=124), three independent variables (k=3), DW it was found that DL is 1.613 and DU is 1.736. DW score resulted from regression analysis is 2.095 (Table 4.5). DW score (2.095) is located in DU<DW<4-DU region (1.736<2.095<2.264). Therefore, it can be concluded that there is no autocorrelation problem in this study.

Heterocedasticity Test

Regression model assumes there is no heterocedasticity (Hair et al. 1998; Gujarati, 2003). This means that regression model assumes homoscedasticity; the variance of the error is constant for all values of independent variable (Xi). This study will use Glejster method to examine heterocedasticity problem in which independent variables are regressed on absolute residual as dependent variable. Rule of decision is there is no heterocedasticity problem if there is no independent variables significantly affect absolute residual as dependent variable. The result shows that none of coefficient regression of three independent variables significantly affects dependent variable (Absolute Residual). All of p-value of independent varibales is higher than 0.05. Therefore there is no heterocedasticity problem in the regression model.

Overall, the results of classical regression assumptions test above show that there are no problems of multicollinearity, heterocedasticity, and autocorrelation in regression model of this study.

Result of Hypotheses Testing

This section reports the results of hypotheses testing using regression analysis. The results are presented in Table 4.

Table 4. Result of Hypothesis Testing
(Dependent Variable: Earning Management)

Independent Variables	Hypothesis	Coefficient	t-statistics	Sig.
Constant		0.774	4.440	0.000
Independent BOC	-	-0.013	-2.901	0.004
Independent AC	-	-0.004	-1.867	0.064
Auditor Size	-	-0.010	-0.120	0.904
Adjusted R Square	**0.146**			
F Statistics	**8.020**			
Sig. F	**0.000**			

Table 4 shows that F Statistics is 8.020 and significant with probability of 0.000 (<0.05). This result means that regression model can be used to predict the dependent variable (Earnings Management). In other words, Independent BOC, Independent AC, and Auditor Size variables simultaneously affect Earnings Management. Significant value of F as shown in Table 4 means goodness of fit of regression model used in this study. Adjusted R Square is 0.146 (14.6%). It means that three independent variables of this study can explain 14.6% of Earnings Management variation. Meanwhile, the remaining part of Earnings Management variation (100%-14.6%=75.4%) is explained by other variables not included in the research model.

Hypothesis 1 states that independent Board of Commissioner (BOC) member negatively affects firm’s earnings management. The result in Table 4 shows that regression coefficient of Independent BOC variable is negative (-0.013) and significant with t-statistic -2.901 and p-value of

0.000 (less than 0.05). This means that Independent BOC variable negatively and significantly affects Earnings Management. Therefore, hypothesis 1 is strongly supported by empirical evidence of this study.

Hypothesis 2 states that independent Audit Committee (AC) member negatively affects firm's earnings management. The result in Table 6 shows that regression coefficient of Independent AC variable is negative (-0.004) and insignificant at 5% level with t-statistic -1.867 and p-value of 0.064 (greater than 0.05). Therefore, hypothesis 2 is not supported. Independent audit committee member does not negatively affect firm's earnings management.

Hypothesis 3 states that auditor size negatively affects firm's earnings management. Auditor size is measured by dummy variable; 1 for auditors that have affiliation with Big 4 auditors and 0 for auditors that doesn't have affiliation with Big 4 auditors. The result in Table 4.7 shows that regression coefficient of Independent AC variable is negative (-0.010) and insignificant at 5% and 10% level with t-statistic -0.120 and p-value of 0.904 (greater than 0.05 and 0.10). It can be concluded that hypothesis 3 is not supported by empirical evidence of this study. Auditor size does not negatively affect firm's earnings management.

As summary, the results of hypothesis testing are:

a. Hypothesis 1 (independent Board of Commissioner (BOC) member negatively affects firm's earnings management) is supported.
b. Hypothesis 2 (independent Audit of Committee (AC) member negatively affects firm's earnings management) is not supported.
c. Hypothesis 3 (auditor size negatively affects firm's earnings management) is not supported.

DISCUSSION

The objective of this study is to provide empirical evidence about the effect of independent board of commisssioner and audit commitee member on firm's earnings management for Indonesia case. The other objective is to provide empirical evidence whether the auditor size negatively affects client's earnings management.

The result of this study provides an empirical evidence that independent board of commissioner negatively affects. This means that the higher the ratio of independent of board of commissioner member, the lower the firm's earnings management. This finding supports argument of agency theory (Jensen and Mecking, 1976) that hiring independent board of commissioners member is important as corporate governance mechanism to align the interests of the management with those of the shareholders. Independent boards of commissioner members are needed to monitor the behavior of the management especially to reduce earnings management practice that may has negative effects on shareholder's interest. The finding of this study also supports the argument that strong corporate governance structure should result in better quality financial reporting, including lower earnings management (Klein, 2002). Corporate governance mechanisms, especially independent board of commissioner, are important to constrain management opportunistic earnings behaviour and, consequently, to make accounting information more credible and relevant to investors.

The finding that independent board of commissioner negatively affects firm's earnings management supports Fama and Jensen's (1983) argument that independent members have incentives to carry out their monitoring tasks and to avoid colluding with management to expropriate shareholder wealth. These incentives include developing their reputations as experts in decision control because this will enhance their chances of securing other directorships. Moreover, the finding that the ratio of independent boards of commissioner member negatively affects firm's earnings management is consistent with previous research such as Klein (2002), Peasnell et al. (2005), Osma and Noguer (2007), Chen et al. (2007), and Cornett et al. (2009). This study recommends regulator to support the public listed companies in hiring independent BOC members. The inclusion of outside directors increases a board's independence and its ability to monitor top management effectively. Independent BOC members can inhibit firms from engaging in earnings management.

The result of this study also provides empirical evidence that hypothesis of a negative effect of ratio of independent audit committee on firm's earnings management is not supported. The possible explanation for this finding is as follow. Independent of audit committee members alone cannot be effective to constrain firm's earnings management if they did not have financial and accounting expertise that needed to review firm's financial reporting. Mustafa and Youssef (2010) found that an independent audit committee member is only effective in reducing the occurrence of fraud (misappropriation of assets in their study) if he/she is also a financial and accounting expert. Thus, audit committee members should be independent and have financial and accounting expertise to constrain firm's earnings management. It can be recommended that effective oversight by an audit committee requires that its members should be independent and possess sufficient expertise in accounting and financial to assess the financial reporting presented to them. It can be recommended for companies to hire independent and expert audit committee member. In addition, independence of audit committee members alone will not effective in detecting and constraining firm's earnings management if they are not active. The level of activity of an audit committee also has been recommended as important to enhance its effectiveness in improving earnings quality. Bedard et al. (2004) argued that an "actively functioning audit committee" is more likely to detect earnings management than a "dormant committee".

This study proposes hypothesis that auditor size negatively affects firm's earnings management. Large audit firms (Big 4) is hypothesized to be able to detect client's earnings management because of their advanced knowledge and to control opportunistic earnings management to protect their reputation. However, this hypothesis is not supported by empirical evidence. This finding is not consistent with the finding of previous research such as Francis et al. (1999), Balsam et al. (2003), and Chen et al. (2005). This finding may be due to auditor size variable (measured by dummy variable; Big 4 vs. non Big 4) does not represent audit quality construct. Although several previous studies have used auditor size as proxy for audit quality (for example Francis et al., 1999; Balsam et al., 2003; and Chen et al., 2005), the result of this study shows that this proxy may be not accurate for Indonesian case. The other possible explanation for the finding that hypothesis 3 is not supported may be due to moderating effect of client size on the relationship between audit quality and earnings management. Carcello and Nagy (2004) found that the positive benefits of high quality auditor in deterring financial fraud is affected by client size. They argue that larger clients have greater bargaining power and are more likely to be able to convince the auditor to acquiesce to aggressive accounting (earnings management). Future research should examine the moderating role of client size on the relationship between auditor quality (proxied by auditor size) and firm's earnings management.

CONCLUSION, IMPLICATION, LIMITATION AND SUGGESTION

Conclusions

The conclusions of the research are as follows:

a. Hypothesis 1 that independent board commissioner negatively affects firm's earnings management is supported by empirical evidence. This finding supports agency theory (Jensen and Mecking, 1976) that independent board of commissioners is important as corporate governance mechanism to monitor the behavior of the management especially to reduce earnings management practice that may has negative effects on shareholder's interest.
b. Hypothesis 2 that independent audit committee negatively affects firm's earnings management is not supported by empirical evidence. Audit committee member should not only be independent but also has financial and accounting expertise to be able in constraining firm's earnings management.
c. Hypothesis 3 that auditor size negatively affects firm's earnings management is not supported. Indonesian auditors that have affiliations with Big 4 auditors are not better able to detect and constrain client's earnings management than auditors that don't have such affiliation.

Implications

The implications of the research are as follows.

a. It is important for regulator (Indonesian Securities Exchange Commission) to support public listed companies in Indonesia to have higher percentage of independent board of commissioner's member. Higher percentage of independent board of commissioner's member appears to be an effective corporate governance mechanism to reduce the agency problem and to constrain firm's earnings management.
b. Effective oversight by an audit committee requires that its members should be independent and possess sufficient expertise in accounting and financial to review firm's financial reporting. Regulators should recommend public listed companies to have more independent and expert audit committee member. Moreover, it is important also to have audit committee that are active in conducting review of financial reporting in order to detect and constrain firm's earnings management.
c. The result of this study shows that Big 4 auditors were not better in detecting and constraining client's earnings management practice. This finding shows initial evidence about the low of audit quality in Indonesia. Therefore, it is important for regulators to enhance the audit quality in Indonesia.

Limitations and Future Research Agenda

The limitations and suggestions for future research are as follows:

a. This study only focuses on the role of independent audit committee member in constraining earnings management. Future research should examine the effect of audit committee expertise on firm's earnings management.

b. The proxy for audit quality construct is limited only using auditor size. Future research can use another proxy such auditor industry specialization to measure audit quality.
c. Sample size of this study is limited due to many companies did have complete annual report. If the data is available, future research can use more sample companies. In addition future research can use sample from different industry such banking and insurance.
d. Time period of this study only focuses on 2008 and 2009. Future research can enlarge time period to test the generalization of this study's findings.

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