

# The Effect of Good Corporate Governance Mechanism to Earnings Management

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## THE EFFECT OF GOOD CORPORATE GOVERNANCE MECHANISM TO EARNINGS MANAGEMENT BEFORE AND AFTER IFRS CONVERGENCE

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### Abstract

This study aims to determine the effect of differences in the "Good Corporate Governance" (GCG) mechanism on Earnings Management, before and after Indonesian Financial Accounting Standards (PSAK) convergence IFRS, on the companies listed on the Indonesia Stock Exchange (IDX) in the year 2010-2013. The population in this study amounted to 136 manufacturing companies, where samples obtained was 65 companies in accordance with the sample selection criteria. GCG Mechanism is an independent variable that includes internal and external mechanisms. The study concluded that the effect of different GCG mechanisms to earnings management, depending on the proxy used for GCG mechanism.

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**Keywords:** Earnings Management, IFRS, Indonesian Financial Accounting Standards (PSAK), GCG Mechanism

### 1. Introduction

The fundamental difference between IFRS with a statement of financial accounting standards in Indonesia (PSAK) before convergence lies in the use of fair value, whereas PSAK prior to the convergence of IFRS using historical

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value in its calculations. Suwardjono (2005) "Fair value is the amount of Rupiah agreed to an object in a transaction between parties who will freely without pressure or compulsion". Furthermore, the historical value is "historical boarding an agreement or rupiah exchange rates have been recorded in the accounting system". The use of historical cost is considered to be interrupted in the creative accounting practices such as earnings management and others. Because the preparation of financial statements based on historical cost does not reflect the real situation in the event of changes in purchasing power, so that the resulting financial statements are less able to reflect the real situation in case of price changes (Leng, Pwee. 2002). This will lead to inaccuracies and lack carefully situations of financial statements that are presented. Inaccurate financial reporting, can lead to errors in the delivery of information to stakeholders, and will eventually have a negative impact on the company itself.

Implementation of PSAK convergence to IFRS in Indonesia for a company that has been listed in the Indonesia Stock Exchange (BEI) is effective starting January 1, 2012 (Bapepam-LK. 2010). One such standard is PSAK 16 which regulates fixed assets. PSAK Before the convergence to IFRS, that is PSAK 16, 1994 governing the treatment of fixed assets are measured according to historical cost, while after the convergence of IFRS, PSAK 16 revised according to IAS 16, fixed assets are measured at fair value (fair value). Changes in the use of historical value into a fair value will impact on the financial statements. The transition from historical cost to fair value on fixed assets required professional judgment by management as manager of the company. Improper of professional judgment will lead to errors in the presentation of financial statements and will affect the errors in decision-making by users of the financial statement, in this case primarily shareholders. This can occur because the not symmetric information between management and users of financial statements. To avoid this asymmetric information, the parties may appoint the principle that will help reduce this information asymmetry, to appoint an independent party control, which is reflected in the mechanism of Good Corporate Governance (GCG = GCG).

Research Ball et al. (2003) showed that high quality standards are not always produce high-quality information, but also related to the oversight function is a mechanism GCG. GCG role in monitoring is important in a company, GCG is one of the controls to achieve the company's management, the weaker of corporate governance is believed to be the main source of earnings management that is detrimental to stakeholders and ultimately the cause of the financial crisis. The financial crisis in various countries in 1997-1998, which begins in Thailand (1997), Japan, Korea, Indonesia, Malaysia, Hong Kong and Singapore which eventually turned into the Asian financial crisis, is seen as a result of weak practices of GCG in Asia. The argument underlying mechanisms of GCG effect on earnings management is when the company had established this mechanism, then there is the behavior of management to manage earnings will be reduced due to increased oversight and control with this mechanism. Nasution and Setiawan (2007) proved that the mechanism of GCG as measured by the composition of the board of commissioners negatively affect earnings management. Many of the standards set out in SFAS, but this study only focused on fixed assets. The reason is the management as an agent allowing for earnings management associated with discretionary management of the fixed assets, which one of them by changing the method of depreciation of assets. The application of PSAK convergence of IFRS is principle-based standards, causing the comparability of financial statements slightly decreased, especially when the use of professional judgment boarded with interest to regulate the profit, in the financial statements as an assessment of management performance.

The use of the accrual basis is superior than the cash basis for measuring performance and financial condition of the company. On the other hand the use of the accrual basis to provide flexibility to management in assessing and determining the accounting numbers. These conditions allow the management to beautify the financial statements by earnings management (Subramanyam et al, 2005). Earnings management is management intervention deliberately in the process of determination of the profits, usually to meet a personal goal (Schiper, 1989 in Subramanyam et al, 2005). This process is often done to beautify the financial statements, especially profit so that company stakeholders assess the company performs well. Several studies have shown that the application of IFRS in financial reporting can reduce earnings management. Theresia (2012) has done research in Indonesia and the result is that the practice of

income smoothing decreased after conversion GAAP to IFRS, while other studies indicate that there is a significant difference between the level of earnings management before and after the adoption of IFRS. (Abhiyoga, 2013).

## 2. Literature Review & Hypothesis Development

Financial statements are prepared and used by management to accountability to stakeholders. Accountability is measured from the financial performance achieved by the management which is reflected on the profit - loss generated. It presented should be based on applicable accounting standards in general, that is PSAK to IFRS convergence. From various studies, the results were not consistently stated direction of influence, but the use of IFRS through the GCG mechanism significant effect on earnings management. So that earnings management is not arbitrarily made by the management company it is necessary to monitor the behavior or policy management. The argument underlying this is that when the company had established a mechanism GCG then the behavior of management to manage earnings will be reduced due to lack of monitoring and control by such a mechanism, in this case the independent board, the audit committee, managerial ownership and institutional ownership and audit quality. This is in accordance with the wishes of the regulator, in this case the Financial Services Authority, which encourages the implementation of corporate governance principles through corporate governance mechanisms, which will increase protection for the stakeholders of the company.

The composition of the board of commissioners may affect management in preparing the financial statements through its role in carrying out supervisory functions so as to obtain a quality income statement (Boediono, 2005). Nasution and Setiawan (2007) proved that the composition of the board of commissioners negatively affect earnings management. This means that more and more independent directors, the smaller the earnings management. This is supported Chtourou et al., (2001) and Wedari (2004) that an independent board of director which will limit earnings management activities.

The audit committee is responsible for overseeing the financial reporting, external audit and internal control systems observed (including internal audit). In addition, it may reduce the opportunistic management conduct earnings management by means of supervising the implementation of the external audit (Siallagan and Machfoedz (2006). Research conducted by Nasution and Setiawan (2007) proved that the existence of audit committees in the banking company was able to reduce earnings management. Wedari (2004) also prove the existence of the audit committee negatively and significantly impact to discretionary accrual.

Siallagan and Machfoedz (2006) proved that managerial ownership affects the quality of earnings. This shows that the greater managerial ownership then the lower discretionary accrual. Jensen and Meckling (1976) found that managerial ownership managed to be a mechanism to reduce agency problems by aligning the interests of managers and shareholders. Ujjiyantho and Pramuka (2007) proved that managerial ownership has significant negative effect on earnings management. These results are consistent with the results obtained Dhaliwal et al., (1982), Morck et al., (1988) in Ujjiyantho and Pramuka (2007), as well as Mdiastuty and Machfoedz (2003). The percentage of shares held by institutions can influence the process of preparing financial statements and did not rule out there accrued accordance with the interests of management (Boediono, 2005). Jensen and Meckling (1976) proved that high

institutional ownership limit managers to manage earnings. Likewise Midiastuty and Machfoedz (2003), has found that institutional ownership is negatively related to earnings management.

Audit is a process to reduce dissonance information contained on managers and shareholders by using outsiders to give approval to the financial statements (Meutia, 2004). Qualified auditors whose will audit the quality as well. Meutia (2004) concluded that the public accounting firm that is bigger, the quality of the resulting audit also better.

Based on the explanations above, the hypothesis of this study is structured as follows:

- H<sub>1</sub>: There is a difference in the effect of composition of the Board of the Independent Commissioner (X<sub>1</sub>) to Earnings Management (Y) before and after the convergence of PSAK to IFRS.
- H<sub>2</sub>: There is a difference in the effect of the Audit Committee Composition (X<sub>2</sub>) of the Earning Management before and after the convergence of PSAK to IFRS.
- H<sub>3</sub>: There is a difference in the effect of Managerial Ownership (X<sub>3</sub>) of the Earnings Management before and after the convergence of PSAK to IFRS
- H<sub>4</sub>: There are differences in the influence of Institutional Ownership (X<sub>4</sub>) on Earnings Management before and after the convergence of PSAK to IFRS
- H<sub>5</sub>: There is a difference in the effect of Audit Quality (X<sub>5</sub>) on Earnings Management before and after the convergence of PSAK to IFRS.

### 3. Research Methodology

The research is an explanatory empirical verification research. The populations of this research are manufacturing companies listed in Indonesia Stock Exchange in 2010 - 2013. The population of 136 companies, the sample selection based on certain criteria (purposive sampling), among others completeness of the data and the company never delisting during the study period, Find were the results obtained from 65 of the sampled manufacturing enterprises, the data used in this study were collected in the form of secondary data, obtained from the Indonesian Capital Market Directory (ICMD), or [www.idx.co.id](http://www.idx.co.id). Testing hypothesis is by using multiple linear regression method. In order to make the regression analysis model used theoretically produce a valid parametric values, classical assumptions test held first, which include: the normality test, autocorrelation test, heteroscedasticity test, and multicollinearity test. Regression analysis was performed before and after the convergence of PSAK to IFRS, then the regression test results will be compared to all answer the proposed hypothesis.

### 4. Findings

The following details how much the company indicated to earnings management (Table 4.1).

Table 4.1. Results Indications Management

No	Indication:	Earnings Management			
		Before Convergence		After Convergence	
		2010	2011	2012	2013
1	Exist	35	48	11	34
2	No Exist	30	17	54	31
	<b>Total</b>	<b>65</b>	<b>65</b>	<b>65</b>	<b>65</b>



Source: Secondary data were processed (2014)

Companies that perform earnings management in 2010 as many as 35 companies, and in 2011 as many as 48 companies, the year 2010 - 2011 is assumed to prior PSAK to IFRS convergence, then after the convergence of PSAK to IFRS, in 2012 to 11 companies indicated to earnings management, and in 2013 as many as 34 companies or by 52.31% of the companies indicated to earnings management of the company's total number sampled. Multiple linear regression was performed after classical assumption test done. All the variables have passed the test classic assumptions. Multiple linear regression analysis resulted in the following regression equation.

- a. The PSAK before convergence of IFRS  

$$Y_a = 0.088 + (-0.091) X_1 + (-0.049) X_2 + 0.039X_3 + (-0.001)X_4 + (-0.030)X_5 + e$$
- b. The PSAK after convergence of IFRS  

$$Y_b = -0.008 + (-0.099) X_1 + (-0.052) X_2 + (-0.32)X_3 + 0.010X_4 + (-0.047)X_5 + e.$$

The results of hypothesis testing indicated that the composition of the independent board have significant negative effect on earnings management in 2010 - 2011, before PSAK convergence IFRS, whereas hypothesis testing when the company after PSAK convergence IFRS in 2012 - 2013 indicated the same result. The role of independent board is seen as a good mechanism for monitoring/control and to bridge the management (agent) or to protect the interests of directors and shareholders (principal). According to the agency theory, independent directors will bridge or as an intermediary in the event of a conflict between shareholders with the manager of the company that management or directors. One is to minimize earnings management to improve the quality of accounting information so that the information generated is not mislead users one of which is a shareholder. In practice, according Sutedi (2011), the majority of companies in Indonesia already comply with selecting independent directors in accordance with the criteria and the spirit of independence is expected. The results support the research Nasution and Setiawan (2007) proved that the composition of the independent board negatively affect earnings management. This means that more and more independent directors, the smaller the profit management. This is supported Chtourou et al., (2001) and Wedari (2004) that an independent board of directors which will limit earnings management activities.

Before and after the PSAK convergence IFRS, the results of hypothesis showed that the composition of the audit committee significant negative effect on earnings management. Negative coefficient means that the greater the smaller the composition of the audit committee of earnings management. The audit committee is responsible for overseeing the financial reporting, external audit and internal control systems observed (including internal audit). In addition it may reduce the opportunistic management conduct earnings management by means of supervising the implementation of the external audit (Siallagan and Machfoedz (2006). Price Waterhouse (1980) in Sari et.al. (2010) stated that investors, analysts and regulators consider the audit committee contributes to the quality of reporting finance.

Managerial ownership is not a significant positive effect on earnings management before PSAK convergence IFRS, whereas hypothesis testing after PSAK convergence IFRS indicated that it is not a significant negative effect on earnings management. Earnings management is largely determined by motivation manager. Different motivations will produce different amount of earnings management, such as between manager who also serves as shareholders and managers who do not as a shareholder. This is consistent with the company's management system in two criteria: (a) the company is led by managers and owners; and (b) the company led by the manager and non-owners. In general it can be said that the percentage of stock ownership by management tends to affect earnings management action (Boediono, 2005).

The results of hypothesis testing indicated that institutional ownership is not a significant negative effect on earnings management before PSAK convergence IFRS, whereas after the PSAK convergence IFRS indicated that institutional ownership is not a significant positive effect on earnings management. Generally, institutional ownership held by major shareholders. With a large stock holdings, institutional investors have a strong incentive to monitor practices of

earnings management. Then the percentage of shares held by institutions can influence the process of preparing financial statements and did not rule in the interests of the parties are accrued management (Boediono, 2005). Jensen and Meckling (1976) proved that high institutional ownership limit managers to manage earnings. Associated with institutional ownership on earnings management after PSAK convergence IFRS, the results Boediono (2005) proved that institutional ownership has positive influence on earnings management action. This is in line also with the view that the institutional is the owner while and focus on short-term profits (Porter, 1992) in Boediono (2005). Concentrated ownership in an institution usually reflects the power, so as to have the ability to intervene against the running of the company and set up the process of preparing financial statements. As a result, managers are forced to take action in the form of earnings management in order to meet the desire of certain parties, including the owner.

The audit quality significant negative effect on earnings management in the sample before and after the PSAK convergence IFRS. Audit is a process to reduce dissonance information contained on managers and shareholders by using outsiders to give approval to the financial statements (Meutia, 2004). Public accountants as external auditors are relatively independent from management than the internal auditor, as far as the case is expected to minimize the profit engineering and enhance the credibility of accounting information in the financial statements. Financial statement quality, relevant and reliable results from audits carried out effectively by a qualified auditor. Before PSAK convergence IFRS, the results showed that the quality of the audit significant negative effect. The results were not significant research shows that the existence of audit quality does not necessarily decrease or minimize earnings management. Then the same thing happened after the PSAK convergence IFRS.

These results are consistent with research conducted by Meutia (2004) concluded that the public accounting firm that is bigger, the quality of the resulting audit also better. Differences in the quality of services offered by public accounting firms indicate the identity of the public accounting firm. Independence and quality auditor may have an impact on the detection of earnings management. There is a presumption that a reputable auditor can detect the possibility of earlier earnings management so as to reduce the level of earnings management conducted by the management company. The use of high-quality auditors will also reduce the company the opportunity to cheat in presenting inaccurate information to the public. Thus potential investors have misleading information about the company's prospects in the future.

## 5. Conclusion

From the description above can be concluded that: the composition of the independent board, audit committee composition and quality of the audit as an independent variable, before and after the PSAK convergence of IFRS significant negative impact on earnings management. While other, managerial ownership having positive effect was insignificant before PSAK convergence IFRS, and the negative effect after PSAK convergence IFRS but not significant to earnings management. The institutional ownership before PSAK convergence IFRS negative effect, whereas after PSAK convergence IFRS positive effect but not significantly to earnings management.

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