CORPORATE GOVERNANCE AND REAL EARNINGS MANAGEMENT

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ABSTRACT

Financial reports are published still an accrual basis so that it opens the opportunity for management to make earnings management. Earnings management is a phenomenal activity. Financial Accounting Standards also adopt the International Financial Reporting Standard which allows management to enter judgment in financial reporting in accordance with Financial Accounting Standards. Earnings Management that has been studied is the accrual earnings management because it is easier to detect seen from the published financial statements. Real earnings management is difficult to detect because it is done in the real activities of companies such as sales and production. The purpose of the research was to obtain empirical evidence that corporate governance affects the real earnings management. Corporate governance used in this study include the audit committee of accounting experts, audit committee, audit committee meetings, boards of directors, independent commissioner, managerial ownership, institutional ownership. The method used using multiple regression analysis. This study used a sample of manufacturing companies listed in Indonesia Stock Exchange from the period 2011 to 2014. The results showed that the audit committee meetings, board of directors, institutional ownership affect the real earnings management. Audit committee meetings cannot reduce real earnings management. The audit committee as an external party companies have less information related to the real activity of the company. The board of directors is an internal party company who know the company's operations. If there is deviation operational activities, the board could supervise properly. Institutional ownership as a majority owner to have information about the activities of the company. With that information, institutional ownership can reduce the deviation of real activity.

Key words: Real earnings management, corporate governance, audit committee meeting, board of directors, institutional ownership.

Introduction

In practice, financial reporting to the public has been highlighted by various scandals of financial fraud by the management company. On July 21, 2015, the Kompas daily release accounting irregularities scandal news has been by the company Toshiba Corporation is a manufacturer of televisions and electronics, including computers. Toshiba Corporation's top management systematically involved in the scandal inflate the company's profit amounted to 1.3 billion US dollars since 2008 with the purpose of keeping the view the company's success.

Every company has a goal to earnings in an effort to maintain business continuity. Profit is defined as the excess of the revenue with the cost within a certain period cannot be separated from management performance. Earnings as one measure of the success of management in operating the company. Therefore, the management company is always willing to show a profit in the financial statements. One alternative that is performed by the company's management is to take earnings management. Earnings management is an engineering financial statement through opportunistic actions of managers in maximizing desires. By increasing these earnings, will be reflected in the company's performance was good through the manipulation of financial statements, which in turn make the information contained earnings become irrelevant.

Real earnings management practices carried out through three approaches, namely the manipulation of operating cash flow, production costs and discretionary expenses. The shift of earnings management to the accrual-based earnings management through real activities manipulation caused by several factors. First, Gunny et al. (2014) revealed that the manipulation of accruals is more often used as a center for observation or inspection by auditors and regulators rather than decisions on price and production. Second, Graham et al. (2005) states simply focusing on a accrual manipulation is an action that is risky because the company may have limited flexibility to adjust the accruals. Third, Ratmono (2010) find that earnings management through real activities manipulation is very difficult to detect by the auditors, even by auditors qualified and have particular expertise.

Manipulation of real activity is a practice that deviates from the normal operation of the company motivated by the desire managers to mislead shareholders. An opportunist action of this management is the impact of the agency relationship conflict. Implementation of Corporate Governance is expected to overcome this agency problem. The motivation of the research is how the real earnings management can be minimized by corporate governance. The research study modify Sun et al. (2014), the study seeks to test the ability of the variables that exist in the study of Sun et al. (2014), the audit committee of accounting experts and audit committee size that affect the real earnings management. The research question is the audit committee of accounting experts, audit committee, audit committee meetings, boards of directors, independent commissioner, managerial ownership, institutional ownership effect on real earnings management? This study aims to find empirical evidence that the audit committee of accounting experts, audit committee, audit committee meetings, boards of directors, independent commissioner, managerial ownership, institutional ownership affect the real earnings management.

Agency Theory

Jensen and Meckling (1976) defines the agency theory as the relationship between the agent (management of a business) and the principal (shareholders). In an agency relationship there is an employment agreement (contract) where one or more persons (the principal) govern another person (the agent) to perform a service on behalf of the principal and authorized agent to make the best decisions for the principal. In the agency theory, described relations within the company between the shareholders of the company (as the principal) and the management of the company (as agent). Agency theory that began to develop refers to the fulfillment of the main goal of management is to maximize shareholder value. Agency theory states that between management and owners have different interests (Jensen and Meckling, 1976).

Agency conflict arises when the management of a company apart from its ownership. Principals give authority to the board of commissioners and directors for the care of the running of the company and make decisions on behalf of the owner. With its authority, then the manager is not likely to act in the best interests of the owners for their differences of interests. Manager wants contractual fee as a means of fulfilling the needs of economic and psychological, otherwise the owner is motivated to contract with agencies to maximize the return to add to well-being. In other words, management has different interests with the principals. Conflict of interest is on the increase because the owner cannot monitor the daily activities of managers to ensure that the manager acted as expected by shareholders. Managers who are directly involved with the activities of the company, has more information than the shareholders. This is what is called information asymmetry. Conflict of interest and information asymmetry may encourage agents to not deliver the actual information to the principal and may affect the financial statement presentation. The financial statements are made may be irrelevant and not neutral because the financial statements of the agent's interests. The financial statements show as good as possible through manipulation by management may mislead users of financial statements to make decisions.

Corporate Governance

Separation of ownership and control by the principal agent in a company tend to cause the agency conflict between principal and agent. Motivation for compensation bonuses encourage management to manipulate accounting numbers that exist in the financial statements . Watts and Zimmerman (1990) states that the financial statements prepared by the accounting numbers are expected to minimize the conflict between the parties concerned. The financial statements used for accountability agent performance. Financial reports are also a means for the principal to assess measure and monitor the extent to which the agency works to improve the welfare and as basis in determining the amount of compensation to be received by the agent. One mechanism that is expected to control the cost of the agency is to implement the Corporate Governance. According to the Forum for Corporate in Indonesia (FCG1) (2000), Corporate Governance is a set of rules that govern the relationship between shareholders, management, creditors, government, employees and holders of other internal and external interests relating to rights and obligations, or in other words a system that regulates and controls the company. Corporate Governance is the principles that underlie a company's processes and management mechanisms based on legislation and business ethics. Each company must ensure that the principles of Corporate Governance applied to every aspect of business and the entire company. Corporate Governance Principles of transparency, accountability, responsibility, independence and fairness are needed to achieve business sustainability companies by taking into account the stakeholders.

Audit Committee of Accounting Experts and Real Earnings Management

Bedard et al. (2004) found that the audit committee of accounting experts negatively affected by aggressive earnings management. Lin et al. (2006) states that there is a negative relationship between the audit committee of accounting experts and earnings management. The study found that an audit committee comprised of at least one accounting expertise will reduce earnings management. The audit committee of accounting experts can reduce earnings management for companies that have weak corporate governance. Otherwise no effect of audit committee of accounting experts on earnings management for the company has implementation good corporate governance.

Susanto (2014), Pamudji et al. (2010), Nasution and Setiawan (2007) found audit committee of accounting experts not significant effect on earnings management. This suggests that the formation of audit committees with competence in accounting and finance is only mandatory to regulations. In addition, the lack of clear definition of financial literacy should be owned by members of the audit committee led to each company is likely to have different definitions in determining the number of audit committee members who have financial literacy.

Decision-making technique a member of the audit committee can show his experience. A member of the audit committee who has a lot of experience in the accounting field has certainly used to dealing with the problem of accounting and good at making decisions (Qi and Tian, 2012). Audit committee members who have had work experience in accounting in particular audit can improve the competence of the audit committee in reducing earnings management (Wardhani and Joseph, 2010). Different results showed that work experience in finance has a positive effect on earnings management (Qi and Tian, 2012). This indicates that the audit committee who are not experienced working in finance will be a lot to learn and maximize the ability to suppress

earnings management. The same result states that the audit committee members work experience in accounting, especially audit has a positive influence on earnings management (Wardhani and Joseph, 2010). The hypothesis is:
H1 The higher work experience in accounting, the lower real earnings management.

Audit Committee and Real Earnings Management

Lin et al. (2006) showed that there is a negative relationship between the size of the audit committee and earnings management. It indicates that the larger the size of the audit committee more quality financial reporting. The size of the audit committee to minimize the occurrence of earnings management. While, Indrawati and Yulianti (2010), Agustia (2013), Nasution and Setiawan (2007) and Pradipta (2011) showed that the size of the audit committee has no significant effect on earnings management. The hypothesis is:
H2 The larger the size of the audit committee, the lower real earnings management.

Audit Committee Meetings and Real Earnings Management

Pamudji et al. (2010), Nasution and Setiawan (2007) showed that the frequency of audit committee meetings activity does not affect earnings management activities. The frequency of audit committee meetings can be considered to minimize earnings management. The more frequent audit committee meetings, the easier it is for an audit committee to oversee the activities of the management company. The frequency of audit committee meetings has a negative effect on earnings management (Qi and Tian, 2012). This suggests that the more frequent audit committee meetings, the easier it is for an audit committee to oversee the management of the company as well as the possibility of detecting earnings management. The higher the frequency of audit committee meetings held, the lower the earnings management (Gulzar and Wang, 2011). The hypothesis is:
H3 The more the frequency of audit committee meetings, the lower earnings management.

Boards of Directors and Real Earnings Management

Suhartini (2006) showed that the number of board of directors has no effect on earnings management. Pradipta (2011) showed that the number of members of the board of directors effect on earnings management. The number of board of directors will be less effective in doing so is believed to minimize the monitoring of earnings management. The different results indicate that the board does not have an influence on earnings management (Wirawan, 2010). This indicates that the number of board of directors is little do not effect on the company's control. It is same with Farida et al. (2010), Sun et al. (2011) and Widyaningdyah (2001) which showed that the number of board of directors does not affect the occurrence of earnings management. The hypothesis is:
H4 The number of board of directors has a negative effect on earnings management.

Independent Commissioner and Real Earnings Management

Agustia (2013), Indrawati and Yulianti (2010), Handayani and Rachadi (2009), Kartina and Nikmah (2010) showed that the number of independent commissioner members have no effect on earnings management to avoid earning losses. Nabila and Daljono (2013) showed that the proportion of independent commissioner positive effect on earnings management. The proportion of independent commissioner who are not able to reduce earnings management.

The existence of an independent commissioner in the company serves as a counterweight in the decision-making process in order to provide protection to minority shareholders and other parties related to the company (Guna and Herawaty, 2010). If the company has a lot of independent commissioners, the likelihood of earnings management will be smaller. This is because they do not side with management and capable of detecting earnings management. It is the same with Gulzar and Wang (2011) and Jao and Pagalung (2011) which showed that the independent commissioner negative affect earnings management. The hypothesis is:
H5 Independent commissioner has a negative effect on earnings management.

Managerial Ownership and Real Earnings Management

Pradipta (2011) showed that managerial ownership no significant effect on earnings management. Indrawati and Yulianti (2010) and Agustia (2013) showed that managerial ownership has no effect on earnings management. Kartina and Nikmah (2011) showed that managerial ownership significantly influence the quality of earnings. Charfeddine et al. (2013) concluded that managerial ownership have a significant effect on earnings management. Niri et al. (2014) showed that managerial ownership has positive influence on earnings management.

Farida et al. (2010), Guna and Herawaty (2010) provides empirical evidence of managerial ownership can restrict managers for earnings management. Managerial goals aligned with shareholders' objectives, the supervision of the companies will be more effective and make managers more cautious in doing earnings management. While, Midiastuty and Machfoed (2003), Wedari (2004) provides empirical evidence that managerial ownership is not capable of restricting managers for earnings management. Agustia (2013) found that managerial ownership companies in Indonesia are very small with an average below 5%. The manager who also owns shares of companies tend to take a policy to manage earnings in light of the desire of investors, for example by increasing earnings so many investors are interested in investing and could raise the share price.

Greater share ownership has greater incentives to monitor the performance of management companies. When managerial ownership is low, increasing the likelihood of earnings management. The different results indicate that managerial ownership has

no effect on earnings management (Handayani and Rachadi, 2009). This indicates that high managerial ownership does not affect earnings management. This is consistent with Guna and Herawaty (2010), Jao and Pagalung (2011) that managerial ownership has no effect on earnings management. The hypothesis is:
H6 Managerial ownership has a negative effect on earnings management.

Institutional Ownership and Real Earnings Management

Charfeddine et al. (2013) showed that the majority ownership affect the presence or absence of earnings management. Niri et al. (2014), Fakhfakh and Nasfi (2012), Indrawati and Yulianti (2010) found that institutional ownership has a significant positive correlation with the quality of earnings. While, Agustia (2013) found no effect of institutional ownership on earnings management. Similarly Pamudji et al. (2010) showed that the need for external funds by issuing shares to the exchange has no effect on earnings management. Kusumaningtyas (2012) and Praditpa (2011) showed that institutional ownership has no effect on earnings management. The hypothesis is:
H7 Institutional ownership has a negative effect on earnings management.

Research Methods

The sample used in the study is listed manufacturing companies in Indonesia Stock Exchange. The sample selection in the study using purposive sampling method (Sekaran and Bougie, 2013). The data used in hypothesis testing as many as 244 data drawn from public manufacturing company from 2011 to 2014. The sample selection procedure can be seen in table 1.

Tabel 1: Sample Selection Procedure

No	Sample Criteria	Company	Data
1.	Manufacturing companies in Indonesia Stock Exchange during the period 2011-2014	128	512
2.	Companies that do not report any financial statements as of December 31	(4)	(16)
3.	Companies that do not use Rupiah	(26)	(104)
4.	Companies that reported a loss	(35)	(140)
5	Companies that do not have institutional ownership	(2)	(8)
	The number of companies and data used in the study	61	244

Measurement of Real Earnings Management by Sun et al. (2014) using a model developed by Roychowdhury (2006) to three approaches:
1. Sales Manipulation
This strategy can increase sales volume and earnings of the current period, assuming a positive margin. However, the provision of price discounts and credit terms will decrease the more lenient current period cash flow resulting in a cash flow that is not normal (abnormal cash flow from operations). Abnormal value cash flows from operations will fall due to their manipulation of sales, so if the value of abnormal high cash flows from operations indicate that the low real earnings management. The calculations are as follows:
$CFO_t/TA_{t-1} = a_0(1/TA_{t-1}) + a_1(SALES_t/TA_{t-1}) + a_2(\Delta SALES_t/TA_{t-1}) + \varepsilon$ (1)
Where CFO_t Cash flow operation, TA_{t-1} total assets, $SALES_t$ Sales, $\Delta SALES_t$ change of sales. Abnormal CFO obtained residual value from the equation (1).

2. Dicretionary expenditures
Companies can reduce discretionary expenditures such as research and development expenses, advertising and sales, and general administration. This strategy can increase profit and cash flow this time period, but with the risk of lowering the cash flows coming period. The decline in discretionary load will decrease the value of abnormal discretionary expenses, so that if a high value indicates abnormal discretionary expenses lower real earnings management. The calculations are as follows:
$DISXt/TA_{t-1} = a_0(1/TA_{t-1}) + a_1(SALES_{t-1}/TA_{t-1}) + \varepsilon$ (2)
Where DISXt Dicretionary expenditures (sum of advertising expense, research and development expense, sales and general expense), $SALES_{t-1}$ prior sales. Abnormal discretionary expenses obtained residual value from the equation (2).

3. Over production
To increase earnings, manager of the company can produce more than is necessary on the assumption that the higher production rate will cause the fixed costs per unit of product is lower. This strategy can reduce the cost of sales and increase operating profit. Excessive production of abnormal production costs will increase, so that the abnormal production of high value indicates that the high real earnings management. The calculations are as follows :
$PRODt/TA_{t-1} = a_0(1/TA_{t-1}) + a_1(SALES_{t-1}/TA_{t-1}) + a_2(\Delta SALES_t/TA_{t-1}) + a_3(\Delta SALES_{t-1}/TA_{t-1}) + \varepsilon$ (3)
Where PRODt Production cost, $\Delta SALES_{t-1}$ change of sales. Abnormal production cost obtained residual value from the equation (3). To get the real earnings management can be measured by Sum of standardized of Abnormal CFO, Abnormal discretionary expenses and Abnormal production cost. The measurement of variables are summarized in Table 2.

Table 2: Measurement of Variable

Variable	Measurement
REM	Sum of standardized of Abnormal CFO, Abnormal discretionary expenses and Abnormal production cost.
Expert	Accounting working experience, the proportion of members that have accounting working experience in audit committee.
Size	the size of the audit committee
Meeting	Frequency of audit committee meetings can be measured by how many audit committee meetings held within 1 year
Director	The number of board of directors
Independent	Independent commissioners, the proportion of commissioners who come from outside the company in commissioners
Managerial	Dummy variable, which value of 1 there is a company that owns the management and 0 otherwise.
Institutional	The proportion of shares owned by institutional parties divided by the total shares outstanding

Results and Discussions

Test results of descriptive statistics and hypothesis testing can be seen in the following table 3 and 4:

Table 3: Descriptive Statistics

Variable	Minimum	Maximum	Mean	Std. Deviation
REM	-3.356635	3.279407	0.086363	1.009432
Expert (%)	25	100	66.721310	24.711351
Size	2	5	3.106557	0.440863
Meeting	1	38	6.401639	6.668716
Director	2	15	5.286885	2.715538
Independent (%)	20	100	40.582907	12.967622
Managerial	0	1	0.479508	0.500607
Institutional (%)	32.215626	98.463280	70.599542	17.665826

Table 4: Result of Research

Variable	B	VIF
Constant	1.37391**	
Expert	-0.00170	1.036
Size	0.01223	1.227
Meeting	0.02421**	1.090
Director	-0.09740***	1.193
Independent	-0.00647	1.032
Managerial	0.18192	1.063
Institutional	-0.01024***	1.057

** 5%, *** 1%, Adjusted R^2 0.127, $F_{7,236}$ 6.05629***

Accounting expertise of audit committee has no effect on real earnings management. The size of the Audit Committee has no effect on real earnings management. Frequency of audit committee meetings has a positive impact on real earnings management. Audit committee meetings cannot reduce real earnings management. The audit committee as an external party companies have less information related to the real activity of the company

The size of the board of directors has a negative effect on the real earnings management. The board of directors is an internal party company who know the company's operations. If there is deviation operational activities, the board could supervise properly. Independent commissioner has no effect on real earnings management. Managerial ownership has no effect on real earnings management. Institutional ownership has a negative effect on the real earnings management. Institutional ownership as a majority owner to have information about the activities of the company. With that information, institutional ownership can reduce the deviation of real activity.

Conclusion, Limitation and Recommendation

The conclusion showed that the audit committee meetings, board of directors and institutional ownership affect the real earnings management. While the audit committee of accounting experts, audit committee, independent commissioner and managerial ownership do not affect the real earnings management. The study uses only manufacturing companies as samples not cover the whole types of existing companies as a trading company. The study only uses seven independent variables while there are many other variables that can affect real earnings management, as independent directors, audit committee members of the engagement period. Corporate governance of each country is different because the culture of each country is different. The different of corporate governance can be used as development of future research for other country.

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