

EARNINGS MANAGEMENT: DISCLOSURE QUALITY AND DIRECTOR CHARACTERISTICS

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Abstract: *The purpose of this research is to get empirical evidence about the influence of disclosure quality and director characteristics on earnings management. Director characteristics are director size, gender, tenure, and independent commissioner. This research used 81 manufacturing companies which are listed in Indonesia Stock Exchange from 2016 until 2018 and selected using purposive sampling method and analyzed using multiple regression. The result of this research found that the effect of director size and tenure on earnings management were negative and significant. The other hand, disclosure quality, director gender, and independent commissioner have not influence to earnings management. The larger the directors size and long as director will make authority become spread and minimize the chance for doing earnings management.*

Keywords: disclosure quality; director size; director tenure; earnings management

INTRODUCTION

In agency theory type 1, a problem arises when there is a difference between principal and agent's interest as a human natural innate which always prioritize their self-interest. Investor demand a higher return from their shares and the management interested with the compensation for their performances as the investor receive return from their shares. Corporate governance conducted to balancing every party in the company.

Zouari et al. (2015) found that expertise and duality on ownership affect positively on director behavior to use aggressive earnings management. Peni and Vahamaa (2014) found firms with female executives and a higher participation of female directors report a higher earnings quality while female executives are expected to be risk averse (Watson and Mcnaughton 2007) and less aggressive in decision making (Byrnes et al. 1999).

From the issue above, author interested to discover the effect of disclosure quality and director characteristics on earnings management. This research is developed from Jatiningrum et al. (2016) with several differences from the previous research. First, author added director characteristics (size, gender, tenure, and independent commissioner). The next differences is, author use sample from public manufacturing company in Indonesia with 3 years fiscal year 2015 until 2018. The purpose of this study is to examine the effect of disclosure quality and director characteristics on earnings management. Director characteristics are director size, gender, tenure, and independent commissioner.

Disclosure Quality and Earnings management

Abadi & Janani (2013) stated in their journal, earnings and its associated components

are such information that users interest in and since in accordance to accepted standards; accounting earnings is measured based on the commitment, managers have greater opportunities to engage in earnings management. Evidence shows that earnings management among firms has become a common procedure (Darmawati, 2015). It should be noted that the level of earnings management proportional to the level of information asymmetry increases, it means information asymmetry between management and investors are necessary for earnings management.

Since the improvement of company disclosure quality causes reduction of information asymmetry, and reduction of information asymmetry of management is associated with lower earnings, so there is the negative correlation between company disclosure quality and earnings management (Chandra & Dewi, 2016). In the long term, those companies with high earnings management and less disclosure quality obtain a stock price below the value which means there is a direct correlation between the quality of disclosure and firm value (Abadi & Janani 2013). Previous research from Jatiningrum, Hamid, & Popoola (2016) found results consistent with Lobo & Zhou (2001) which stated that firms with lower disclosure ratings tend to engage more in earnings management, and firms that engage more in earnings management tend to have lower quality disclosures. Based on previous research, the following hypothesis:

H₁: Disclosure quality has influence to earnings management

Director Size

A corporate governance system is the combination of mechanisms which ensure that the management (the agent) runs the firm for the benefit of one or several stakeholders (principals) (Susanto & Pradipta 2016). The

board size is an important factor for the effectiveness of the board and most studies examined there are link between board size and earnings management. Previous studies argued that a large board strengthens its ability to control (Daghsni, 2016). The authors predicted that a large number of directors have more opportunities to have independent directors with sufficient experience, which helps to mitigate the earnings management. Jatiningrum, Hamid, & Popoola (2016) found a negative relation between earnings management and board size which consistent with Cheng & Warfield (2005) research in USA.

Finally, the majority of the researches indicated that a small-sized board is more effective in controlling than large-sized one. In this context, Peasnell et al. (1998) showed that small-sized boards are generally more effective and lead to the improvement of the earnings management. These authors stated that there is a significant negative relationship between the board size and the earnings management. Gulzar & Zongjun (2011) examined the efficiency of the board characteristics in reducing the earnings management from Chinese listed firms. His result indicated that a smaller board is associated with a low level of earnings management. Fuzi et al. (2016) stated the independent directors on the board would monitor the company performance in order to ensure the company's strategy should also consider in stakeholders' interest not on the management interest. Susanto (2013) and Susanto et al. (2019) that director size has no influence on earnings management. Based on previous research, the following hypothesis:

H₂: Director size has effect on earnings management

Director Gender

Psychology and management literature have long acknowledged that significant gender-

based differences exist, for instance, in leadership styles, communicative skills, conservatism, risk averseness, and decision-making (Xiong, 2016). The results of previous research from Peni and Vahamaa (2014) indicate that firms with female director are associated with income-decreasing discretionary accruals, thereby implying that female director are following more conservative financial reporting strategies. But several studies from Carter et al. (2018), Farrell et al. (2005) and Campbell et al. (2007) document that gender diversity is associated with improved financial performance and higher firm value.

Another research come from Adams & Ferreira (2009) found there are no significant influence between gender diversity and financial performance, but they also indicate that gender diversity may improve financial performance if the corporate governance of the firm is weak. Different result come from Xiong (2016) that found female gendered director engage in less accrual-based and real earnings management. Na & Hong (2017) found female director not likely engages in aggressive earnings management. Based on previous research, the following hypothesis:

H₃: Director gender has influence to earnings management

Director Tenure

The director has primary responsibility for the company's financial statements (Adiasih and Kusuma 2009). Director expertise has an impact on the firm's discretionary accruals, specifically, director who have experience served as director in other companies have more income-decreasing discretionary accruals (Matsunaga et al., 2008). Nevertheless, experienced managers become more confident than non-experienced managers, which lead them to use aggressive accounting practices upwardly biased earnings forecasts (Zouari et al., 2015). Hribar and Yang (2011) also argue

that director overconfidence affects their decisions to manage earnings to meet their forecast and when faced with biased forecasts, they will need to attribute such earnings deficit to bad luck due to earnings management, with the belief that he will make it up in the following periods.

Holmstrom (1999) argues that the director career concerns over valuation community towards its performance, encouraging the director to work harder at the beginning the year of office where the desire to give maximum results is converging on reporting earnings overstatement. This happened because company are said to have good performance when generating large profits and high stock prices (Adiasih & Kusuma, 2009). This means, it is not only about the incentive but also about director expertise reputation as the senior director due to expectation from the stakeholders that expecting performance of the company is increasing from year to year.

Director power into structural, ownership, expertise, and prestige powers, and suggesting that the expertise power affect particular managerial strategic decision making. So, director expertise are expected has significant positive effects on controlling manager behavior, specifically on the use of earnings management. Consistent result come from the extended research by Zouari et al. (2015) that found expertise affects positively director behavior to use aggressive earnings management to display biased optimistic estimations.

Another research from Muniroh (2016) and Setyawan & Anggraita (2018) found there are difference practice of earnings management at the beginning of their position as director and the end of their term. This proves the longer the tenure the more expert of a director in executing earnings management. Xiong (2016) also found that the long-tenured director engages in less accrual-based and real earnings management.

Based on previous research, the following hypothesis:

H₄: Director tenure has influence to earnings management

Independent Commissioner

The bigger the proportion of independent board is sought to be more effective to decrease the earnings management (Pradipta, 2013). Because, independent commissioner can act as a mediator in disputes between internal managers and supervise the policies of the board of directors as well as advising the board of directors (Chaarani, 2014). But, Asitalia and Trisnawati (2015) stated independent commissioner might not totally independent because they are appointed through general meeting shareholders by shareholders who might is affiliated with management.

Independent Commissioner can act as a mediator in disputes between internal managers and supervise the policies of the board of directors as well as advising the board of directors (Chaarani 2014). Different result came from Asitalia & Trisnawati (2015), they stated independent commissioner is not totally independent because they are appointed through general meeting shareholders by shareholders who might is affiliated with management. In agency theory, independent

commissioners are expected to conduct surveillance and control of conflicts between the controlling shareholders and the minority shareholders (Jensen & Meckling, 1976).

Previous research from Jatiningrum, Hamid, & Popoola (2016) found independent commissioners has significant negative relationships with discretionary accrual. This result is consistent with the previous study by Shen & Chih (2007) that firm with good corporate governance tend to engage less in earnings. Susanto (2013) also found that independent commissioner has influence on earnings management which they able to detecting earnings management. Zulfikar et al. (2017) stated that the reason commissioner has influence on earning management because they might did not understand and carry out the task that as an independent party to supervise, direct, and evaluate the implementation of the corporate governance and strategic policy. This means, the independent commissioner did not working properly. Different result come from Asitalia & Trisnawati (2015) and Permanasari (2012) which found that independent commissioner has no influence to earnings management. Based on previous research, the following hypothesis:

H₅: Independent commissioner has influence to earnings management

RESEARCH METHOD

Sampling result following table

Table 1 Sample Criteria

| Criteria Description | Companies | Data |
|---|-----------|------|
| Manufacturing companies consistently listed in period 2016 to 2018 | 119 | 474 |
| Manufacturing companies which annual report are not available | (10) | (30) |
| Manufacturing companies which report do not stated in IDR | (27) | (81) |
| Manufacturing companies which report do not ended at 31st of December | (1) | (3) |
| Number of sample | 81 | 243 |

Earnings management is the misused of accounting techniques to produce "delightful"

financial reports that present positive perspective of a company's business activities

and financial position (Susanto, 2013). This research used absolute value from the modified Jones's model to measure the level of earnings management or discretionary accruals (DACC) (Qamhan et al. 2018). Defined as follow:

$$\frac{TAC_t}{A_{t-1}} = \alpha \frac{1}{A_{t-1}} + \beta_1 \frac{\Delta REV_t - \Delta REC_t}{A_{t-1}} + \beta_2 \frac{PPE_t}{A_{t-1}} + \epsilon \quad (1)$$

Where TAC total accrual period t, TAC = EBXTit-OCFit, EBXTit earnings before extraordinary items and discontinued operations period t, OCFit operating cash flow for period t, ΔREV_t change in net sales in period t, ΔREC_t change in period t net receivables, PPE property, plan, and equipment, ϵ absolute value of discretionary accrual. Measurement of independent variable following table.

Table 2 Measurement of Independent Variable

| Independent Variable | Measurement |
|--------------------------|--|
| Disclosure Quality | $\sum \frac{\text{Total of Yes}}{98}$ |
| Size | Number of director disclosed in the board |
| Gender | 0 for male, 1 for female |
| Tenure | <i>Year of reporting period – Year of beginning position + 1</i> |
| Independent Commissioner | $\frac{\text{Independent Commissioners}}{\text{Board of Commissioners}}$ |

RESULT

Descriptive statistics and t-test result following table

Table 3 Descriptive Statistics

| Variable | N | Minimum | Maximum | Mean | Std. Deviation |
|--------------------------|-----|---------|----------|----------|----------------|
| DACC | 243 | 0.00050 | 0.030395 | 0.04985 | 0.04975 |
| Disclosure Quality | 243 | 0.37800 | 0.66300 | 0.52647 | 0.49759 |
| Size | 243 | 2 | 11 | 4.89711 | 2.11099 |
| Gender | 243 | 0 | 1 | 0.07407 | 0.26243 |
| Tenure | 243 | 1 | 48 | 10.70370 | 11.73408 |
| Independent Commissioner | 243 | 0.00 | 1.00 | 0.41925 | 0.13963 |

Source: result of data processing

Table 4 t Test Result

| Variable | Coefficient | Significance |
|--------------------------|-------------|--------------|
| Constant | 0.051 | 0.124 |
| Disclosure Quality | 0.034 | 0.574 |
| Size | -0.004 | 0.007 |
| Gender | -0.005 | 0.713 |
| Tenure | -0.001 | 0.008 |
| Independent Commissioner | 0.027 | 0.241 |

Disclosure quality has significance level 0.574 which is above 0.05. This mean H_1 is rejected, this showed that disclosure quality has no influence to earnings management. This result consistent with and inconsistent with Jatiningrum, Hamid, and Popoola (2016) and Lobo and Zhou (2001). This may be caused by companies only disclose the information just for fulfill the requirements of POJK and there are insecurities from the company that their information and strategy be read by competitors.

Director size has significance level 0.007 which is below 0.05. This mean H_2 is accepted, this showed that director size has influence to earnings management. This result consistent with Jatiningrum, Hamid, and Popoola (2016), and Cheng and Warfield (2005) but inconsistent with Susanto (2013) and Susanto et al. (2019). The reason maybe because the greater the size of board of director will make authority become spread and not only focused on one or two directors, so this increasing the feel of responsibilities of directors (Handojo 2013).

Director gender has significance level 0.713 which is above 0.05. This mean H_3 is rejected, this showed that director gender has no influence to earnings management. This result consistent with Adams and Ferreira (2009) and inconsistent with Carter et al. (2018), Farrell et al. (2005), Campbell et al. (2007), and Xiong (2016).

Director tenure has significance level 0.008 which is below 0.05. This mean H_4 is accepted, this showed that director tenure has influence to earnings management. This result consistent with Zouari et al. (2015), Muniroh (2016), and Xiong (2016). However, experienced

managers become more confident than non-experienced managers, which lead them to use aggressive accounting practices upwardly biased earnings forecasts (Zouari et al. 2015).

Independent commissioner has significance level 0.241 which is above 0.05. This mean H_5 is rejected, this showed that Independent commissioner has no influence to earnings management. This result consistent with Asitalia and Trisnawati (2015) and Permanasari (2012) and inconsistent with Jatiningrum, Hamid, and Popoola (2016), and Susanto (2013).

CONCLUSION

The conclusion of the study are: director size and tenure has negative influence to earnings management. While, disclosure quality, director gender, and independent commissioner have no influence to earnings management. The results of this study can provide input for investors. The more directors in the company are likely to suppress earnings management. Multiple directors can supervise each other so as to prevent earnings management.

There are some limitations in this study (1) this research couldn't explain the long-term effect because the data chosen only from 2016 until 2018, (2) Indonesia woman are rarely become a president director, so the data can't represent the existence of woman as president director. Recommendation for the next study (1) add the period of research more than 3 years in order to get the result for long term effect, (2) using non-financial company or the sample, not only manufacturing company in order to get richer variance of data.

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