CHAPTER II
THEORETIES AND HYPOTHESIS DEVELOPMENT

2.1 Earnings Management

Earnings management is a process of corporate financial reporting through the selection of accounting policies to regulate the number of reported earnings with the aim of forming an impression about the performance of the company to increase the value in the company, as well influencing the results of the contract based on accounting figures which reported for getting the benefits for private management. Within a limits, earnings management can be used to protect the company from unfortunate consequences as a result of violations of company contracts. Earnings management according to Schipper (1989) is intentional interference from the management of the company's internal financial reporting process for personal gain.

Earnings management also known as an influential management method for manipulating earnings reports using various methods that can affect short term earnings (Isenmila & Elijah, 2012). The interest in earnings management is financial reporting, manager always tried to manipulate profits according to their respective goals. It can be defined that earnings management is a change in the report on the economic performance of the company by the manager for self-interest.

Earnings management cannot be measured directly but using the discretionary accruals (Islam, Ali & Ahmad, 2011). Othman et al. (2006) argue that the presence of positive and negative signs of discretionary accruals
determines the possibility of earnings management. If discretionary accruals shows negative result, it indicates that a decrease in occurrence of data manipulation. Likewise with the opposite if discretionary accruals shows positive results then there is an increase in data manipulation.

Roodposhti and Chashmi (2011) reveal that discretionary accruals are actions that managers use to transfer accounting earnings from one period to another period. Otherwise, nondiscretionary accruals are normal accruals that are not influenced by earnings management because they are out of the manager's control (Roodposhti et al., 2011). The conclusion of discretionary accruals are management determined accruals and nondiscretionary accruals themselves are accruals that are determined by economic conditions.

2.2 Literature Review

There are some prominent studies reviews the association between corporate governance and earnings management. This is empirical evidence regarding earnings management proposed by Jensen and Meckling (1976), which focuses on the problem of managerial ownership which has the potential to harmonize interests between managers and shareholders. Jensen (1983) states that the strongest relationship between shareholder wealth and executive wealth is direct share ownership by managers.

Many researchers from corporate governance on earnings management is one of them, Miko and Kamardin (2014), and Ayemere and Elijah (2015) conducted a study of the influence audit committee structure on earnings
management. The independent variable used is the audit committee, audit committee activities and audit committee size. Miko and Kamardin (2014) added the independent variables is the audit committee expertise, big four, auditor tenure and audit costs, and Ayemere and Elijah (2015) added independent variables is the audit committee expertise, and audit committee activities, with control variables firm size, and leverage.

The prior research also from Malaysia was carried out by Ishak et al. (2011). In addition to examining the influence of the audit committee on earnings management, this study also includes board characteristics, company characteristics, and external auditors as independent variables. The samples taken are 236 companies listed on Bursa Malaysia.

Several previous studies have been conducted to explore an understanding of the influence of corporate governance on earnings management. Chtorou, Bedard, and Courteau (2001) conducted a study of 100 companies in the United States in 1996. Other variables such as the characteristics of the board, agent, big 6, block, and company size were also included in this study.

Yusof (2010) continued his research on the influence of the audit committee on earnings management by taking a sample of 124 companies registered with the Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ). The independent variable examined focuses on the characteristics of the audit committee, such as independence, expertise, craft, and experience of the audit committee members. This study also uses control variables in the form of total assets, asset returns, big 4, and audit costs.
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In contrast to previous research, Li, Liu, and Eddie (2011) took ownership structures as independent variables to test the level of earnings management in 136 companies listed on the Shanghai Stock Exchange. Independent variables tested include state ownership, legal ownership, foreign ownership (Ali, Salleh, & Hassan, 2008); Boubakri and Cosset (2015); Poli (2015), and individual ownership. Control variables in the form of leverage and company size were also examined in this study.

Gerayli, Yanesari, and Ma'atooofi (2011) examine the relationship of audit quality to earnings management in Iran. The data used as a sample are 90 non-financial companies registered in Iran with the period 2004-2009. The independent variables used are industry auditor specialists, auditor size, and independent auditors. Operational cash flows, leverage and growth prospects are used as control variables.

Kouki, Elkhaldi, Atri, and Souid (2011) examined the effect of corporate management mechanisms on earnings management. Ownership structure is part of corporate governance. The sample used was 171 companies registered in the United States from 1998 to 2005. The independent variables used were the size of the board of directors, dual functions, the independence of the audit committee,
the CEO as a member of the nomination committee, and managerial ownership. The control variable used is company size.

Prior accounting research on earnings management was also examined by Gulzar and Wang (2011) with research topics on Corporate Governance Characteristics and Earnings Management in China the period 2002 to 2006 the sample data from Shanghai and Shenzhen Stock Exchange. The independent variables in this study is board of directors, proportion of independent non-executive directors, CEO quality, board size, audit committee, frequency of board meetings, corporate ownership, concentration ownership, and director shareholdings. The dependent variable uses discretionary accruals and the control variables are return on assets, leverage, firm size and cash flow. The results of this study indicate that board size, board meetings, and concentration ownership have a significant and positive relation on Discretionary accruals.

Research conducted by Peni and Vahaama (2010) shows that female directors executives, female CFO, have a significant influence on accrual earnings management, while female CEO not significant influence. The study shows that female executives are closely related to more conservative accounting profits. The study also shows that earnings management influenced by variable market to book value ratio, sales growth rate and firm size. While the leverage variable has a non-significant effect on earnings management.

Thiruvadi and Huang (2011) has the conducted research with the existence of female audit committee reduces the level of earnings management carried out by management. The study proves that there a significant negative
relationship between members of the female audit committee and earnings management. Research conducted by Krishnan and Parsons (2007) shows that firms with more women in their top management have lower earnings management levels compared to companies with fewer women in top management.

Research conducted by Christiani and Nugrahanti (2014) about determine the influence audit quality and earnings management. The purpose of this study is to examine the effect of audit quality on earnings management. Audit quality in this study was measured by the Public Accounting Firm (KAP) to be the big four and non-big four and the industry specialization of auditors. The results showed that the size of KAP did not affect earnings management. Auditor industry specialization negatively affects earnings management. Paradisea (2011) has conducted the research with the good corporate governance on the earnings management using ISO9001 as a moderating variable in banking industry in Indonesia. This study talk about determine and analyze the effect of good corporate governance in the composite score which eleven indicators with earnings management using ISO 9001 as a moderating variable. The study sample used 13 banking companies listed in Indonesia Stock Exchange from 2008-2011. The study used purposive sampling method. The results of the individual tests, showed that GCG had no effect on earnings management.

Rauf et al. (2012) has conducted the research with the impact of company and board characteristics on earnings management practices Malaysian Public issuers. Data was obtained using content analysis annual report in 2008. Revenue
management practices are measured by discretionary accrual flows based on modifications Jones model (1991). The firm size has a significant positive with earnings management.

Usman and Yero (2012) and Lakhal et al. (2014) conducted research on earnings management practices. The variables are the leverage and firm size. Usman and Yero (2012) add a control variable the rate of return on assets. Lakhal et al. (2014) added shares, and exercise options in independent variables, as well as opportunities for growth and firm performance as control variables.

Greco (2012) conducted research on the factors influence earnings management. The samples is all companies oil and gas in Europe. In addition to examining ownership structure factors, Greco (2012) also added characteristics of the audit committee and board characteristics to the study.

Subsequent research was conducted by Hassan and Ahmed (2012) taking samples form companies engaged in the food and beverage sector in Nigeria. This research was conducted to examine the effect of ownership structure on earnings management. The independent variables are institutional ownership (Alves, 2011; Greco, 2012; Aygun, Ic, and Sayim, 2014; Alzoubi, 2015; Guo and Ma , 2015; Poli, 2015; Adebiyi and Olowookere, 2016); Isenmila and Elijah, 2012, managerial ownership, concentration ownership, and family ownership, and control variables in the form of firm size were used in this study.

Soliman and Ragab (2013) examined the board attributes and earnings management in Egypt. The variables used in the study were board size, board independence, board activity, institutional ownership, firm size and leverage.
Sukcecheep et al. (2013) added independent variables interlocking CEO board and duality, as well control variables namely operational cash flow, market price ratio to stock book prices, and big four. Gonzalez and Meca (2013) added independent variables internal ownership, concentration ownership, family ownership, CEO duality, and government index, as well control variables auditors external, growth and returns on asset.

Amar (2014), and Salihi and Jibril (2015) has conducted the research with the effects of audit committees and board of directors on earnings management. The independent variable used is the audit committee size and leverage, Firm size as a control variable. Salihi and Jibril (2015) added an independent variable, board size, and the control variable profitability.

The prior research ,Uwuigbe et al. (2014) examine the effects of corporate governance on earnings management. The results of the study show that board size and board independence have a significantly and negative relationship on Discretionary accruals. Previous research on earnings management also conducted in Canada by Cormier, Houle, and Ledoux (2013), in China by Gulzar and Wang (2011), and in the United States by Epps and Ismail (2009).

Alzoubi (2016) examines the influence of ownership structure on earnings management in companies listed on Jordan. This study uses the independent variable is structure ownership, namely managerial ownership, institutional ownership, concentration ownership, family ownership, and foreign ownership. The control variables used are board meetings, board independence, leverage, board size, growth, firm age, return on asset, cash flow from operations,
firm size, business losses and audit quality.

Bassiouny, Soliman, and Ragab (2016) examined the effect of company characteristics on earnings management, the companies from the period 2007-2011. The sample used was 50 companies listed on Egypt Stock Exchange. The variables used are firm size, leverage, firm age, and audit quality.

Mishra and Malhotra (2016) examine the characteristics of audit committees and earnings management in India. The sample used 130 companies in India the period from 2013-2015. This study takes the independent variable is the audit committee size, audit committee independence, audit committees directors, the knowledge of the audit committee, and audit committee meeting. The control variables used are leverage, firm size, business loss, price to book value of share, and big 4.

Research on corporate governance on earnings management has also been studied in Indonesia by (Indra et al., 2017). This research was conducted at manufacturing companies in Indonesia from 2011 to 2015. The independent variable used in this study was the composition of the board independence and audit committee with earnings management as the dependent variable. The results of this study indicate that the variable composition of the board independence and audit Committee has no effect on earnings management.

This research examines the mechanisms of corporate governance: board independent, board gender diversity, managerial ownership, audit committee, audit quality, board size, and leverage on earnings management practices carried out in manufacturing companies in Indonesia. In detecting earnings management
using a modified Jones model.

### 2.3 Independent Variables on Dependent Variables Effect

#### 2.3.1 Board Independence

Board independence is a independence member of the board commissioners is not affiliated with management, other members of the board of commissioners and controlling shareholders, is free from business relationships or other relationships that can affect his ability to act independently or act solely for the company's interests (National Committee on Governance, 2006). Increased the percentage of independence of commissioners will reducing the fraud in the company because independence of commissioners will more effective in monitoring company management.

Independent commissioners can examine profit processes better than insiders, because they can easily resist the company's insistence on manipulating profits. Assigning board independent commissioners is an effective earnings management mechanism to reduce agency problems and improve financial reporting quality (Klein, 2002; Peasnell, Pope, & Young, 2005). The results of the study by Iraya et al. (2015) and Swastika (2013) provide a conclusion that companies with board independent can influence earnings management actions. If board independent members increase supervision, the use of discretionary accruals will be lower.

As external members, commissioners independent do not play a direct role in the management of the company. The existence of commissioners
independent can provide effective supervision, and thus produce high-quality financial reports (Hashim & Devi, 2008). Therefore, companies with high board independence more likely to manage income efficiently than opportunistically. Rezaei (2012) found that board independence had a positive significant effect on earnings management. This result have similar with research of Kurawa and Saheed (2014) and Bala and Kumai (2015). However, research conducted by Soliman and Ragab (2013) and Latif and Abdullah (2015) not find significant influence between board independence and earnings management. This explains that the size of board independence can’t control the management of the company so it will impact to earning management.

2.3.2 Board Gender Diversity

The presence of board diversity in good corporate governance mechanism represent the principle of accountability and independence of decision making. This principle of accountability should then be able to reduce the manager's intention to make earning management.

Carter et al. (2003) argue that differences in gender are likely to produce unique information available to management in better decision making because various directors have important access in the external environment. In France, Aguir et al. (2015) found a negative and significant relationship between female directors and earnings management. The results show that female directors provide greater oversight and monitoring thereby reducing agency costs (Adams and Ferreira, 2009). The same thing was stated by Mulder (2017) that the presence of female directors and earnings management has a significant negative
relationship. Likewise with Gavious et al. (2012); Peni and Vahamaa (2010), Wicaksana et al. (2017) show that the existence of one of the female CEO or female CFO is significantly negative at the level of earnings management.

Adams and Ferreira (2009), in a sample of US companies, found that female directors had better attendance records than male and female directors were likely to join a monitoring committee. Abbott et al. (2012) report that women on board US companies encourage better financial reporting. They hypothesize that women are more conservative and prefer to take risks when making financial investment decisions that can lead to greater board awareness in monitoring financial statements. In South Africa, Ntim (2015) found a significant positive relationship between board gender diversity and firm value. Other studies found no significant relationship between board gender diversity and earnings management proposed by (Rose, 2007).

2.3.3 Managerial Ownership

Managerial ownership is one of the variables that has been studied a lot from the corporate governance concept. This variable arises because considered as the root of agency theory which is closely related to earnings management (Hassan & Ahmed, 2012).

Jensen and Meckling (1976) argue that managers with low share ownership in companies have a incentive to do manipulate. Directors only act as managers to process companies and do not own companies, do not have the same interests as shareholders who have material shares in the company. So, managers with high levels of ownership are less possible likely to manipulate low earnings
and mislead investors.

Share ownership makes managers feel have the same interests as shareholders so opportunistic actions such as earnings management are rare (Jensen & Meckling, 1976). The results of the research by Sanchez-Ballesta and Garcia- Meca (2007) show that managerial ownership has a significant and negative relation on earnings management measured as discretionary accruals. This supports the hypothesis that managerial ownership contributes to the informativeness of earnings and to inhibit earnings management when the proportion of shares held by insiders is not too high at around 40% - 48%. This result is also supported results of a study in Widyastuti (2007), Kouki et al. (2011), Alves (2012) and Saleem and Alzoubi (2016).

Warfield et al. (1995) also mentions that the supervisory function of managerial ownership does not always influence in reducing agency conflict. This can occur when the committee formed to carry out the supervisory function has worked well in order to achieve the objectives of the shareholders. Likewise with the results of research conducted by Ujiyantho (2007) found positive but not significant results between managerial ownership and earnings management. Issuers that are analyzed include having a ownership structure that is concentrated in an institution that usually has large enough shares that reflect power, so that it has the ability to intervene in the course of the company and regulate the process of preparing financial statements. As a result, managers are forced to take action in the form of earnings management in order to fulfill the wishes of certain parties, including the owner.
2.3.4 Audit Committee

The audit committee has the duty to support the supervisory function of management, do this so that management not do opportunistic. The increasing members of audit committee can improve the performance of the audit committee. This will result in increased monitoring functions, so that the quality of reporting carried out by management is guaranteed. Several studies have proven the role of audit committees in improving financial reporting quality.

When an audit committee member is in independent company, there will be no conflict of interest that can encourage opportunistic behavior in the form of earnings management. An independent audit committee is believed to be able to provide a means of formal communication between the board, internal control, and external auditors so that the monitoring function can running well (Siam et al., 2015). The above argument is supported by research conducted by Ayemere and Elijah (2015) in Nigeria. The regression test results from the study indicate that the independence of the audit committee has a significant negative effect on earnings management. This result in line with previous studies conducted by Alkdai and Hanefah (2014), Salleh and Haat (2014), Soliman and Ragab (2014), and Siam et al. (2015). Different opinions expressed by Yusof (2010) conducted research in Malaysia. Yusof (2010) argues that the average company in Malaysia has audit committee member consisting of one executive director and independent outside party. Audit committee members from outside the company tend to find it difficult to access financial data available to the company. This makes the audit committee members unable to carry out the
supervisory function optimally, thus failing to suppress earnings management practices.

The opinions above are supported by the results of Chandrasegaram et al. (2013) which was also conducted in Malaysia. Chandrasegaram et al. (2013) were unable to find a significant influence between the independence of the audit committee and earnings management activities in their research. In addition to Malaysia, the same results are also shown by studies from different countries.

2.3.5 Audit Quality

Audit is independent examination of the company's financial statements presented by company management. The auditor is appointed by the company to express professional opinion on the company's financial statements. Whether the financial statements and company position at the end of the period have been presented correctly and in accordance with relevant regulations and professional regulations (Izedonmi, 2000). Jensen and Meckling (1976) state that audits reduce the possibility of information asymmetry that occurs between investors and management.

In the capital market, financial statements are the key to communication in establishing good relations with companies in public performance and financial position. Auditors are considered as effective third parties helping to reduce information asymmetry and conflicts of interest between investors and management (Mansi, Maxwell & Miller, 2004) identify two auditor roles, namely the role of information and the role of insurance. As an information intermediary, the auditor is an independent and effective person verifying the
truth of the company's financial statements before being published. As an insurance provider, the auditor is law, responsible for verified financial reports. The literature acknowledges that the Big Four provides high audit quality and offers greater reliability for financial statements than Non-Big Four. Krishnan (2003) shows that the Big Four auditors are better at limiting client earnings management compared to non-Big Four auditors, they find that clients from non Big Four auditors have a higher level of discretionary accruals. In a previous study conducted by Herusetya (2012) regarding the effect of quality audit on earnings management. The research results show that audit quality has a negative and significant influence on earnings management. The same results are also shown by (Shuaibu, 2018).

2.3.6 Board Size

According to Lennox (2005) the board size of directors has a significant impact on the selection of high-quality auditors. Mgba me et al. (2012) stated that the higher the number of boards of directors, the higher the likelihood of conflict, where this statement is consistent with the results of research by Adeniyi and Mieseigha (2013) and Makni et al. (2012) suggested that the larger the board size, the greater the role of supervision.

The results of this study are consistent with the research conducted by Lennox (2005), Makni et al. (2012), Ianniello et al. (2013), and Karaibrahimoglu (2013) which means that the higher the number of members of the board of directors can increase control capacity and performance.
2.3.7 Leverage

Leverage can be interpreted as the level of use money borrowed by management to increase profits in a company (Alkhatib, 2012). The influence of leverage on earnings management raises empirical debates among experts (Alsharairi & Salama, 2012). High leverage figures can limit earnings management behavior in a company (Christie & Zimmerman, 1994). Generally companies with a high degree of leverage must face close supervision from the borrower (Ardison, Martinez, & Galdi, 2012). Strict supervision will certainly make it difficult for management to manage earnings.

The results of Soliman and Ragab (2014) in Egypt show that leverage has a significant negative effect on earnings management. This finding is in line with the results of the study shown by Emamgholipur et al. (2013), Aygun et al. (2014), Alzoubi (2015), and Ayemere and Elijah (2015). This opinion is in line with the research of Lin et al. (2009), Alves (2011), and Qallap (2014). The regression test results in these studies indicate that leverage has a significant positive effect on earnings management.

Different arguments by Nuswantara (2004). The leverage ratio is considered not able to influence earnings management significantly. Without the strict supervision of the lender, the use of debt as funding cannot affect the level of earnings management in a company (Nuswantara, 2004). This is evidenced by the results of a study from Gulzar and Wang (2011), Ishak et al. (2011), and Salihi and Jibril (2015).
2.4 Research Model

Based on the previous description, this study aims to examine the effect of Corporate Governance and Earnings Management with companies in Indonesia. The model in this research is:

![Research Model Diagram]

*Figure 2.1 Research model of the Corporate Governance and Earnings Management in Indonesia: A Study of Manufacturing Company. Source: Author research, 2019.*
2.5 Hypothesis Development

Based on the problems that have been formulated and the research model above, the research hypothesis that can be proposed is as follows:

H1: Board independence has a significant and positive relation on earnings management.

H2: Board gender diversity has a negative significant effect on earnings management.

H3: Managerial ownership has a significant negative effect on earnings management.

H4: Audit committee has a significant negative effect on earnings management.

H5: Audit quality has a negative significant effect on earnings management.