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# The application of corporate governance to the earnings management of the banking industry in Indonesia in the 2005-2007 period

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**ABSTRACT**

The aims of this research is to examine the influence of corporate governance mechanisms, such as, board of commissioner composition and size, audit committee size, composition of independent audit committee members and their expertise on earnings management practice in public bank companies listed in Indonesia Stock Exchange. The samples of this research are all of the public bank companies that existed in Indonesia in the year 2005-2007 which were listed on the Indonesia Stock Exchange. The research data were collected from the public bank's financial statement and annual report for the period of 2005 to 2007. From purposive sampling method, I have collected 72 observations from 24 public bank companies/3 years. By using multiple regression analysis as the research method, the results showed that five independent variables influenced the earnings management of public bank companies simultaneously. The conclusion of this research is only board commissioner composition and audit committee expertise that significantly affects earnings management, while board commissioner size, composition of independent audit committee members and size has no significant effect on earnings management.



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## 1. INTRODUCTION

For investors who carry out investment activities in Indonesia, the financial statements of the Indonesian economy are currently experiencing an increase. This is indicated by the large number of investment activities that enter Indonesia, both in the form of foreign direct investment and through a foreign portfolio investment in the stock market which is one of the main references for assessing the financial performance of companies that will be targeted for investment.

The financial statements presented in the form of a balance sheet, profit and loss statement, and cash flow statement reflect the track record of a company's financial development during a certain period.From 1998 to 2001, there have been many financial scandals in public companies involving manipulation of financial reports, such as what happened to PT Lippo, Tbk and PT Kimia Farma, Tbk (Boediono, 2005). As a public company that registers its shares on the stock market, the presentation and disclosure of financial statements should comply with applicable financial accounting standards both in the form of PSAK and the provisions imposed by Bapepam as the supervisor of the capital market in Indonesia.

One element of information that is an important reference for users of financial statements in assessing the company's development is the company's profit. The company's profit describes an acquisition of net income that was successfully collected by the company during one period after deducting the expenses incurred by the company to collect income. Earnings management actions carried out by this management can be detrimental to users of financial statements, especially shareholders who have direct ownership authority over the company. Conceptually, the shareholders or owners of the company are the principal parties, while the management acts as an agent for the company.

One of the causes of the condition for the emergence of financial statement manipulation that occurs in these companies is the lack of implementation of corporate governance (Setiawan and Nasution, 2007). Evidence shows that weak corporate governance practices in Indonesia lead to deficiencies in company decision-making and company actions. According to the Forum for Corporate Governance in Indonesia (FCGI), corporate governance is a proposed concept because corporate governance systems help improve company performance through supervision or monitoring of management performance. and guarantee management accountability to stakeholders based on the regulatory framework so that more transparent corporate management will be achieved for all users of financial reports.

The banking industry is an industry that has different characteristics from other industries that are developing in Indonesia. The banking industry is engaged in the financial sector as an intermediary institution whose job is to collect funds from people who have excess funds in the form of savings, demand deposits and time deposits to then distribute them to the public in the form of credit. This industry is an industry that operates on the basis of public trust. If public trust in banks decreases or disappears due to negative issues, this will result in a rush that can disrupt bank liquidity, as happened in the 1998 monetary crisis. If liquidity or trust in one bank is disrupted, other banks will be affected.

Bank Indonesia as the highest monetary policy holder in Indonesia and also as Indonesia's banking supervisor has tightened regulations on banks in Indonesia. This is done to maintain the health of the bank. One of the regulations issued by Bank Indonesia, for example, is the fulfillment of the minimum CAR for each bank. their company can meet the criteria required by BI. Considering the high risk that is owned by the banking industry, corporate governance is needed to minimize the level of earnings management in the banking industry while at the same time helping to create a conducive environment for creating efficient and sustainable growth in the banking environment.

Bank Indonesia defines good corporate governance as a bank governance that applies the principles of transparency, accountability, responsibility, independence and fairness. In the PBI, Bank Indonesia emphasizes the implementation of good corporate governance at several management levels in the banking organizational structure such as the board of commissioners, directors, and several committees. The Audit Committee monitors and evaluates the planning and implementation of audits as well as monitors follow-up on audit results in order to assess the adequacy of internal controls including the adequacy of the financial reporting process. The Risk Monitoring Committee has the task of evaluating risk management policies for their implementation and monitoring the implementation of the duties of the Risk Management Committee and the Risk Management Work Unit. Meanwhile, the Remuneration and Nomination Committee is primarily responsible for the remuneration and nomination process for the board of commissioners and directors.

## 2. RESEARCH METHOD

The object of this study are national commercial banks listed on the Indonesia Stock Exchange during the 2007-2009 period with a focus on corporate governance and earnings management. The selection of corporate governance as the research focus is based on the premise that corporate governance is a corporate management concept that prioritizes transparency so that it can influence earnings management actions. The concept of corporate governance has now become an obligation for banks operating in Indonesia based on PBI No 8/4/PBI/2006.

Methods of data collection. This research was conducted with reference to secondary data collected by researchers from certain sources related to corporate governance and earnings management. Secondary data is data obtained from pre-existing sources and does not need to be collected by the researcher himself. Secondary data used in this research are literature, research journals, articles, reports, and other documents. The reports used in this study are audited annual financial reports and reports on the implementation of good corporate governance contained in the annual reports of national commercial banks for 2007-2009 which are listed on the Indonesia Stock Exchange.

Sampling Method,The sampling technique was carried out by purposive sampling method with the aim of obtaining a representative sample according to the specified criteria. the population is the whole group of people, events, or other things that the researcher wants to investigate, while the sample is part of the population, whose members are selected from that population. The population in this study were all banking companies listed on the Indonesia Stock Exchange during the 2007-2009 period.

Data collection technique,To obtain corporate governance and earnings management data required in this study, the authors used the following data collection techniques: a). Library Studies (Library Research), this technique is carried out by studying various literature in the form of text books, journals, and articles that discuss corporate governance and earnings management. b). Data collection, this technique is done by looking at and studying documents and recording written data that has something to do with the object of research. Data were collected in the form of financial reports, annual reports and reports on the implementation of banking GCG listed on the Indonesia Stock Exchange 2007-2009 through the Indonesian Stock Exchange internet site and the websites of each company.

Data analysis method. a). Data Processing Techniques,Data processing begins with taking and modifying raw data related to corporate governance mechanisms including the composition of the independent commissioner board, the size of the board of commissioners, the size of the audit committee, the composition of independent parties in the audit committee, and the expertise of the audit committee and obtaining proxies from earnings management.

Hypothesis Testing Techniques. To find out the level of significance of the independent variables and the dependent variable in this study, hypothesis testing was carried out with the following steps: 1). Classical Assumption Test, One method of estimating parameters in a linear regression model is Ordinary Least Square (OLS). The OLS method is used based on a number of certain assumptions. a). Residual Normality Test, the normality assumption of disturbance or error (ut) is very important, because the model existence test (F test) as well as the validity test for the influence of independent variables (t test) and the estimation of the value of the dependent variable require this. b). Multicollinearity test. The multicollinearity test aims to determine whether there is a correlation between the independent variables in the regression model. c). Heteroscedasticity Test, The heteroscedasticity test aims to determine whether the regression model has similarities or differences in variance from one observation to another. d). Autocorrelation test (Autocorrelation) Autocorrelation test aims to see whether in a regression model there is a correlation between confounding errors in period t (analysis period) and errors in period t-1 (previous period). 2). Descriptive Statistics Descriptive statistics aim to provide an overview or description of a data seen from the average, standard deviation, minimum, and maximum. 3). The autocorrelation test aims to see whether in a regression model there is a correlation between confounding errors in period t (analysis period) and errors in period t-1 (previous period). 2). Descriptive Statistics Descriptive statistics aim to provide an overview or description of a data seen from the average, standard deviation, minimum, and maximum. 3). The autocorrelation test aims to see whether in a regression model there is a correlation between confounding errors in period t (analysis period) and errors in period t-1 (previous period). 2). Descriptive Statistics Descriptive statistics aim to provide an overview or description of a data seen from the average, standard deviation, minimum, and maximum. 3). Partial Test (t test, Partial test with t test is intended to test whether or not the influence of each independent variable on the dependent variable is strong.

## 3. RESULTS AND DISCUSSIONS

Banking is an intermediary institution that collects funds from the public in the form of deposits and distributes them back in the form of credit on the basis of trust. Therefore, banking is an industry that has very strict regulations. In carrying out its operational activities, banks do not only refer to laws made by the government, but also to regulations made by Bank Indonesia as the supervisor of commercial banks in Indonesia. Based on data from Bank Indonesia, currently there are 149 commercial banks operating in Indonesia with the following details:

Table.1 Data on the Number of Commercial Banks in Indonesia

| Information | Amount |
|---|---|
| state-owned banks | 5 |
| Foreign Exchange BUSN | 44 |
| Non Foreign Exchange BUSN | 35 |
| BPD | 26 |
| Mixed Bank | 28 |
| Foreign Banks | 11 |
| Amount | 149 |

This amount is only for conventional commercial banks and does not include sharia business units, sharia commercial banks and conventional rural banks. Of the 149 conventional commercial banks registered with Bank Indonesia, not all of them are listed on the Indonesia Stock Exchange. The number of conventional commercial banks that have been listed on the Indonesia Stock Exchange until 2009 was 29 banks.

Determination of the pooled data regression estimation model between the common effect (OLS) model, fixed effect, or random effect is carried out by carrying out the Chow test and Hausmann test.

Table.2 Regression Results of the Common Effect Method

| Variables | coefficient | std. Error | t-Statistics | Prob. |
|---|---|---|---|---|
| C | 76.72018 | 10.51838 | 7.293913 | 0.0000 |
| KDK? | -3.738195 | 0.674000 | -5.546287 | 0.0000 |
| UDK? | 2.531616 | 1.268025 | 1.996503 | 0.0500 |
| AC_NUMB? | 0.171120 | 0.085856 | 1.993106 | 0.0504 |
| AC_INDP? | 0.031231 | 0.049374 | 0.632538 | 0.5292 |
| AC_EXPERT? | -27.73878 | 6.448220 | -4.301774 | 0.0001 |
| R-squared | 0.486086 | Mean dependent var | | 58.88889 |
| Adjusted R-squared | 0.447153 | SD dependent var | | 11.91112 |
| SE of regression | 8.856358 | Akaike info criterion | | 7.279804 |
| Sum squared residue | **5176715** | Schwarz criterion | | 7.469526 |
| Likelihood logs | -256.0729 | Hannan-Quinn criter. | | 7.355333 |
| F-statistics | 12.48522 | Durbin-Watson stat | | 1.337727 |
| Prob(F-statistic) | 0.000000 | | | |

Based on the two regression results tables above, the sum square residual value for the calculation of the Common Effect method is 5176.715. Meanwhile, the sum square residual value for calculating the Fixed Effect method is 1398.348. The number of observations for the two methods above is 24 companies with a period of 3 years and the number of independent variables is 5 variables.

1. **Classic assumption test**

The classical assumption test in this study was conducted to obtain a linear regression model that meets the BLUE assumptions (Best Linear Unbiased Estimator). The classical assumption test consists of a normality test, multicollinearity test, autocorrelation test, and heteroscedasticity test.

Table 3. Multicollinearity Test Results

| Model | Unstandardize dCoefficient s | | Standardize d Coefficients | t | Sig. | CollinearityStatistics | |
|---|---|---|---|---|---|---|---|
| | B | std. Error | Betas | | | tolerance | VIF |
| (Constant) | -.208 | .119 | | -1,741 | 087 | | |
| KDK | -.001 | 001 | -.140 | -.968 | .337 | .643 | 1,556 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| UDK | 002 | 006 | 044 | .268 | .789 | .499 | 2003 |
| AC_NUMB | .023 | 010 | .363 | 2,370 | .021 | .572 | 1,749 |
| AC_INDP | 001 | 001 | .242 | 1863 | .067 | .792 | 1,263 |
| AC_EXPERT | 001 | .000 | .148 | 1,237 | .221 | .938 | 1,066 |

2. **Descriptive statistics**.

Descriptive statistics aim to provide an overview or description of a data seen from the average, standard deviation, minimum, and maximum.

Table 4. Results of Descriptive Statistics

| | N | Minimum | Maximum | Means | std. Deviation |
|---|---|---|---|---|---|
| KDK | 67 | 43 | 100 | 59.04 | 12.125 |
| UDK | 67 | 1 | 8 | 5.09 | 1856 |
| AC_NUMB | 67 | 2 | 7 | 3.76 | 1.143 |
| AC_INDP | 67 | 50 | 100 | 92.31 | 13,951 |
| AC_EXPERT | 67 | 33 | 100 | 81.15 | 19,903 |
| DA | 67 | -.20175 | .11888 | -.0025848 | .07227434 |
| Valid N (listwise) | 67 | | | | |

Based on table 4. the average value of the variable composition of the board of commissioners (KDK) is 59.04%. This value is higher than the value of the composition of the independent board of commissioners stipulated by Bank Indonesia through PBI No. 8/4/PBI/2006 concerning GCG. Thus it can be concluded that on average Indonesian banks have complied with the GCG regulations stipulated by Bank Indonesia as the banking authority.

3. **Hypothesis Testing Results**

As previously described in the Research Methodology, hypothesis testing in this study uses multiple regression methods. The total sample for three years is 72 samples. However, the number of samples was reduced to 67 after handling to meet the assumptions of the residual normality test.

The multiple regression model in this study uses a Fixed Effect model based on the results of the Chow test and Hausmann test with the following equation:

Regression results through the F test between the dependent variable (DA) and all independent variables (KDK, UDK, AC_NUMB, AC_INDP, and AC_EXPERT) obtained an F value of 7.118849 with a significance level of 0.000000 where this value is smaller than the α value 0.05. Therefore, H06 in this study was rejected or in other words Ha6 was accepted. Thus it can be concluded that the corporate governance variables, namely KDK, UDK, AC_NUMB, AC_INDP, and AC_EXPERT, have a simultaneous effect on DA. In addition, the adj-R Squared value of 0.714544 indicates that earnings management proxied by discretionary accruals (DA) can be explained by the corporate governance variables contained in the research model (KDK, UDK, AC_NUMB, AC_INDP, and AC_EXPERT) of 71, 45% while the rest is 28,

## 4. CONCLUSION

Based on the description that has been stated in the previous chapters, the conclusions obtained from this study are as follows: a). The results of data processing and regression equations show that earnings management practices in the banking industry can be explained by corporate governance mechanisms in this case the composition of the independent board of commissioners (KDK), the size of the board of commissioners (UDK), the size of the audit committee (AC_NUMB), the composition of the independent audit committee (AC_INDP ), and audit committee expertise (AC_EXPERT). b). The implementation of corporate governance in this case the composition of the independent board of commissioners (KDK), the size of the board of commissioners (UDK), the size of the audit committee (AC_NUMB), the composition of the independent audit committee (AC_INDP), and the expertise of the audit committee (AC_EXPERT) have a significant effect simultaneously on management practice profits in the banking industry. c). The composition of the board of independent commissioners (KDK) has a significant negative effect on earnings management practices in banking. This shows that statistically the variable composition of the independent board of commissioners is able to reduce earnings management practices in the banking industry. The more members of the independent commissioners, the higher the quality of the supervisory process carried out by this board with the increasing number of independent parties within the company demanding transparency in the company's financial reporting. d). The size of the board of commissioners (UDK), the size of the audit committee (AC_NUMB), and the composition of the independent audit committee (AC_INDP) have no influence on earnings management practices in the banking industry. It is suspected that the size of the board of commissioners and the size of the audit committee owned by commercial banks are only to comply with the provisions set by Bank Indonesia. In addition, the duties and responsibilities of the audit committee are still focused on compliance with Bank Indonesia regulations. So that no matter how big the composition of the independent audit committee is, it will not affect earnings management practices. e). The audit committee's expertise in accounting and finance (AC_EXPERT) has a significant negative effect on earnings management practices. This shows that statistically the expertise of the audit committee is able to reduce earnings management practices in the banking industry. The expertise of commercial bank audit committees in accounting and finance is necessary because in practice the duties and responsibilities of supervision and evaluation carried out by audit committees are more focused on financial reports. So that no matter how big the composition of the independent audit committee is, it will not affect earnings management practices. e). The audit committee's expertise in accounting and finance (AC_EXPERT) has a significant negative effect on earnings management practices. This shows that statistically the expertise of the audit committee is able to reduce earnings management practices in the banking industry. The expertise of commercial bank audit committees in the fields of accounting and finance is very much needed because in practice the duties and responsibilities of supervision and evaluation carried out by the audit committee are more focused on financial reports. 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