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AUDIT QUALITY, AUDIT COMMITTEE, INSTITUTIONAL OWNERSHIP AND INDEPENDENT DIRECTOR ON EARNING MANAGEMENT

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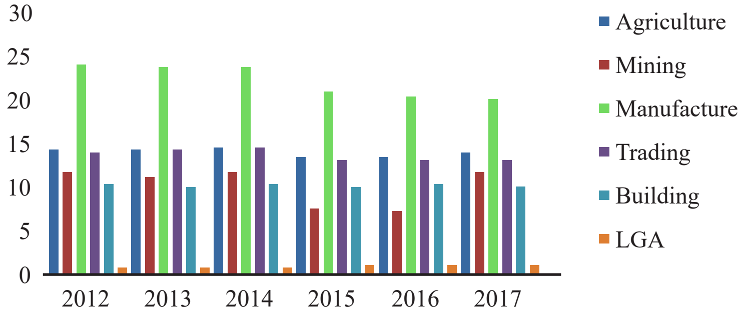
Abstract
This study aims to analyze audit quality, audit committees, institutional ownership and independent director on earnings management at manufacturing companies listed on the Indonesia Stock Exchange in 2012-2016. The sampling method use purposive sampling for 5 years so its obtained 160 observation data samples. The results in this study indicate that earnings management that occur is the type of income decreasing. Simultaneously audit quality, audit committee, institutional ownership and independent directors significantly influence on income decreasing. Partially, audit quality and independent director variables have a negative effect on income decreasing. While audit committee independence has a positive effect on income decreasing. Furthermore, audit quality, audit committees, and institutional ownership have no effect on earning management type income decreasing.

INTRODUCTION

Manufacture industry is one of rapidly-growing industry in Indonesia. This supported by the fact that Indonesia was one of ten major country in manufacturing industry according to International Yearbook of Industrial Statistic 2016. Moreover, Indonesian manufacture industry gave high level of contribution to country's economy, compared to other sectors (Figure 1).



Source: Badan Pusat Statistik (2017) with changes

Figure 1. Indonesia GDP Contribution by Sector

Manufacture industry became one of Indonesian industry that attract investor's interest by showing capabilities to generate profit. According to Statement of Financial Accounting Concept (SFAC) No. 1, profit information was the main interest to estimate management performance and accountability. Management performance appraisal encourages implementation of earning management.

Scott (2011) defined earning management as the choice by a manager of accounting policies so as to achieve some specific objective. It means that earning management became manager's decision to choose certain accounting policies, which considered would achieve certain objectives, either increasing profit or reducing reported loss. Discretionary accrual became the most common proxy for earning management practices, due to tracking difficulty of accounting policy. Implementation of earning management was caused by conflict of interest. According to agency theory, conflict of interest happened when the two parties, management and owner, would like to only maximizing their own gain and benefit (Jensen & Meckling, 1976).

Within earning management, there were two concept of accrual transaction, namely discretionary accrual and non-discretionary accrual. Scott (2011) described discretionary accrual as a way to decrease hard-to-detect profits through manipulating accounting policy connected with accrual. While non-discretionary accrual was the recognition of reasonable profit which comply the general accounting principle. Therefore, in case of it being violated, the financial statement becomes unfair. Discretionary accrual became common proxy for earning management practices, due to tracking difficulty of accounting policy.

Opportunistic manager behavior underlay the birth of earning management concept. Opportunism was a view that describe people simply desire to gain as much profit as they can from every chance, unheeding commonly accepted principles (Fajri & Senja, 2002). Furthermore, the birth of earning management concept also came as the effect of agency problems, namely unaligned interest between managers and firm's owner due to information asymmetry. Information asymmetry was a situation created due to principal not having necessary information about agent's performance, making principal unable to determine the actual result of agent's contribution to the firm (Supriyono, 2000). Scott (2011) stated there were several motives for management to implement earning management, namely bonus, debt covenant hypothesis, meet investor earning expectations, maintain reputation, and initial public offering (IPO).

As per mentioned motives, earning management scandals would not come as a surprise. In Indonesia, there was a case of PT Inovisi Infracom, Tbk (INVS). Earning management practice of INVS happened in 2015. Indonesia Stock Exchange (IDX) found at least eight mistakes within INVS's annual report in III-24 quarter. IDX requested INVS to revised their value of fixed assets, earning per share, business segment report, financial instrument category, and liabilities in business segment information. Previously, INVS's management had revised their annual report for January – September 2014 period. One example is the decreasing value of fixed assets to Rp1.16 trillion. INVS also acknowledged earning per share based on current year earning, making it seems higher. Even though the firm should use current period earnings distributed to parent entity (detikFinance, 2017).

Similar case involving earning management practice were also found in one of Japan's leading electronic company, Toshiba, in 2015. Hisao Tanaka, CEO of Toshiba Corp., along with several senior officers resigned themselves after being involved in the biggest accounting scandal in Japan within the last few years. Tanaka found to be manipulating his company's earning, reaching almost ¥ 151.8billion or approximately US$ 1.22million, during the last few years. Tanaka's predecessor and the Vice-Director, Norio Sasaki, and the advisor Atsutoshi Nishida, also resigned themselves after independent team had shown their involvement in the earning scandal for fiscal year 2008 (Hakim, 2015).

Good Corporate Governance (GCG) recently became a hot topic for public, stakeholders, government, and management in increasing transparency. As mentioned by Sulistyanto (2008), GSG was a system that organizes and controls a firm so that it would create added value for all of its' stakeholders. In order to prevent earning management practices, Indonesian government, through Bapepam, published GCG system with the purpose of increasing transparency and consistency in economic policy, and also encourage the implementation of good industrial governance.

GCG mechanism used in this research was audit quality, audit committee, institutional ownership, and independent director. Audit quality defined as combined probability to detect and report material mistakes in financial report (Christiani & Nugrahanti, 2014). Audit quality could be proxied by public accounting firm (KAP) measurement, KAP tenure, and tenure auditor. Audit quality given by public accountant could be measured through the size of auditing KAP. Major KAP (The Big 4) would be considered giving better quality audit, due to resource capability compared to smaller firms. Research by Alzoubi (2016) showed that the practice of earning management would be significantly lower in firms using The Big 4 audit service, compared to other firms that did not.

Meanwhile, audit tenure was the time of service of auditor working in KAP that gave audit service to its client (Al-Thuneibat, et. al., 2011). This engagement period controls the tenure between KAP and client, and tenure between auditor and client. The relationship duration between auditor and client had potency to develop economic bond. Thus, auditor could give its approval upon the usage of accounting manipulation by the client in the financial statement (Chi, et. al., 2011). In Indonesia, Financial Service and Exchange Monitoring Agency (BAPEPAM) had released the Act of Accountant Independency in Giving Service to Exchange (Keputusan BAPEPAM-LK No. 310 2008), that limits audit tenure of financial statement by KAP in maximum six continuous years, and by Public Accountant in maximum three continuous years. Voluntary partner rotation within KAP frequently suggested by professional accounting agency as a compromise to reduce auditor independency (IESBA, 2009).

Audit committee was one of the committees working professionally and independently, appointed by board of commissioner, to help and strengthen board of commissioner's supervising function (Widyati, 2013). Audit committee in this research was projected through audit committee's independency, and financial expertise. The following formula was used to test audit committee's independency:

$$\text{ACINDP} = \frac{\text{Count of external members}}{\text{Total members of Audit Committee}} \times 100\%$$

While to count the level of expertise of audit committee, following formula was used:

$$\text{ACCOMP} = \frac{\text{Count of financial expert members}}{\text{Total members of Audit Committee}} \times 100\%$$

Mahariana and Ramantha (2014) described institutional ownership as the ownership of a firm's stock by another institution (assurance company, bank, investment company, etc.). The existance of institutional ownership presumed to gave supervising mechanism to various interest within a firm. Institutional ownership structure was the percentage of stock owned by institution divided with number of share outstanding, or calculated with following equation:

$$\text{INSTOWN} = \frac{\text{Institution owned share}}{\text{Number of share outstanding}} \times 100\%$$

Independent director refers to member(s) of board of directors which absent from material relationship with the firm, directly or indirectly as a partner, share owner, or an employee of partnering firm (Arjoon, 2005). Independent director had the ability to manage pressure from the firm to manipulate earnings, and more capable to monitor earning process. In this research, independent director would be calculated as follows:

$$\text{INDPDIREC} = \frac{\text{Number of independent director}}{\text{Total members of board of director}} \times 100\%$$

Audit quality was one of the most important criteria in determining the quality of financial statements. Good financial statements were capable to describe real condition of the firm and minimize information asymmetry. Audit conducted by The Big 4 auditors had better expertise and reputation compared to other auditors. Thus, auditor(s) from The Big 4, should seriously maintain their market share, public trust, and their reputation by giving protection to the public (Sanjaya, 2008). Previous Research by Alzoubi (2016) had shown that the practice of earning management would be significantly lower in firms using The Big 4 audit service, compared to other firms that did not. The result was also supported by Inaam and Khamoussi (2016), whom stated that KAP size negatively influencing earning management practice. On the other hand, Agustia (2013) and Christani & Nugrahanti (2014) found other result that KAP size did not have significant influence to earning management.

Aside from KAP size, audit quality could also be observed through audit tenure. Tenure refers to time span of auditor assignment to clients that heed government's regulation (Chi, et. al., 2011; Nihlati & Meiranto, 2014). The longer the time span, the higher auditor's knowledge of the firm (Giri, 2010). Thus, long assignment time gave auditor the convenience to discover earning management within the firm. Previous research by Fatmawati (2013) found empirical result that audit tenure positively influencing discretionary accrual. It confirmed that the longer the assignment time, the higher level of earning management practice, which lowers auditor's independency. Subsequently, research by Kurniawansyah (2016) also support the discovery. However, research by Kono and Yuyetta (2013) pointed out the inexistence of relationship between audit tenure with earning management.

One of good corporate governance (GCG) characteristic was the existence of audit committee. Audit committee must use their independency and competency in performing their activities according to regulator. Agoes (2012) described independency as rigorous for persuasion, because auditor conducts their job for public interest. Aside from being the frontline of corporate governance in financial statements (Trautman, 2013), the inherent function of audit committee means that the committee members demanded to possess supervising, accounting, and financing competency. Prior research by Alzoutbi & Selamat (2012) discovered that firms with audit committee possessing independency and financial expertise did not engage in earning management practice. Kusumaningtyas (2012) also supported the notion by discovering that audit committee's independency was negatively influencing earning management, proxied by discretionary accrual. As for audit committee's financial expertise, empirical research by Chen and Zhang (2012) and Fairuzza (2014) support the notion that it was negatively influencing earning management practice, while Prastiti and Meiranto (2013) discovered the inexistence of relationship between them.

Institutional ownership was the proportion of firm's share owned by institution by the end of fiscal year (Nabela, 2012). The existence of institutional investor presumed to brought effective monitoring mechanism in managerial decision making. Prior research by Utari and Sari (2016) and Alzoubi (2016) found that institutional ownership was negatively influencing earning management. While still, the possibility of relationship inexistence between the two variables remains (Maharina and Ramantha, 2014; Anggani and Nazzar, 2015).

Independent director refers to member(s) of board of directors which absent from material relationship with the firm, directly or indirectly as a partner, share owner, or an employee of partnering firm (Arjoon, 2005). Indonesian Stock Exchange in 2014 released regulation about Stock Listing and Equity Securities other than Shares Published by Listed Company (SK Direksi BEI No. 1 2014). It had been regulating that candidate of listed company must have at least one independent director. Prior empirical research by Chen and Zhang (2012) and Uadiale (2012) found that board of directors with majority being independent directors negatively influencing earning management practice withing firm. While on the other hand, Al-Thuneibat, et al. (2016) found the inexistence of relationship between the two variables during empirical study in Saudi Arabia. Table 1 described the details of variable operationalization of each variable.

Table 1. Variable Operationalization

Variable	Variable Concept	Indicator(s)	Scale
Audit Quality (X_1)	1. Big Four Auditor are auditors with expertise and reputation exceeding other Non-Big Four auditors. Thus, The Big Four KAP have higher quality to prevent earning management from public perspective (Sanjaya, 2008) 2. Longer engagement period between audit personnel or KAP with the client could create concern over personal closeness and interest which interferes auditor's independency (IESBA, 2009).	1. Dummy variable (categorical or dichotomy variable). Code 0 was given to excluded group (non-big four firms) and code 1 was given to included group (big four) 2. Measured by calculating the number of years it tooks for KAP and its auditor to audit financial report of a firm consecutively (Al-Thuneibat, et al., 2011)	1. Nominal 2. Nominal
Audit Committee (X_2)	1. The more independent audit committee would give better supervision to management in composing financial statements (Beasley, 1996) 2. Indicator(s) used to measure success of audit committee with financial expertise to supervise management in creating good financial statements and reducing earning management practice (Sulistyanto, 2008)	$\text{ACINDP} = \frac{\text{Count of external members}}{\text{Total members of Audit Committee}} \times 100\%$ $\text{ACCOMP} = \frac{\text{Count of financial expert members}}{\text{Total members of Audit Committee}} \times 100\%$	Rasio

Institutional ownership (X_3)	Institutional ownership is the proportion of firm owned by institution investor(s), measured by the percentage of share owned by institutional investor divided with total share outstanding (Chen, et al. 2005)	$\text{INSTOWN} = \dfrac{\text{Institution owned share}}{\text{Number of share outstanding}} \times 100\%$	Rasio
Independent Director (X_4)	Independent director(s) could supervise effectively, in maintaining and developing reputation as independent director and to give market signal that they act in shareholder's interest (Fama and Jensen, 1983) McMeeking, et. al., (2006) also found that the higher proportion of independent director would minimize abnormal accrual revenue acknowledgement.	$\text{INDPDIREC} = \dfrac{\text{Number of independent director}}{\text{Total members of board of director}} \times 100\%$	Rasio
Earning Management (Y)	Earning management is management's decision to determine accounting policy which are able to obtain desired outcome, whether increasing earning or reducing reported loss (Scott, 2011)	$DA_{it} = TA_{it} / A_{it-1} - NDA_{it}$	Rasio

METHOD

The population of this research was manufacture companies listed in Indonesian Stock Exchange (IDX) in 2012-2016. Purposive sampling technique (Sugiyono, 2014) were used with several criteria, such as: (1) Manufacture company listed in IDX during 2012-2016; (2) Manufacture company whom published their annual report consistently during observation period of 2012-2016; (3) Manufacture company whom published their audited annual report during observation period of 2012-2016; (4) Manufacture company whom used Rupiah currency in their annual report during 2012-2016; (5) Manufacture company whom had complete data regarding earning management during 2012-2016. Based on mentioned criteria, 160 sample units from 32 sample firms were obtained on the course of 2012-2016. Analysis technique used in this research was descriptive analysis and data panel regression, with following equation.

RESULT

The testing result conducted with common effect method shown in Table 2.

Table 2. Descriptive Statistics Result

	EM	KAPSIZE	KAPTENURE	AUDTENURE	ACINDP	ACCOMP	INSTOWN	INDPDIREC
Mean	-2.45E+08	0.400000	2.643750	1.462500	0.980250	0.837404	0.682479	0.189051
Median	-29255415	0.000000	2.000000	1.000000	1.000000	1.000000	0.688600	0.166700
Maximum	9.86E+09	1.000000	5.000000	4.000000	1.000000	1.000000	0.977300	0.833300
Minimum	-1.18E+10	0.000000	1.000000	1.000000	0.670000	0.000000	0.209600	0.000000
Std. Dev.	1.60E+09	0.491436	1.397873	0.717153	0.070058	0.214345	0.183527	0.195259
Skewness	-1.072750	0.408248	0.305550	1.414742	-3.314655	-1.212718	-0.360018	1.051586
Kurtosis	29.41076	1.166667	1.797307	4.180338	12.25823	4.462160	2.533970	3.918324
Jarque-Bera	4680.877	26.85185	12.13274	62.66120	864.4177	53.47101	4.904237	35.11103
Probability	0.000000	0.000001	0.002320	0.000000	0.000000	0.000000	0.086111	0.000000
Sum	-3.91+10	64.00000	423.0000	234.0000	156.8400	133.9847	109.1966	30.24810
Sum Sq. Dev.	4.09E+20	38.40000	310.6937	81.77500	0.780390	7.305059	5.355445	6.062022
Observations	160	160	160	160	160	160	160	160

From the data panel test, common effect was chosen as the method. Constant value amounted to -2,050,000,000 described that if audit quality (KAPSIZE, KAPTENURE, AUDITORTENURE), audit committee, (ACINDP and ACCOMP), institutional ownership (INSTOWN), and independent director (INDPDIRECT) as variables were to amounted 0 or constant, then the value of earning management practice (EM) would be -2,050,000,000. Negative value of constants indicating income decreasing pattern of earning management.

From data panel regression result (Table 3), indicating that audit quality, audit committee, institutional ownership, and independent director were able to describe of influence the value EM in the amount of 12.99%. The value of prob (F-statistic) in the amount of 0.000183.

Table 3. Weighted Fixed Effect Test Results

Dependent Variable: EM
Method: Panel EGLS (Cross-section weights)
Date: 12/14/17 Time: 15:50
Sample: 2012 2016
Periods included: 5
Cross-sections included: 32
Total Panel (Balanced) observations: 160
Linear estimation after one-step weighting matrix

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-2.05E+09	7.30E+08	-2.803095	0.0057
KAPSIZE	-2.39E+08	71338265	-3.354057	0.0010
KAPTENURE	-34282952	21531952	-1.592190	0.1134
AUDTENURE	-2247657	40415609	-0.055614	0.9557
ACINDP	1.98E+09	7.27E+08	2.716232	0.0074
ACCOMP	1.07E+08	1.21E+08	0.887632	0.3761
INSTOWN	1.83E+08	1.51E+08	1.206805	0.2294
INDPDIREC	-3.69E+08	1.38E+08	-2.666484	0.0085
Weighted Statistics				
R-squared	0.168166	Mean dependent var		-3.60E+08
Adj. R-squared	0.129858	S.D. dependent var		1.19E+09
S.E. of regression	1.14E+09	Sum squared resid		1.97E+20
F-statistic	4.389816	Durbin-Watson Stat		1.641093
Prob(F-statistic)	0.000183			
Unweighted Statistics				
R-squared	0.043199	Mean dependent var		-2.45E+08
Sum squared resid	3.91E+20	Durbin-Watson stat		1.828996

DISCUSSION

Audit quality variable, proxied by KAP size, has p-value amounted to 0.0010 and regression coefficient valued at -239,000,000, which means audit quality is partially influencing income decreasing earning management. Regression coefficient in amount of -239,000,000 shows the positive relationship between KAP size to earning management practice with income decreasing pattern. Thus, the conclusion arrived at the size of KAP positively influence the level of earning management practice with income decreasing pattern in manufacture firms listed in IDX during 2012-2016. The result presumably caused by the majority of sample firms using the service of The Big Four KAP.

Audit quality variable, proxied by KAP tenure, has p-value of 0.1134 and regression coefficient of -34,282,952. It means that audit quality, proxied by KAP tenure, partially not influencing earning management with income decreasing pattern in manufacture firms listed in IDX during 2012-2016. Presumably, the inexistence of relationship was caused by the usage of KAP tenure only as a means to comply with the regulation.

Audit quality variable, proxied by auditor tenure, has p-value of 0.9557 and regression coefficient of -2.247.657. It means that audit quality, proxied by audit tenure, partially not influencing earning management with income decreasing pattern in manufacture firms listed in IDX during 2012-2016. Presumably, the inexistence of relationship was caused by the usage of audit tenure only as a means to comply with the regulation.

Audit committee variable, proxied by independency, has p-value of 0.0074 and regression coefficient of 1,980,000,000. It means that audit committee variable proxied by independency partially influencing income decreasing EM practice in manufacture firms listed in IDX during 2012-2016. The result aligned with agency theory whom stated independent audit committee would give effective supervision to management. The more independent the committee is, the more effective the supervision. Kusumaningtyas (2012) argued that the more indepent the committee member, then the quality of financial statements would become more trusted. Thus, independency of audit committee could minimize the EM practice in the firm

Audit committee variable, proxied by expertise, has p-value of 0.3761 and regression coefficient of 107,000,000. It means that audit committee variable proxied by expertise partially does not influence income decreasing EM practice in manufacture firms listed in IDX during 2012-2016. Presumably, the result caused by the existence of audit committee member(s) with financial expertise only act as compliance to regulation, without proper execution of their function (Dwiharyadi, 2017).

Institutional ownership variable has p-value of 0.2294 and regression coefficient of 183,000,000. It means that institutional ownership variable partially does not influence income decreasing EM practice in manufacture firms listed in IDX during 2012-2016. It is presumed to be caused by information asymmetry between management and institutional owner(s), leading to ineffective implementation of supervision function.

Independent director variable has p-value of 0.0085 and regression coefficient of -369,000,000. It means that independent director variable partially influences income decreasing EM practice in manufacture firms listed in IDX during 2012-2016. Regression coefficient of -369,000,000 shows positive relationship between independent director variable to income decreasing EM practices, meaning that the existence of independent director would cause increasing EM practices. Presumably, the result could be caused by several reasons. First, regulation regarding the compulsion of independent director presence in firm's board of directors was just recently implemented. Furthermore, the independent directors were still transitioning and adjusting their duty and function as supervisory agent, they require certain time to fully understand the firm's condition. Additionally, the low ratio of independent directors in 2012-2016 presumed to caused ineffective and inefficient supervisory function, which ultimately leads to inability to suppress EM practices.

The government is trying to improve the quality and quantity of services by providing a solution in the form of SIMP3AK. SIMP3AK in government agencies has an important role to be able to present quality reports. Tuser subjectivity assessment whether they will use the system sustainably or not (Li & Shang, 2020).

CONCLUSIONS

Simultaneously, audit quality, audit committee, institutional ownership, and independent director show significant influence over earning management with income decreasing pattern. KAP tenure, auditor tenure, audit committee expertise, and institutional ownership do not have significant influence over earning management with income decreasing pattern. KAP size and independent director have significant positive relationship over earning management with income decreasing pattern. Audit committee independency has significant negative relationship over earning management with income decreasing pattern.

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