Effect of Corporate Governance Mechanism, Independence and Management of Earnings Integrity of Financial Statements

(In Manufacturing Companies Listed on the Stock Exchange)

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Abstract

This study aims to analyze and obtain empirical evidence about the effect of corporate governance mechanisms (independent commissioners, managerial ownership, institutional ownership, audit committees,), Independence and earnings management for the integrity of financial statements in manufacturing companies in Indonesia. Integrity of financial statements is defined as the extent to which the financial statements show a true and honest information. Independent variables used in this study is the corporate governance mechanisms are analyzed by independent commissioners, managerial ownership, institutional ownership, audit committees, independence and earnings management. Dependent variable used in this study is the integrity of financial statements analyzed by conservatism, in observation from 2013-2015.
This study uses 14 manufacturing companies listed on the Stock Exchange in 2013 through 2015. Samples obtained using a purposive sampling method. The research data were analyzed with multiple linear regression analysis.
The study is an independent commissioner, audit committee did not significantly affect the integrity of financial statements. As for managerial ownership, institutional ownership, independence and earnings management significantly affect the integrity of the financial statements.

Keywords: *Corporate Governance, an independent commissioner, Managerial Ownership, Institutional Ownership, and the audit committee, independence, earnings management, and integrity of financial statements.*

1. Preliminary

The financial report is presenting information about financial data company for users of financial statements that are useful in decision making. In the era of globalization, as now, the progress of a country's economy is getting better, one of which is motivated by the entity or company. To know the prospects and the level of smoothness of an entity can be seen from its financial statements. Each company presents the financial statements to determine how the condition of the company itself. Financial statements are expected to be presented feasible, clear, and complete, which reveals the economic realities of the existence and operation of the company. In preparing the financial statements, accounting confronted with the possibility of danger deviations (bias), misinterpretation and inaccuracy.

2. Literature review

In an implementation of the company's activities, the principles of Good Corporate Governance (GCG) is poured into a mechanism. This mechanism is needed so that activities can run a healthy company in accordance with the specified direction. Good Corporate Governance mechanism according to Mas Ahmad Daniri (2005) is a pattern of relationships, systems, and processes used by the company organs (Board of Directors, Board of Commissioners, GMS) in order to provide added value to shareholders on an ongoing basis over the long term by taking into account the interests of stakeholders the other, based on rules and regulations and norms.

Corporate governance is one key element in improving economic efficiency, which includes a series of relationships between the company's management, board of directors, shareholders, and other stakeholders who also provide a structure that facilitates the determination of the objectives of a company, and as a means to determine performance monitoring techniques, Deni, Khomsiyah and Rica (2004), Khaddafi et all (2014). Companies that have implemented good corporate governance should already comply with the principles of Good Corporate Governance (GCG), namely fairness, transparency, accountability, and responsibility. The fourth component is important because the application of the principles of GCG consistently proven to improve the quality of financial reports, Beasley in Ariel and Bambang (2007). Quality financial statements must be able to provide information that is relevant and useful in economic decision making and investment decisions for its users.

The information in financial statements must also have reliable criteria (reliable). According to the Indonesian Accountants Association (2011), information can be considered reliable if free from misleading understanding, the existence of material errors, and can be relied upon by users of financial statements as sincere or honest representation of who should have presented or are reasonably expected to be presented so as to reduce the emergence of accounting manipulation. But the reality is a lot happening during the manipulation of accounting data is more particularly in the financial statements. As was the

case in some large American companies such as Enron, Tyco, Global Crossing, and WorldCom as well as several large companies in Indonesia such as PT. Kimia Farma and Bank Lippo who previously had a good audit quality, Susiana and Herawaty (2007), Heikal at all (2014)

One of the information presented in the financial statements that became the center of attention in decisions by external parties is profit. This leads to the importance of information management profits tend to act earnings management. According Setiawati in order to study and Herawaty (2010) stated earnings management constitute interference in the management of the external financial reporting process with the goal of benefit himself (the manager).

Independence is a state or a position where we are not tied to any party. This means that our existence is independent, does not carry the interests of certain parties or organizations. In this issue, independency is addressed to the auditor. People really need independence of an auditor opinion in the presentation of financial statements, because it is very influential in the decision to invest, therefore, in carrying out its duties, the auditor requires confidence in the quality of service provided to users, because the better the quality of the auditor, the more society who believe it and use its services. Therefore, for users of financial statements, it is important to look at the Public Accounting Firm (KAP) as independent and competent parties, and influential in determining whether or not the valuable services rendered by the auditors. So in his capacity as a service provider in assessing audit quality then KAP required to have high professionalism, Susiana and Herawaty (2007). In performing its duties, the auditor also should maintain its independence. Auditor independence would also have an impact on the detection of earnings management. Independent auditors is one of the factors that can reduce the occurrence of earnings management, order and Herath (2010).

Earnings management is defined as a business manager to do a deliberate manipulation of financial statements within the limits allowed by accounting principles that aim to provide misleading information to users of financial statements to the interests of the manager, Vanessa (2004). While one of the triggers of earnings management is an imbalance in the mastery of information that can be a trigger for a condition known as asymmetric information (information asymmetry).

According Susiana and Herawaty (2007), in the case of manipulation of accounting data is actually not just a party of the company who is responsible, but also very influential outsiders. As the external auditor must also take responsibility for the many cases of manipulation of accounting data like this. The position of public accountant who is regarded as an independent party which provide a fairness opinion on the financial statements and the audit profession is a profession of public trust as users of financial statements also began to widely questioned, especially after proven that increasing lawsuits against accounting firms. While the accounting profession itself has an important role in the provision of reliable financial information for governments, investors, creditors, shareholders, employees, debtors, as well as for the public and other parties concerned.

This study aims to prove whether the corporate governance mechanisms (independent commissioner, managerial ownership, institutional ownership, audit committee) independence and earnings management affect the integrity of the financial statements listed in the Stock Exchange 2011-2013.

Based on the theoretical basis and the results of previous studies that have been presented, then the hypothesis is formulated as follows:

H1: The number of independent directors affects the integrity of financial statements

H2: Managerial ownership affects the integrity of the financial statements.

H3: Institutional ownership affects the integrity of the financial statements.

H4: The audit committee affects the integrity of the financial statements.

H5: The independence of an auditor affects the integrity of the financial statements.

H6: Earnings management affects the integrity of the financial statements.

3. Research methodology

Which became the location of this research is on manufacturing companies listed on the Stock Exchange in the period 2013-2015.

The population used in this study were all manufacturing companies listed in Indonesia Stock Exchange (BEI) in 2013 through 2015, with the aim of knowing how the development of the integrity of financial statements from time to time.

The samples used in this study were obtained by purposive sampling method with the following criteria:

1) The company is listed on the Indonesia Stock Exchange, with the criteria listed as a public company the period December 31, 2013 until December 31, 2015.

2) The Company issued financial statements for the period ended December 31, 2013 to December 31, 2015.

3) The company is listed on the Indonesia Stock Exchange does not conduct acquisitions and mergers during the period December 31, 2013 until December 31, 2015. Companies that do a merger or acquisition have a high bias in their financial statements as a result of the union of different companies.

4) The financial statements of manufacturing companies that use Rupiah, companies presenting financial statements to the dollar will be excluded from the sample.

5) Companies that provide information about the study variables.

Based on the criteria that have been set, the sample obtained by 14 companies. With the observation period of 3 years in a row, this study used the data in the data pooled cross sectional shape that is by combining the cross section data for 3 years in a row. So with a sample of 14 firms, the data are pooled cross section of research will amount to 42.

Independent commissioner was measured by counting how many independent directors in a company every year. Managerial ownership is measured by the number of shares owned by managers and commissioners divided by the total shares of the company. Institutional ownership is measured by the percentage of the shares owned by institutions divided by the number of shares outstanding. Audit committee Measured by counting how many of the audit committee of a company every year.

The independence is measured by calculating the length of the relationship KAP became auditor at the client company.

Earnings management is measured by the Modified Jones models, namely the Total accrual – Non-discretionary accrual. And integrity of the financial statements proxy for conservatism as the model used by Daniel Salfauz Tawakal son, Dul Muid (2012), namely:

$$Cit = \frac{(\text{RP res it} + \text{DEPR res it})}{\text{NOA it}}$$

Description:

RP = the amount of research and development costs contained in the financial statements.

DEPR = depreciation costs contained in the financial statements.

NOA = net operating assets, as measured by net financial liabilities formula:

(total debt + total equity + total dividends) - (cash + total investment)

Data analysis techniques in this study using multiple linear regression techniques. By first passing through the classical

assumption test, which is processing the data using SPSS version 16.

4. Results and discussion

4.1. Classic assumption testing

This study used four classical assumptions to be tested, namely, normality, multicoloniarity, autocorrelation, and hetero-kedastisitas. If violations are found then the treatment will be done before the model is used to test the hypothesis. Treatment is done so that the assumptions are met so that the estimation (parameter) to be more accurate.

The analysis in this study using multiple regression analysis were used to analyze the influence between the two variables are independent variables and the dependent variable. To determine the influence of independent directors, managerial ownership, institutional ownership, audit committee, management independence and integrity of the financial statements of profit to be used the regression equation:

$$ILK = a + b_1KI + b_2KMa + b_3KIs + b_4KA + b_5Idp + b_6ML + e$$

Testing data is done with the help of a computer program SPSS (Statistical Package for the Social Sciences). After processing the data, obtained results in the regression analysis as shown in *table 1*.

Table 1. Results of Multiple Regression Analysis

Model		Unstandardized Coefficients		Standardized Coefficients
		B	Std. Error	Beta
1	(Constant)	.864	.746	
	Independent Commissioner (X1)	.217	.135	.283
	Managerial Ownership (X2)	.283	.079	.302
	Institutional Ownership (X3)	.383	.090	.359
	Audit Committee (X4)	.152	.118	.163
	Independency (X5)	.452	.092	.595
	Profit Management (X6)	.456	.075	.443

a. Dependent Variable: Integrity Financial Statements
Source: research, 2017

The effect of partially done by using a statistical t-test. This test aims to determine whether the independent variables included in the model is able to explain the dependent variable individually. The test results can be seen in the *table* below:

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.864	.746		1.159	.254
	Independent Commissioner (X1)	.217	.135	.283	1.598	.119
	Managerial Ownership (X2)	.283	.079	.302	3.595	.001
	Institutional Ownership (X3)	.383	.090	.359	4.246	.000
	Audit Committee (X4)	.152	.118	.163	1.441	.162
	Independency (X5)	.452	.092	.595	4.924	.000
	Profit Management (X6)	.456	.075	.443	6.051	.000

Table 2.
Partial results of analysis (t test)

a. Dependent Variable: Integrity Financial Statements
Source: research, 2017

Table 3. Results Effect of Variable Variable X to Y

No.	Variable X	Variable Y	Specification
1	Independent Commissioner (X1)	Integrity Financial Statements	No Effect
2	Managerial Ownership (X2)		Take Effect
3	Institutional Ownership (X3)		Take Effect
4	Audit Committee (X4)		No Effect
5	Independency (X5)		Take Effect
6	Profit Management (X6)		Take Effect

From *Table 2* it can be seen that t value of independent directors amounted to 1.598 with significant value was 0.119, while the value of t table with (df) = nk (42-7 = 35) at α = 0.05 was obtained a value of 1.689. Thus t <t table is 1.598 <1.689 and 0.119 significant level, then the independent directors do not affect the integrity of the financial statements. This is according to research conducted by Daniel Salfauz Tawakal, Muid Dul (2012) and Pancawati Hardiningsih (2010) that is independent commissioner does not affect the integrity of the financial statements.

The first hypothesis testing independent commissioner did not significantly affect the integrity of the financial statements. Because the number of independent directors is relatively small, so that its performance is less effective in providing surveillance. The existence of independent directors within the company serves as a counterweight in the decision-making process in order to provide protection to minority shareholders and other parties associated with the company, Barry (2003).

From *Table 2* it can be seen that t value of managerial ownership amounted to 3.595 with significant value was 0.001, while the value of t table with (df) = nk (42-7 = 35) at α = 0.05 was obtained a value of 1.689. Thus t > t table is 3.595 > 1.689 and the significant level of 0.001, the managerial ownership affect the integrity of the financial statements. This is according to research conducted by Pancawati Hardiningsih (2010) that managerial ownership affect the integrity of the financial statements.

The second hypothesis testing managerial ownership significantly affect the integrity of the financial Belief. Because the number of percentage of shares owned by the management limit deviant behavior and decision-making so as to improve the integrity of financial statements. Managerial ownership is one of the mechanisms that can be applied to improve the integrity of financial statements. Thus, a manager at a company that has a percentage of managerial ownership will tend to have a greater responsibility in running the company, taking the best decisions for the welfare of the company, and reporting of financial statements with information that is correct and honest so that it has a high integrity of the financial statements, Astria (2011).

From Table 2 it can be seen that t value of institutional ownership amounted to 4.246 with significant value was 0.000, while the value of t table with (df) = nk (42-7 = 35) at α = 0.05 was obtained a value of 1.689. Thus t > t table is 4.246 > 1.689 and 0.000 significant levels, the institutional ownership affect the integrity of the financial statements.

The third hypothesis testing institutional ownership significantly affect the integrity of the financial statements. Because the number of percentage of shares held by institutions can influence the process of preparing the financial statements,

thereby reducing management behavior in the manipulation that benefit themselves, so they can focus more on the good performance of the company. High institutional ownership limit managers to manage earnings and can improve the integrity of financial statements.

From *Table 2* it can be seen that the t value of the audit committee amounted to 1.441 with significant value was 0.162, while the value of t table with (df) = nk (42-7 = 35) at α = 0.05 was obtained a value of 1.689. Thus t < t table is 1.441 < 1.689 and 0.162 significant level, the audit committee did not affect the integrity of the financial statements. This is according to research conducted by Pancawati Hardinigsih (2010) that the audit committee did not affect the integrity of the financial statements.

The fourth hypothesis testing audit committee significantly affect the integrity of the financial statements. Due to the quality of audits and heavier in providing sanctions for companies which so far have not noticed the implementation of good corporate governance.

From *Table 2* it can be seen that t value of independence is at 4.924 with significant value was 0.000, while the value of t table with (df) = nk (42-7 = 35) at α = 0.05 was obtained a value of 1.689. Thus t > t table is 4.924 > 1.689 and 0.000 significant level, then the independence affect the integrity of the financial statements. This is according to research conducted by Daniel Salfauz Tawakal son, Dul Muid (2012): independence affects the integrity of the financial statements.

The fifth hypothesis testing independence significantly affects the integrity of the financial statements. Because independence is a stand-alone that is not easily influenced by any party. In case this is KAP, KAP in performing their duties which is not for personal interest but the public interest and are not partial to anyone, so that this independence affects the integrity of the financial statements.

From *Table 2* it can be seen that t value of earnings management amounted to 6.051 with significant value was 0.000, while the value of t table with (df) = nk (42-7 = 35) at α = 0.05 was obtained a value of 1.689. Thus t > t table is 6.051 > 1.689 and 0.000 significant level, then the earnings management affects the integrity of the financial statements. This is according to research conducted by Daniel Salfauz Tawakal, Dul Muid (2012), namely earnings management affects the integrity of the financial statements.

The sixth hypothesis testing earnings management significantly affects the integrity of the financial statements. Because earnings management is a business manager in managing a company's profits, which acts performed by the manager can affect the profits to be reported in the financial statements and this affects the integrity of the financial statements.

Earnings management is the management every action taken to affect profit reported in the financial statements. According Setiawati in order to study and Herawaty (2010) stated earnings management constitutes interference in the management of the external financial reporting process with the goal of benefit himself (the manager). This can cause the users of financial statements misperception in making investment decisions, because those statements are of high integrity.

5. Conclusion

Based on the research that has analyzed the above, it can be concluded that, independent commissioner does not affect the integrity of the financial statements in manufacturing companies. Managerial ownership affects the integrity of the financial statements in manufacturing companies. Institutional ownership affects the integrity of the financial statements in manufacturing companies. Audit committee does not affect the integrity of the financial statements in manufacturing companies. The independence affects the integrity of the financial statements in manufacturing companies. Earnings management affects the integrity of the financial statements in manufacturing companies. Independent commissioner, managerial ownership, institutional ownership, the audit committee, the independence and earnings management affect the integrity of the financial statements in manufacturing companies.

The next researcher to be able to add other variables not examined in this study in order to know the other variables that affect the integrity of the financial statements.

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