THE EFFECTS OF CORPORATE GOVERNANCE AND ACCOUNTING CONSERVATISM ON EARNINGS MANAGEMENT

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THE EFFECTS OF CORPORATE GOVERNANCE AND ACCOUNTING CONSERVATISM ON EARNINGS MANAGEMENT

by

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ABSTRAK

Penerapan konservatisme perakaunan di Indonesia dicerminkan dalam prinsip piawaian perakaunan yang digunapakai semasa penyediaan penyata kewangan di Indonesia. Berlandaskan dasar perakaunan konservatif, para pengurus tidak dapat melaporkan pendapatan secara berlebihan. Oleh itu, penerapan konservatisme perakaunan boleh menghalang amalan pengurusan pendapatan yang oportunis. Tujuan kajian ini adalah untuk menentukan pembolehubah tadbir urus korporat yang boleh menggalakkan penggunaan konservatisme perakaunan dan penggunaan konservatisme perakaunan sebagai pembolehubah pengantaraan perakaunan ke atas pengurusan pendapatan. Kajian ini menggunakan model Jones (1995) yang diubahsuai untuk mengukur pengurusan pendapatan dan Khan dan Watts (2009) untuk mengukur konservatisme perakaunan. Pembolehubah tadbir urus korporat yang digunakan dalam penyelidikan ini adalah kebebasan jawatankuasa audit, kepakaran jawatankuasa audit, mesyuarat jawatankuasa audit, kebebasan lembaga pengarah, pelabur institusi, saiz juruaudit, dan tempoh pengauditan. Penyelidikan ini menggunakan data penyata kewangan syarikat yang tersenarai di bursa saham Indonesia dari tahun 2012 hingga 2016 dengan tidak termasuk bank dan institusi kewangan lain, jumlah sampel yang digunakan adalah 67 syarikat dengan tempoh pemerhatian 5 tahun menjadikan jumlah data yang digunakan adalah 335 pemerhatian. Kajian ini menggunakan *partial least square* (PLS) untuk analisis statistik. Hasil kajian ini mendapati saiz juruaudit menyokong hipotesis, ini menunjukkan bahawa pelaksanaan konservatisme perakaunan dipengaruhi oleh

juruaudit. Namun kebebasan jawatankuasa audit, kepakaran jawatankuasa audit, mesyuarat jawatankuasa audit, pengarah bebas, pemilikan institusi dan tempoh pengauditan tidak menyokong hipotesis. Tambahan pula, konservatisme perakaunan mempunyai pengaruh penting yang negatif terhadap pengurusan pendapatan, yang menunjukkan pelaksanaan konservatisme perakaunan dapat mengurangkan amalan pengurusan pendapatan dan konservatisme perakauan sebagai pembolehubah pengantaraan boleh memeterai hubungan antara saiz juruaudit dan pengurusan pendapatan. Kajian ini menyokong penerapan konservatisme perakaunan dalam penyediaan penyata kewangan untuk menghalang amalan pengurusan pendapatan. Oleh itu, adalah disyorkan kepada para pemegang saham untuk menggalakkan firma audit bersaiz besar dalam menjalankan audit laporan kewangan. Tambahan pula, penyelidikan ini telah menemui penyelesaian kepada masalah asimetri maklumat yang disebabkan oleh amalan pengurusan pendapatan, melalui penggunaan firma audit bersaiz besar untuk menggalakkan penggunaan dasar perakaunan konservatif dalam penyediaan penyata kewangan supaya maklumat kewangan yang dibentangkan lebih telus dan bertanggungjawab.

THE EFFECTS OF CORPORATE GOVERNANCE AND ACCOUNTING CONSERVATISM ON EARNINGS MANAGEMENT

ABSTRACT

The application of accounting conservatism in Indonesia is reflected in the principles of accounting standards as applied in the preparation of financial statements. By applying conservative accounting policy, managers will be more prudent in recognizing income and expenses to prevent excessive earnings reports. Hence, the application of accounting conservatism can prevent the practice of opportunistic earnings management. The purpose of this study is to determine the corporate governance variables that can encourage the adoption of accounting conservatism and the mediating role of accounting conservatism on earnings management. This study employs the modified Jones (1995) measure of earning's management and Khan and Watts' (2009) method to measure accounting conservatism. The variables of corporate governance as applied in this research are audit committee independence, audit committee expertise, audit committee meeting, independent director, institutional investors, auditor size, and auditor tenure. This research uses data of financial statements of companies listed on the Indonesian Stock Exchange from 2012 to 2016 by excluding banks and other financial institutions from the sample. A total sample of 67 companies over a period of five years (2012-2016) was used in this study with total data obtained from 335 observations. This study employs a partial least square (PLS) statistical analysis. The results of this study indicate that auditor size encourages the adoption of conservative accounting. However, audit committee independence, audit committee expertise, audit committee meetings, independent directors, institutional ownership, and auditor tenure does not support the relationship between corporate governance and accounting conservatism. Furthermore, the implementation of accounting conservatism reduces earnings management practices, and accounting conservatism mediates the relationship between auditor size and earnings management. This study supports the application of accounting conservatism in the preparation of financial statements to prevent the practice of earnings management; therefore, it is recommended for shareholders to encourage hiring a big accounting firm in conducting financial audits. Furthermore, this research has found a solution to the problem of information asymmetry caused by earnings management practices through the big accounting firm encourage the adoption of conservative accounting policies to prepare of financial statements so that the financial information presented is more transparent and accountable.

CHAPTER 1

INTRODUCTION

1.1 Background of the Study

Management has the independence to choose the accounting policies used in preparing financial statements in accordance with the needs of a company. Accounting methods used by the management will affect the financial information generated, especially the company's performance information, because it will cause investors to make investments. However, accounting policies that are implemented are likely aimed at highlighting or exaggerating the performance of managers in managing company revenues. In line with Wu, Chen, and Lee (2016) earnings management is a strategy used by management professionals for their personal gain, as managers may manipulate financial statements or accounting numbers within the generally accepted accounting principles (GAAP) to exaggerate the company's performance so as to match the expectations of corporate earnings from the stock market. Furthermore, many managers practice earnings management to meet or beat profit benchmarks, avoid violations of debt agreements, or delay reporting earnings to facilitate meeting targets easily in the future (Aerts & Zhang, 2014).

Earnings management, however, is not without cost because the practice may bring about considerable negative consequences. For example earnings management can increase the probability of litigation. Defond and Subramanyam, (1998) found that companies have litigation risks when practicing earnings management. Moreover, earnings management practices are detrimental to investors because they reduce transparency and cannot properly monitor manager performance (Hazarika, Karpoff, & Nahata, 2012).

The practice of earnings management occurs because a company maintains accounting records on an accrual basis. Accruals are "pairings of income and expense in the period in time of occurrence" and not at the time the cash is received or a fee is paid. Accrual-based accounting transactions record expenditures and cash receipts also indicate the number of debts and receivables of the company. Accrual accounting provides a more accurate picture of the financial condition of the organization rather than cash accounting and managers perform earnings management within the limits of generally accepted accounting principles (Sankar & Subramayam, 2001).

Managers practice earnings management using accounting policies that are governed by financial accounting standards. The company is given the discretion to choose the accounting policy to be used so that the company will choose an accounting policy that can protect it from economic uncertainty. One of the accounting policies that can be applied in the company to protect the interests of the company is accounting conservatism.

The Financial Accounting Standard Board (2008) defines accounting conservatism as a prudent reaction to ensure inherent business uncertainty and risk has been adequately considered. Thus, accountants are more likely to choose the direction of understatement rather than overstatement of net income and net assets. An understatement of financial reports will anticipate the possibility of failure to recognize revenue from receivables and the possibility of recognition of extraordinary expenses. Therefore, the earnings information that is displayed in financial statements is more realistic.

Furthermore, accounting conservatism is the accounting policy that refers to the recognition of costs and debt with prudence, although there is uncertainty about the outcome. However, revenues and assets are recognized only if there are guarantees to be received (Vishnani & Misra, 2016). In accounting conservatism, if there is a possibility of loss, it should remain recorded in the books, but if there is a possibility of profits, and as long as there is still no certainty to get it then it should be not recorded. By implementing accounting conservatism, managers cannot report unrealized earnings for personal gain because the company chooses to report a smaller but more achievable profit. Therefore, accounting conservatism can prevent opportunistic earning management (Gao, 2013).

The application of accounting conservatism in Indonesia is reflected in the principles of Financial Accounting Standards number 14 related to inventory states that inventories are measured based on costs or net realizable value which is lower. The lowest cost of purchase indicates that the company uses the conservatism principle. Because the reported value of inventory is considered to be the lowest value not the actual value provided by the market (Riri Zelmiyanti, 2014).

Financial Accounting Standards number 16 related to fixed assets explain that in valuing fixed assets the company adheres to the valuation of fixed assets based on the acquisition price or exchange price. Valuation of fixed assets based on acquisition prices indicates the company uses the principle of conservatism. Financial Accounting Standards number 19 related to intangible assets, states that companies may not recognize intangible assets arising from the research stage. Expenditures at the research stage are recognized as expenses when incurred (Ikatan Akuntan Indonesia, 2015). However the company has not been able to show the addition of assets before the research is completed.

Accounting Standards number 57 related to contingent liabilities. Explain about estimated liabilities, contingent liabilities, and assets. These estimated liabilities are recognized however there is no recognition of estimated assets. Therefore accounting policies are applied support companies to assess assets on a balance sheet with a lower value. However, there is an obligation to immediately recognize expenses management. This has an impact on the income presented being lower, and costs are displayed higher so that it will generate lower profits (Riri Zelmiyanti, 2014).

This mechanism is necessary for Indonesia in order to anticipate the re-occurrence of monetary crises and to prevent the practice of opportunistic earnings management practices that have an impact on financial information misdirection, which has the potential to cause economic crises as experienced by Indonesia in 1997. Therefore, fiscal and monetary policies are needed to save the economy. At the end of 2011, the Indonesian government and the house of representatives, (*Dewan Perwakilan Rakyat* (DPR), agreed to establish a financial services authority as a financial sector reform. On November 22, 2012, Law no. 21 on the financial services authority or (*Otoritas Jasa Keuangan* (OJK) was passed.

The Financial Services Authority or (*Otoritas Jasa Keuangan* (OJK) began functioning as of December 31, 2012, which replaced the functions, duties, and regulatory authority previously held by the Ministry of Finance through the Capital Market and Financial Institution Supervisory Agency or (*Badan Pengawas Pasar Modal dan Lembaga Keuangan* (Bapepam LK).

In 2014 OJK published a corporate governance roadmap in Indonesia related to strengthening the implementation of corporate governance in Indonesia, then followed by the issuance of financial services authority regulation No. 21 / POJK.04 / 2015 concerning the application of guidelines for public company governance that requires companies to implement governance practices in accordance with applicable international practice. The adoption of regulation no. 21 / POJK.04 / 2015 is elaborated by the financial services authority circular No. 32 / SEOJK.04 / 2015 regarding guidelines for public company governance which contains five aspects of public company governance, namely guaranteeing the rights of shareholders, encouraging the functions and the role of the board of commissioners, explaining the function of the board of directors, stakeholder participation and information disclosure.

Furthermore, the task of the OJK is to establish an integrated regulatory and supervisory system for overall activities within the financial services sector in banking, capital markets and non-bank financial services sectors such as insurance, pension funds, financing institutions, and other financial services institutions.

In performing its duties, the OJK in 2012, reported that there were 165 companies involved in violations of the rules and manipulation of financial statements (Bangun, 2012). The occurrence of manipulation of financial statements caused by poor implementation of corporate governance was revealed in several cases. The cases were reported by the financial services' authorities, and the tax offices were included. In 2012, Asian Agri was found to have manipulated financial statements to reduce tax payments. The manipulation of financial statements is applied by imposing a non-factual cost-to-income statement (Rahman, 2014).

Meanwhile, in 2013, PT Garda Tujuh Buana (GTBO) manipulated financial statements through a payment scheme. GTBO recorded payments received in advance to buying and selling as income. These accounting policies made GTBO net profit high in the first half of 2012, with a total of Rp939.81 billion Indonesian Rupiah (Nabhani, 2013). Furthermore, in 2014, the Indonesian Stock Exchange found misstatements in the financial statements of PT Inovisi for the period of

September 2014. *Bursa Efek Indonesia* (BEI) asked PT Inovisi to revise the value of fixed assets and net income per share (Suwarso, 2015). In 2015, PT Tiphone manipulated its financial statements by reporting a number of sales that were not reasonable when compared with similar companies (Nabhani, 2015).

Based on the cases above then Indonesia needs the adoption of effective corporate governance to prevent corrupt practices. Therefore, the Indonesian government reformed the implementation of corporate governance, requiring companies in Indonesia to have an independent director and audit committee with the aim of improving the company's performance and financial information quality (Siagian, 2013).

In 2012, the Indonesian securities' market required companies to have an audit committee of at least three members from independent commissioners and external parties. The audit committee should have knowledge of the financial statements, the business at the company, the audit process, and the legislation capital market. The committee has the duty to oversee management in establishing accounting standards used to produce financial statements and to ensure that management complies with applicable regulations so that the audit committee can influence the application of accounting conservatism in the company. Ji, Lu and Qu (2016) stated that audit committees had a significant positive role related accounting conservatism because the committee audit with expertise in finance will encourage companies to apply more conservative financial reporting.

In addition, the audit committee should understand and have expertise in management's accounting, and the audit committee should monitor the financial statement and the audit process (Rahman & Sharif, 2013). Moreover, the audit committee has to understand internal controls to ensure that accounting information is not biased (Sun et al, 2014), and the audit committee could control the quality of an audit as well as selection and appointment of external auditors (Zgarni & Zehri, 2016). In line with Siagian and Tresnaningsih (2011) the presence of an independent audit committee can reduce the practice of earnings management.

Audit committees should be led by an independent director and must have the financial capability to oversee the performance of management. In addition, the audit committee has the obligation to conduct audit committee meetings at least once in three months. Meetings held every three months, or four meetings per year, is very little compared to the day-to-day activities for management. The question is whether the role of the audit committee is effective in overseeing the application of accounting policies that may affect earnings.

To improve the implementation of corporate governance in Indonesia, the government requires all companies to have at least one independent director who is not affiliated with the controlling shareholder in the company (Siagian, 2013). Moreover, to maintain the independence of these directors, the financial services authority requires that the independent director has no relationship with the controller of the company for at least six months before being appointed as independent director and most importantly has no affiliation with commissioners or other directors. By applying these requirements, it is expected that independent directors can work optimally to assist the directors to work for shareholders' profits.

The independent director is involved in overseeing the applied accounting policies in accordance with generally accepted accounting principles. So, the financial statements made by the company are in accordance with the company's performance, and the determination of compensation for managers becomes more transparent. In line with Ji et al., (2016) Independent board members are more likely to see accounting conservatism practices as an effective tool for monitoring management performance.

The role of independent directors that ensures the application of accounting in the company has encouraged more transparent financial reports that will increase investor confidence and the role of independent directors has been shown to significantly inhibit earnings management and raise investors' trust in financial statements (Wu et al., 2016).

Independent directors have the responsibility to improve the implementation of corporate governance; however, the financial services authority (*Otoritas Jasa Keuangan*) issues regulations requiring companies to have at least one independent director. Whether one independent director can influence the implementation of corporate governance because sometimes company decides on a policy through a voting mechanism, so the question arises whether an independent director can oversee management and influence policies, especially accounting policies that may affect earnings management.

To ensure the financial statements generated by the company are in compliance with the accounting standards, the financial services' authority (*Otoritas Jasa Keuangan*) issue financial services authority circular letter number 30 /seojk.04/2016 concerning the form and content of the annual report of the issuer or public company, it is stated that the company must report audited financial statements and published within four months of closing the books. The role of external auditors in implementing corporate governance is to check the conformity of financial statements with accounting standards and to ensure that financial information produced is in accordance with the performance achieved.

The audit quality can be measured by looking at the size of the public accounting firm and the length of co-operation between the company and the public accounting firm. Therefore, external auditors, especially the Big Four, can influence the company to apply accounting conservatism in generating financial statements, because big public accountants periodically improve and maintain the ability of auditors so they can find out the latest ways and guidelines in the preparation of financial statements. Furthermore, auditors are given a good appreciation so that independence will be maintained (Mohammed et al, 2012). However, a longer working period for auditors is associated with lower accounting conservatism because the longer the working relationship is established; the auditor will get closer and understand the needs of managers so that they will not be independent in examining financial statements (Rickett & Maggina, 2016).

According to Lin and Hwang (2010), auditors are responsible for verifying if the financial statements conform to Generally Accepted Accounting Principles (GAAP) and reflect true economic conditions. Thus, verification of external auditors adds credibility to the company's financial statements. Furthermore, the external auditor and audit committee will discuss the accounting standards applied in the company so that the auditor can find out material misstatements or omissions that have an impact on preventing earnings management practices (Wu et al., 2016).

Furthermore, supervision of management performance can be carried out by institutional investors. In general institutional ownership has a large shareholding and companies with institutional ownership will be more careful in monitoring management (Zalewska, 2014). Therefore, institutional ownership often refers to sophisticated investors who have better ability to obtain relevant information, have processing value, and are more effective in monitoring management in taking company policies (Bowen &Venkatachalam, 2008).

The Indonesia Stock Exchange (IDX) stated that share ownership in Indonesia is still dominated by institutional investors compared to individual investors. The percentage of share ownership of institutional investors on the IDX is 73.14 percent (Pasopati, 2015). This is in line with Ni luh (2018) which states that the average institutional ownership in manufacturing companies listed on the Indonesian stock exchange from 2012-2015 is 70,13%. Moreover, higher ownership by institutions that may monitor managers is associated with more conservative financial reporting (Ramalingegowda & Yu, 2012). Hence institutional investors can detect earnings management and oversee managerial performance (Guo & Ma, 2015; Kazemian & Mohd, 2015).

1.2 Problem Statement

The occurrence of fraudulent cases in Indonesia can be seen from several cases such as PT GTBO (2012), PT Inovisi (2014), and PT Tipone (2015) practices earnings management by applying increased revenue to show higher profits. This is in line with Andreas, Ardeni, and Nugroho (2017) which found that in 2012 and 2013 companies listed on the Indonesia Stock Exchange were not conservative in preparing financial statements. Financial statements that were presented in these cases showed overstatements by implementing accounting policies that were not conservative, that is by recognizing revenue that may not be actually gained and avoiding the recognition of expenses. Thus, the practice displays higher profits in the financial statements. Higher profits showed the success of managers in managing the company to achieve the welfare of shareholders so that managers could get compensation from contracts that were arranged with shareholders. Thus, the implementation of earnings management in Indonesia has mislead investors or shareholders by reporting unsuitable income.

Misleading financial statements will have an impact on the business steps that are mistaken, when profits are reported higher, then shareholders will trust that the company is in good condition and provide bonuses and contract extensions to management. Furthermore, high profits will also have an impact on higher tax burdens so that the company pays greater taxes than it should. This happens because, based on agency theory, the manager has a motive to meet his or her welfare in a way to adjust earnings in order to receive higher compensation (Xue & Hong, 2015).

Managers have more information about the performance of the company than shareholders who only have information derived from financial statements. The difference in information between management and shareholders is called asymmetric information. Shareholders know the accounting policies that are applied in the preparation of financial statements. However, shareholders do not know how the accounting policy is implemented so that the resulting numbers in the financial statements. Furthermore information asymmetry is used by management to display the company's performance in accordance with the contract.

Managers can adjust accounting numbers because management is flexible to choose accounting methods to produce financial statements. So, management can provide information that is not appropriate. However, earnings management is implemented based on the use of accounting policies so that there is a possibility of earnings management conducted by the company not from opportunistic managers' actions to obtain personal welfare but earnings management that occurs based on the selection of accounting conservatism policies. Conservatism in accounting refers prudent recognition of expenses and liabilities even if there is uncertainty about the outcome. However, income and assets are recognized only when there is full surety of receiving them (Vishnani & Misra, 2016).

The main factor that determines the implementation of conservatism in financial reporting for the company is the board of directors because boards of directors have control over financial reporting to support the application of accounting conservatism. This requires the encouragement of independent directors who can participate in supervising the accounting policies adopted in preparing financial reports so as to prevent information asymmetry between managers as agents and shareholders as principals. The duties of an independent director according to the Indonesian Stock Exchange Circular are as a counterweight to affiliated directors and accommodating stakeholders, both the interests of majority and minority shareholders and ensuring the fulfillment of the principles of Good Corporate Governance.

Furthermore required supervision of audit committees, who have expertise in finance and holds regular meetings with the board of directors to discuss accounting standards applied in financial reports and determine which external auditors will audit financial statements, therefore it can prevent information asymmetry between managers and shareholders. However, it is not enough to rely on independent directors and audit committees to encourage the adoption of accounting conservatism in the preparation of financial statements. Other instruments are needed such as the role of institutional investors who hold a majority of shares so that they can encourage the board of directors to apply accounting conservatism through agreed contracts between shareholders and the board of directors. Therefore, shareholders will know that the financial statements reflect appropriate and achievable performance so as to prevent information asymmetry. Furthermore, it requires supervision from external auditors who will evaluate the preparation of financial statements to conform to the accounting standard. An independent external auditor will provide the correct opinion to prevent misinformation in the financial statements so as to protect the interests of shareholders.

Accounting conservatism plays a role in reducing earnings management practices because it will minimize the chance for managers to apply earnings management for their personal benefit. Managers cannot recognize earnings before they really exist and cannot delay recognition of expense (Ahmed & Henry 2012; lin et al., 2014; Mohammed et al., 2017).

Earnings management practices in this research are based on agency theory, where agency theory assumes managers are opportunistic, causing agency problems. To prevent agency problems a contract between managers and shareholders is needed; however, this theory faces many obstacles such as information asymmetry, rationality, and fraud. Therefore, to minimize information asymmetry, it is necessary to apply a corporate governance mechanism that guarantees transparency, accountability, and responsibility in reporting company performance.

The company's performance is displayed in the financial statements, which are prepared based on accounting policies. Therefore, in order for the performance of financial statements to be in accordance with the economic conditions of the company, it is necessary to apply a conservative accounting policy so that the earnings presented in the financial statements are not overstated. Internal and external monitoring is needed to ensure the adoption of conservative accounting policies.

This study examines the important role of conservatism accounting in preventing earnings management practices through the selection of accounting policies that can improve company performance. Therefore, corporate governance is needed to encourage managers to choose conservative accounting policies in preparing financial statements. This study investigates the effect of the audit committee, independent directors, audit quality, institutional ownership in encouraging the application of accounting conservatism then examines the effect of accounting conservatism on earnings management, and then this research reveals the application of accounting conservatism as a mediator between the audit committee, independent directors, audit quality, institutional ownership and earnings management practices.

Furthermore, many previous studies Al-Thuneib et al. (2016), Ching et al. (2015), García-meca & Sánchez-ballesta (2009), Mohammad et al. (2016) argued that corporate governance has an effect on earnings management practices. Meanwhile, corporate governance also has an effect on the implementation of accounting conservatism, and other research also discusses earnings management practices that can be prevented by the implementation of accounting conservatism.

Therefore, the application of conservative accounting is very important to prevent managers from practicing earnings management through the selection of accounting policies that have an impact on excessive performance reporting. Furthermore, excessive performance reporting will provide inappropriate information to investors, thus it is necessary to apply corporate governance that can encourage the application of conservative accounting in financial reporting. However, there are limited studies that have been conducted on the role of accounting conservatism. This study will investigate the role of accounting conservatism as a mediator between corporate governance variables and earnings management practices.

1.3 Research Question

1. How does audit committee affect accounting conservatism?
2. How does independent director affect accounting conservatism?
3. How does audit quality affect accounting conservatism?
4. How does institutional ownership affect accounting conservatism?
5. How does accounting conservatism affect earnings management?
6. How does accounting conservatism mediate the relationship between audit committees, independent director, audit quality, institutional investors and earnings management?

1.4 Objective of the Study

1. To examine the role audit committee in the practice of accounting conservatism.
2. To examine the role of independent director in the practice of accounting conservatism.
3. To examine the role of audit quality in the practice of accounting conservatism.
4. To examine the role of institutional investor in the practice of accounting conservatism.
5. To examine the effect of accounting conservatism on earnings management.
6. To examine accounting conservatism as a mediator between audit committee, independent director, audit quality, institutional investor and earnings management.

1.5 Significance of the Study

This section discusses the contribution of this research to theory, practical, and regulator.

1.5.1 Theoretical Perspectives

This study aims to expand the existing literature on earnings management and the occurrence of earnings management based on agency theory, which states that there is a difference of interest between the agent and principal (Jensen & Meckling, 1976). Therefore, with differences in interests, the agent will prioritize personal interests over the interests of the principal through the practice of earnings management (Xue & Hong, 2015). Based on previous literature on preventing earnings management, companies need to implement corporate governance measures such as forming audit committees (Siagian & Tresnaningsih, 2011; Sun et al., 2014), independent directors (Siagian, 2013; Wu et al., 2016), audit quality (Lin & Hwang, 2010; Wu, et al., 2016) and institutional investors (Guo & Ma, 2015; Kazemian & Mohd, 2015). Furthermore, this study will examine the factors that influence the practice of earnings management through the application of accounting conservatism.

This research will contribute to the role of corporate governance, which will directly affect the application of accounting conservatism in financial statements. The adoption of conservative accounting policies can prevent earnings management practices that will have an impact on agency costs. (Lin et al., 2014).

Independent directors and audit committees as internal parties of companies can directly oversee the accounting policy making that is applied in the company. They can encourage the application of accounting conservatism that can prevent opportunistic earnings management. Institutional investors can hold monitoring power by controlling large proportion of shares; therefore, institutional investors have strong incentives to monitor the firm's performance and ensure that management implements accounting conservatism. Furthermore, public accountants as financial report examiners can guarantee that the financial statements made are in accordance with generally accepted accounting standards and reflect the performance of the company.

The most important result of this research is to know the contribution of accounting conservatism to the relationship between corporate governance and earnings management.

1.5.2 Practical and regulatory contribution

By knowing the role of accounting conservatism in preparing financial statements, it will prevent managers from reporting excessive financial performance. Therefore, the manager will receive compensation in accordance with the actual performance (Madanoglu & Karadag, 2016) and protect shareholders from inappropriate financial performance information. Furthermore this study will be useful to the government as regulations, especially for institutions' financial services authority, *Otoritas Jasa Keuangan* (OJK) which creates and develops road maps for the implementation of corporate governance in Indonesia. The results from this study will show the evaluation of the application of corporate governance mechanisms and will contribute to the implementation of accounting conservatism in the preparation of financial statements (Mohammed et al., 2017). The financial services authority can encourage companies to prepare more conservative financial statements. The Regulator and Institute of Indonesia Chartered Accountants can formulate generally accepted accounting principles to be more conservative so that the reported financial report information does not contain exaggerated earnings so as to protect the interests of shareholders.

1.6 Definition of Key Terms

Explanations of key terms used in this study are as follows:

Earnings management

Earnings management is a management action that uses accounting policies to change financial statements so that financial statement information becomes inappropriate (Healy & Wahlen, 1999; Wu et al., 2016). It was measured in this study by the Modified Jones Model because this model is best at detecting earnings management practices when compared to alternative models in measuring unexpected accruals (Chen, Jian, Chen, & Lin, 2007).

Accounting Conservatism

Accounting conservatism is defined as the differential verification needed for recognition of profit versus loss. Conservatism does not anticipate profit but anticipates all losses, (Watts, 2003) and it was measured by G score and C score. G Score shows a firm's responsiveness of reported earnings to positive returns, while C Score indicates its incremental sensitivity to negative returns (Cheng & Kung, 2016).

Corporate governance

Corporate governance is a mechanism that monitors company operations (Huang et al., 2014). The corporate governance dimension used in this study was audit committee, independent director, institutional ownership, and audit quality. An important thread of corporate governance is to ensure the accountability of a company's management through systems designed to reduce the agency's problem between managers and shareholders (Baker, 2015; Hutchinson, Percy, & Erkurtoglu, 2008).

Audit committee

An audit committee is the committee responsible for selecting and appointing an external auditor (Zgarni et al., 2016). The audit committee was measured using indicators. Audit committee independence was measured by the proportion of independent directors on the audit committee. Financial expertise was measured as the proportion of directors with financial expertise on the audit committee, and the number of annual audit committee meetings were measured using meetings per annum as a prescribed benchmark (Sultana, 2015).

Independent director

An independent director is a director who does not own shares of the company and has no business relationship with the company (Siagian, 2013). This was measured by the percentage of total independent boards of a director to the total boards' directors (Yunos, Smith, & Ismail, 2012; Wang, 2014).

Institutional ownership

Institutional ownership refers to shares held by funds, brokers, brokerage of financial products, social security funds, annuity, trusts, financial firms (Xue & Hong, 2015), investment companies, banks, insurance companies, and college endowments (Slovin & Sushka, 1993). This was measured by the percentage of institutional ownership to total shares (Chi et al., 2009).

Audit Quality

The external auditors are independent professional auditors that inspect a company's financial statements (Wu, et al., 2016). This was measured by size to determine if the, auditor is large or small (Kouaib & Jarboui, 2014). The length of the working relationship between the auditor and the company was measured by the number of consecutive years that the auditor has cooperated with the company (Zgarni & Zehri, 2016).

1.7 Organization of remaining chapters

The first chapter contains an introduction and explains the purpose of the study. This chapter discusses the agency theory on the occurrence of earnings management, the objectives of management professionals who perform earnings management, the problems that occurred in Indonesia related to earnings management, and the implementation of corporate governance and accounting conservatism.

Chapter two discusses the theory and previous research on earnings management, corporate governance, and accounting conservatism. This chapter also discusses the theoretical framework underlying the association between indicators of corporate governance on earnings management and accounting conservatism in order to create the hypotheses between variables studied.

Chapter three contains the population and the number of samples used, including the method of determining the sample. It also contains the methodology and statistical techniques used.

Chapter four presents the results of the analyses and discussions of the results. Chapter five provides a summary, implications, and limitations of the study and suggestions for future research.

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

This chapter presents the background literature related to this study. Section 2.2 discusses the agency cost theory. Section 2.3 discusses earnings management. Then, this chapter discusses in detail corporate governance in Section 2.4, including the importance of corporate governance and an overview of the implementation of corporate governance in Indonesia. This section discusses the variables of corporate governance audit committee, independent director, institutional ownership, and audit quality. Further, Section 2.5 discusses research related to accounting conservatism, which is followed by theoretical framework and hypothesis development in Section 2.6. Section 2.7 discusses accounting conservatism and its relation to earnings management. Then this chapter discusses in detail the hypotheses of accounting conservatism as a mediator between corporate governance and earnings management in Sections 2.8.1 – 2.8.4. Section 2.9 discusses the controlled variables used in this study size and the market-to-book ratio. Finally, the whole framework of this research is summarized.

2.2 Agency Theory

Along with the advancement of science, researchers discover several causes of agency problems such as differences in interests between principals and agents, resulting in information asymmetry (Cormier., et al. 2010; Jensen & Meckling, 1976). Further linked with majority shareholders and minority shareholders. In this type agency, problems occur when majority shareholders put forward their interests at the expense of the minorities (Utama., et al 2017). Furthermore agency costs occur when the owner makes a risky investment using funds from creditors, because it has the potential to harm the interests of creditors if the investment is not profitable (Panda & Leepsa, 2017).

The agency theory explains that the agency relationship arises when one or more persons (the principal) employs another person (the agent) to provide a service and then delegates decision-making authority to that agent. Furthermore, this type of agency theory discusses how the principal verifies the behavior of the agent in running the company because there are differences in viewpoints in assessing risk, which is caused by two main problems differences in interests between the principal and agent and costs incurred by the principal to verify that the agent's behavior is in accordance with the principal's interests (Eisenhardt, 1989).

These differences in interests are further discussed by Eisenhardt (1989) in three assumptions of human behavior, namely (a) self-interest, or always putting one's own interests first; (b) risk averse, or always trying to avoid risk; and (c) bounded rationality, or the limited human rational in predicting the future. Differences in interest have an impact on the potential asymmetry of information between managers and investors (Walker, 2013). Moreover, information asymmetry occurs because managers have the freedom to choose the accounting policies used (Cornett et al., 2008), so managers have the opportunity to take personal advantage or conduct opportunistic behaviors.

Furthermore, information asymmetry can also occur between the principal and the creditor, the creditor does not know that the funds given to the principal are used to invest in companies that have high risk, with the expectation that the principal gets a higher profit compared to the cost of debt set by the creditor. In addition, information asymmetry also occurs between shareholders when there is a difference of interest between the majority shareholders and minority shareholders, where the majority shareholders will use their voting power to make decisions for their profits that cause minority shareholders not to be able to protect their interests (Panda & Leepsa, 2017).

Moreover, information asymmetry generates agency costs to ensure agents act according to the principal's interests. According to Jensen & Meckling (1976), there are three types of agency costs, namely (a) monitoring costs, costs incurred due to principal supervisory activities towards agent behavior in managing the company; (b) bonding costs, costs that ensure that the agent will move in accordance with the interests of the principal; and (c) residual loss, the difference between the policies taken by the agent and the welfare expected by the owner. In the implementation of monitoring costs to solve asymmetric information problems that impact manager opportunistic behavior, agency theory recommends that there should be a clear separation between management and control in decision making (Fama & Jensen, 1983).

Corporate governance provides a structure for achieving goals and monitoring performance and should provide the right incentives for management to seek targets base on shareholders' interests. Corporate governance can facilitate effective oversight, thereby encouraging companies to use resources more efficiently (International Finance Corporation, 2014). In addition, the monitoring performance mechanism can be divided into internal monitoring and external monitoring. Internal monitoring consists of parties within the company, and external monitoring is part of the monitoring mechanism that comes from outside the company (Waznah, Aima, & Mohd, 2015 ; Yoo & Jung, 2015) In this study internal monitoring consists of an audit committee and an independent director, and external monitoring is an institutional investor and an external auditor.

Audit committees play a role in overseeing managers’ actions and helping to align the interests of owners and managers (Mansour et al., 2018). Furthermore, audit committee members provide their knowledge and experience in monitoring. More importantly, the audit committee can prevent nepotism and collusion in the company (Du et al., 2017). Moreover internal monitoring can also be applied by independent director many studies have found that the existence of independent directors can effectively hinder earnings management and improve the quality of financial reporting. The higher the proportion of independent directors, the smaller the abnormal accruals (Wu et al., 2016). Furthermore, outside directors are expected to make independent decisions at board meetings (Yoo & Jung, 2015).

Management performance monitoring is also carried out by external parties such as institutional ownership. Institutional ownership has an effective role in monitoring management policies and improving the quality of financial information, because institutional ownership can obtain and process information in a comprehensive manner (E. S. S. Alzoubi, 2016). Furthermore, institutional investors as large shareholders have the ability to monitor management in improving company performance compared to individual shareholders (Yoo & Jung, 2015).

Another factor that can reduce agency problems between managers and shareholders is the role of the auditor's firm size and the auditor's tenure in examining the company's financial statements (Khamoussi, 2016). Furthermore, audits conducted by external auditors are the best monitoring techniques that companies can use to reduce agency costs that have an impact on reporting reliable accounting information (Persakis & Emmanuel, 2016). Therefore, audit activities by external auditors are done to provide credible guarantees regarding financial transparency to creditors and shareholders so that managers will not be involved in fraudulent activities (Persakis & Emmanuel, 2016).

2.3 Earnings Management

The manager acting as the agent will utilize his or her authority in managing the company for the benefit of shareholders; however, based on agency theory, the contract that exists between the manager and shareholders will have a conflict. This is based on differences in interests between managers and shareholders. Therefore, agency theory highlights three main issues related to earnings management (Walker, 2013). The first role is contracts. The company consists of various contracts or agreements that will have an impact on the occurrence of earnings management that is driven by the contract. One perspective that is studied in earnings management is the contract between the key stakeholders and managers. Second role is efficient contracting. Agency theory assumes all stakeholders involved will make the contract efficient and predicts that all contracting parties have the same knowledge about earnings management practices. Therefore, agency theory assumes that all parties involved in the contract will consider the costs and benefits of earnings management practices for their own interests. The last role is the role of asymmetric information. In conditions of uncertainty, the possibility that executives who run the company have direct access to the relevant information to predict future cash flows, while external investors have to wait for a report from the company's executives.

According to Walker (2013), information asymmetry can be caused by moral hazard problem. This problem arises if external investors cannot observe the actions of the manager in managing the company, whether those actions are in accordance