THE ROLE OF CORPORATE GOVERNANCE IN MANAGING SMALL INCOME IN INDONESIAN STATE-OWNED ENTERPRISE

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Abstract

Earnings management is a behaviour that is difficult to avoid because of the impact of accruals in preparing financial statements. Earnings management occurs due to information asymmetry in a company. One way to prevent information asymmetry from occurring so as to reduce earnings management is corporate governance. It aims to determine manager accountability through existing mechanisms to reduce problems between agents and principals. The purpose of this study is to examine the effect of information asymmetry on earnings management through the role of corporate governance in State-Owned Enterprise (SOE) in Indonesia. The focus of this study is on information asymmetry, the proportion of the board of commissioners, the size of the board of commissioners and its effect on earnings management. The result showed that information asymmetry has no effect on the earnings management through the proportion of the board of commissioners and the size of the board of commissioners. The result does not significantly affect earnings management since the capital of SOE is dominated by state assets related to public funds. So company's agent should acknowledge the boundaries of ethical, moral, law, government policies, environmental, social, cultural, political, and economic issues in making decisions. Therefore, earnings management actions in SOE companies in Indonesia cannot be minimized by the proportion of the board of commissioners and the size of the board of commissioners. This study offers the importance of

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corporate governance to build reputation and strength on SOEs in Indonesia.

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1. Introduction

Financial reports presented by companies for public interest should meet the usual standards. Information asymmetry is debatable among academics today. This is because information asymmetry is the result of conservatism in which recognition is acknowledged after the incident and eventually creates bias (Givoly & Hayn, 2002). Lafond & Watss (2008) suggest that accounting is better applied because it can reduce incentives and ability of managers to manipulate financial report numbers and minimize information asymmetry. Information asymmetry is closely related to earnings management, where it is known as phenomenon that is difficult to avoid due to the impact of accruals in preparing financial statements.

Scott (2006) states that earnings management is the choice of accounting policies by managers from existing accounting standards and naturally maximizes the utility or market value of the company. Healy & Wahlen (1999) also revealed that earnings management itself occurs when management uses certain decisions in financial reports and transactions to change financial statements as basis for company performance that aims to mislead owners or shareholders or to influence contractual results that rely on accounting numbers which are reported in the financial statements. Richardson (1998) states that there is systematic relationship between information asymmetry and the level of earnings management. Information asymmetry will encourage managers to present information that is not true, especially if the information is related to the manager's performance measurement. Earnings management occurs because of the information asymmetry where the agent has more and more accurate information than the principal. The agent will tend to convey good company conditions even though the reality is less supportive (Rahmawati, et al., 2006). A similar thing is also explained by Scott (2006) that information asymmetry is a condition in which managers have access to get information on company prospects that are not

owned by outsiders, consisting of moral hazard and adverse selection. One can be used to reduce the existence of earnings management is corporate governance.

Corporate governance aims to determine the accountability of managers through the existing mechanisms in order to reduce problems between agents and principals. The role of corporate governance in financial reporting received a lot of attention, especially after the enactment of the Sarbanes Oxley Act 2002 (SOX). Many studies debate whether some characteristics of corporate governance can effectively limit earnings management, such as managers enforcing corporate governance system for financial reporting at their own risk. Managers can control reported earnings by making discretionary choices in accounting or operating decisions. Graham, et al. (2004) and Cohen, et al. (2008) showed in their research that managers change the method to control reported earnings from accounting choices to discretionary operating decisions. When earnings management occurs, it will affect the company's performance and ultimately sacrifice the principal's wealth.

However, if corporate governance is carried out without limiting operational decisions, the company's performance will be damaged by the personal interests of managers. The action of earnings management has occurred in Indonesia State Owned Enterprises. According to the Law No 19 Year 2003 Article 1, the meaning of SOE is the business entities whose capital is wholly or partly owned by the State through direct participation originating from State assets. The examples of SOEs are PT. Pertamina and PT. Garuda. The indication of earning management occurred at SOEs namely PT. Garuda Indonesia, which presents a net profit in the 2018 financial statements of USD 809,846 or Rp. 11.49 billions (exchange rate Rp. 14,200/ USD). Even though the third quarter of 2018, the company's losses were still USD 114.08 millions or IDR 1.63 trillions. This is inversely proportional to the conditions in 2017, where PT. Garuda Indonesia suffered a loss of USD 216.58 millions or equivalent to Rp. 3.09 trillions. Similar conditions also occurred at PT. PLN Pesero which delivered a net profit of Rp. 11.56 trillions in 2018. This profit increased by Rp. 4.42 trillions or 162.30% compared to the profit in 2017. Even though in the third quarter of 2018, PLN still suffered a loss of Rp. 18.48 trillions due to foreign exchange loss of Rp. 17.32 trillions PT. Pertamina Persero also revealed similar things related to the net profit achieved in 2018, namely USD 2.53 billions or Rp. 35.99 trillions whereas in the third

quarter of 2018, the net profit achieved was only Rp. 5 trillions. Profit in 2018 has decreased compared to 2017, amounting to USD 2.54 billions[1].

This behaviour if related to Agency theory suggests that earnings management problems can be minimized through corporate governance. Kang & Han Kim (2011) revealed that earnings management can be controlled effectively by a corporate governance mechanism where corporate governance has a strong relationship with company performance. The corporate governance component in minimizing earnings management practices can be carried out through a monitoring mechanism to harmonize differences in the interests of owners and management, among others, with:

(1) institutional ownership because it is considered a sophisticated investor with a significant amount of ownership that can monitor management which has a reduced impact managers' motivation to perform earnings management (Midiastuty & Machfoedz, 2003);

(2) increasing the company's share ownership by management (managerial ownership) (Jensen & Meckling, 1976);

(3) the proportion of independent board of commissioners that limits management to perform earnings management (Peasnell, et al., 2001);

(4) the size of the board of commissioners, where a smaller number of commissioners will be able to reduce the indication of earnings management (Midiastuty & Machfoedz, 2003); and

(5) the existence of an audit committee that can reduce earnings management activity which in turn will affect financial reporting, one of which is the quality of earnings (Wilopo, 2004).

Uwuigbe, et al. (2014) consider that the size of the board of commissioners and independent commissioners can reduce earnings management performed by managers, where CEO duality has a positive and significant effect on earnings management.

Mashitoh & Irma (2013) prove that the board of commissioners and audit quality can improve financial performance, while Hermiyetti & Manik (2013) reveal that the Good Corporate Governance mechanism has no effect on financial performance. Masulis, et al. (2007) also stated that the system of corporate governance is designed to oversee the risk management through monitoring and reducing

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[1] *These information are taken from https://www.cnbcindonesia.com.*

managerial actions that harm shareholders. However, Sun & Al Farooque (2018) showed the difference in their research, that is the amount of earnings management does not experience a decrease after the corporate governance reform. In addition, earnings management has developed overtime and become a positive trend. Alareeni (2017) stated that earnings management has a negative correlation to the size of the board of commissioners, so it said that the higher the structure of the board of commissioners, the higher the practice of earnings management.

Although there are a lot of studies on information asymmetry, corporate governance and earnings management carried out in Indonesia both in conventional and Islamic companies, those related on the asymmetry and earnings management through corporate governance as an intervening variable in SOE companies, are rarely found. The assumption of corporate governance is used as an intervening variable because if corporate governance is implemented effectively, discretionary operating decisions can be minimized, thereby reducing earnings management.

This study aims to examine information asymmetry on earnings management through the role of corporate governance. The time period starts in 2017-2018 since during those years, the behaviour indication of earnings management in SOE companies occurred and, in those year, there was a change in regulations related to the board of commissioners of SOE companies in Indonesia.

This study can serve to investors as basis input and consideration in making stock investment decisions, especially in assessing the quality of earnings in financial statements. For capital market managers, it can be used as a reference to encourage companies to present higher quality information to stakeholders. For the government, through the Capital Market Supervisory Agency and Financial Institution (BAPEPAM), it supports and supervises company operations through stock market activities. For companies, the results of this study could help the corporate administrators in understanding the mechanisms and models of corporate governance and earnings management practices. For academics, this study is expected to be an additional literature on roles of corporate governance in minimizing the practice of earnings management on SOE companies in Indonesia and it could give a brief description about the practice of earnings management in various interested parties.

2. Literature review and hypothesis development

2.1 Agency theory

Jensen & Meckling (1976) revealed that there is a relationship between management and shareholders where management is the agent and shareholders are the principal. Agency relationship allows a conflict of interest between agent and principal. Agency theory implies the occurrence of information asymmetry between agent and principal where the agent has more and more accurate information than the principal. The agent tends to convey a good company condition even though sometimes the reality is less supportive. Based on these reasons, it is indicated that agents undertake earnings management. Therefore, one of the ways used to oversee these problems between agent and principal. Furthermore, it is used to limit the opportunistic behaviour of management is through the implementation of corporate governance. When the corporate governance mechanism is implemented effectively, the agent's discretional operating decisions can be minimized so that earnings management will also decrease.

One of the components of corporate governance is the board of commissioners, having an important role in controlling and supervising management and the formulation of strategies in the company (Hillman & Dalziel, 2003). The board of commissioners can be said to be the decision maker to replace or reshuffle management (Fama, 1980). With the board of commissioners, management can obtain information to minimize information asymmetry and ultimately reduce earnings management (Rutherford, & Buchholtz, 2007).

2.2 Information asymmetry

Rahmawati, et al. (2006) state that information asymmetry is a condition where the agent has more information about the company and the company's prospects in the future than the principal. Management who wants to show good performance can be motivated to modify the financial statements in order to generate profits as desired by the owner. Information asymmetry between agent and principal can provide opportunities for managers to carry out earnings management.

However, Kusumawati, et al. (2013) revealed that information asymmetry has no effect on earnings management practices. Likewise, with the study of Suhendah & Imelda (2012) it revealed that information asymmetry has no effect on earnings management. Based on the above expectations, the research hypothesis is:

- H1: Information asymmetry has a positive and significant effect on earnings management.

2.3 Corporate governance

The Organization for Economic Cooperation and Development (OECD) states that corporate governance is a system that regulates and controls a company's business activities. Meanwhile, Boediono (2005) presents corporate governance as a set of regulations that establishes the relationship between principals, managers, creditors, government, employees, and the roles of internal or external stakeholders with respect to rights and obligations, in other words the system that directs and controls the company. The corporate governance elements consist of the proportion of the board of commissioners, the size of the board of commissioners and the existence of the audit committee.

The board of commissioner functions as a supervisor of the information quality contained in financial reports. Peasnell, et al. (2001) and Midiastuty & Machfoedz (2003) said that the existence of a board of commissioners could reduce earnings management practices. Similarly, it was revealed that the size of the board of commissioners had a negative effect on earnings management (Scott, 2006). Conversely, Midiastuty & Machfoedz (2003) asserted that the size of the board of commissioners has a significant positive effect on earnings management. Instead, Veronica & Utama (2005) and Boediono (2005) stated that the proportion of commissioners has no effect on earnings management practices.

In accordance with the Decree of the Chairman of the Indonesian Capital Market Supervisory Board no Kep. 29 / PM / 2004 dated September 24th, 2004 concerning the Establishment and Guidelines for the Implementation of the Audit Committee's Work was revoked and declared no longer valid. Meanwhile, the audit committee was by the established by the board of commissioners to oversee the company's management. Veronica & Bachtiar (2004), and Wilopo (2004) argue that the presence of an audit committee can effectively hinder the increase in earnings management in the company. In other words, the audit committee is able to negatively influence earnings management practices in the company.

Kamran & Shah (2014) also conveyed in their research that the GCG (Good Corporate Governance) mechanism has a negative and significant effect on earnings management. The effectiveness of GCG

is through the supervisory role carried out by the board of commissioners who has high independence. This is stated in the agency theory that independent commissioners are used as alerts to see management performance and behaviour. This supervision can prevent and reduce earnings management. This study is different from the research of Hermiyetti & Manik (2013), which stated that the size of the board of commissioners and the proportion of the board of commissioners have no significant effect on earnings management. The similar result is also shown by Al-Thuneibat, et al. (2016), which underline that corporate governance mechanism has no effect on earnings management. Based on the above expectations, the research hypotheses are:

- H2: Information asymmetry has a negative and significant effect on earnings management through the proportion of the board of commissioners.
- H3: Information asymmetry has a negative and significant effect on earnings management through board size.

2.4 Earnings management

Schipper (1989) states earnings management as disclosure management in the sense that management intervenes with a specific purpose in the external financial reporting process on purpose for personal gain. Positive accounting theory explains three hypotheses that encourage companies to implement earnings management, namely:

1. The bonus plan hypothesis reveals that company managers have a bonus program related to accounting figures that tends to adopt accounting procedures that shift earnings reporting from future periods to current year periods (increasing current reported earnings).
2. The debt covenant hypothesis is a condition in which companies that are threatened with violating debt covenant conventions tend to have accounting procedures that shift earnings reporting from the future period to the current year period.
3. The political cost hypothesis is a condition in which the greater the political costs faced by a company, the managers tend to choose accounting procedures that defer future earnings reporting to the current year period or reducing reported earnings now (Rahmawati, et al., 2006).

3. Operational Definition of Variables

3.1 Information asymmetry

Information asymmetry is a situation where managers have access to information on company prospects that are not owned by outsiders. Information asymmetry is measured using the difference between previous earnings and current year's earnings. So that it can be formulated as follows:

$$IA = P_t - P_{t-1} \qquad (1)$$

Notes:
IA - Information Asymmetry
P_t – Profit, year *t*
P_{t-1} – Profit, year *t-1*

3.2 Corporate governance

Corporate governance uses 2 indicators, namely the proportion of the board of commissioners and the size of the board of commissioners. The proportion of commissioners is measured using the percentage of the number of independent commissioners to the total number of commissioners in the board of commissioners of the sample companies. It can be formulated as follows:

$$PBC = \% \sum NIC \times \sum TNC \qquad (2)$$

Notes:
PBC - Proportion of the Board of Commissioners
ΣNIC - Number of Independent Commissioners
ΣTNC - Total Number of Commissioners.

The size of the board of commissioners is the number of members of the company's board of commissioners as measured by the total number of members of the company's board of commissioners. So that it can be formulated as follows:

$$SBC = \sum TNC \qquad (3)$$

Notes:
SBC - Size of the Board of Commissioners
ΣTNC - Total Number of Commissioners.

3.3 Earnings Management

Earnings management is measured using working capital accruals to sales or it can be formulated as follows:

$$EM = \frac{WCA}{S} \quad (4)$$

$$WCA = \Delta CA - \Delta CL - \Delta Cash \quad (5)$$

Notes:
EM - Earnings Management
WCA - Working Capital Accrual
S - Sales
ΔCA - Current Asset Change
ΔCL - Current Liabilities Change
ΔCash - Cash Change

4. Research Methodology

4.1 Research Samples

The sample of this research uses state-owned companies in Indonesia period of 2017 and 2018. The data collection technique uses purposive sampling. The criteria for taking the sample are as follows:

State-owned companies that have published annual reports for the years 2017-2018.

Availability of related data that is complete and in accordance with the variables to be studied during the 2017-2018 period.

Based on the characteristics of the sample selection above, 76 state-owned companies in Indonesia were obtained which will be used as samples in this study.

4.2 Methods of Data Analysis and Hypothesis Testing

The data analysis method in this study uses panel data regression analysis where the data used is panel data of state-owned companies in Indonesia period of 2017-2018. Data collection is done through each company website. The data analysis technique used the two-stage least squares (2SLS) method with the E-Views 9 program.

The regression equation in this study is:

$$EM_{it} = \beta_0 + \beta_1 PBC_{it} + \beta_2 SBD_{it} + \varepsilon_{it} \quad (6)$$

Notes:
EM - Earnings Management
PBC - Proportion of the Board of Commissioners
SBD - Size of the Board of Commissioners
AI - Information Asymmetry
ε- error
β_0 - constant
β_1 - coefficient 1
β_2 - coefficient 2
'i - company
't - time

5. Results and Discussion

Following are the results of data processing using the two stage least squares (2SLS) method:

Table 1
Test Results of the Two-Stage Least Squares (2SLS) Method

Variable	Coefficient	*Std. Error*	t-Statistic	Prob.
C	-39634.40	29138.84	-1.360192	0.1779
IA ➔ EM	3.96E-05	0.001576	0.025163	0.9800
AI ➔ PC	-3.04E-10	5.34E-10	-0.568966	0.5711
PC ➔ EM	625893.0	368569.0	1.698171	0.0937
IA ➔ SBC	6.15E-09	9.59E-09	0.641442	0.5232
SBC ➔ EM	27135.10	20533.96	1.321474	0.1905

Source: Data Processing Results of E-Views 9

Based on the results of the hypothesis test, it states that the probability of the variable value of information asymmetry on earnings management is not significant (0.9800> 0.05). This result means that hypothesis 1 (H1) is rejected, which means that information asymmetry has no effect on earnings management.

The results of this study are inconsistent with the research of Halim, et al. (2005) which states that information asymmetry has a positive and significant effect on earnings management. Based on the results of this study, it is found that different results indicate that state-

owned companies used as research samples where the agent and principal can access information with the same power. This results in the principal being able to supervise all activities carried out by agents in managing the management of state-owned companies. Therefore, the agent does not have the opportunity to take earnings management action.

The same thing conveyed by Hillman & Dalziel (2003) that the board of commissioners has an important role in controlling and supervising management and the formulation of company strategies. Fama (1980) also stated that the board of commissioners can be said to be the decision maker to replace or reshuffle top management. With the board of commissioners, management can obtain information to minimize information asymmetry and ultimately reduce earnings management (Rutherford, & Buchholtz, 2007).

The results of further study state that the probability of the variable value of the asymmetry of information on the proportion of the board of commissioners is 0.5711 (prob> 0.05) and the probability of the variable value of the proportion of the board of commissioners to earnings management is 0.0937 (prob> 0.05). This result can be interpreted that hypothesis 2 (H2) is rejected. In other words, the proportion of the board of commissioners cannot mediate the relationship between information asymmetry on earnings management. Therefore, information asymmetry does not affect earnings management through the proportion of the board of commissioners. Based on Agency theory, management consists of a board of commissioners who oversees performance and management behaviour as well as management quality audits. This role is performed to prevent and reduce earnings management practices. However, in relation to state-owned companies, where government ownership is often burdened with special missions beyond the achievement of profits, management must also pay attention to the parties related to the corporation widely so that the number of boards of commissioners in making decisions also considers various aspects of the operating environment.

These results are in line with the research of Veronica & Utama (2005) and Boediono (2005) which states that the proportion of the board of commissioners does not affect earnings management practices. The same thing is also expressed by Kamran & Shah (2014) who convey in their research that the Corporate Governance mechanism has a negative and significant effect on earnings

management. Hermiyetti & Manik (2013) and Al-Thuneibat, et al. (2016) underline that the Corporate Governance mechanism has no effect on earnings management. They explain that the Corporate Governance is carried out only as a form of company compliance with laws and government regulations. Therefore, Corporate Governance mechanism is ineffective and not optimal in the implementation of management supervision. However, the results of this study contradict Peasnell, et al. (2001) and Midiastuty & Machfoedz (2003), which revealed that the existence of a board of commissioners can reduce earnings management practices. In line with Yeung & Lento (2020) which also stated that Corporate Governance is able to decrease the earnings management.

The results of the next study state that the probability of the variable value of information asymmetry on the size of the board of commissioners is 0.5232 (prob> 0.5) and the variable value of the size of the board of commissioners on earnings management is 0.1905 (prob> 0.5). This result means that the size of the board of commissioners cannot mediate the relationship between information asymmetry on earnings management. Therefore, hypothesis 3 (H3) is rejected so that information asymmetry does not affect earnings management through board size. This is because state-owned company ownership is related to public funds so that agents must know the boundaries of ethical and moral, legal, government policies, environmental, social, cultural, political, and economic issues in making decisions. **(**Midiastuty & Machfoedz, 2003) state that the size of the board of commissioners has a significant effect on indications of earnings management carried out by agents. However, the results of this study are consistent with the research of Hermiyetti & Manik (2013) and Al-Thuneibat, et al. (2016) that Corporate Governance mechanism has no effect on earnings management.

5. Conclusion

This study aims to examine the effect of information asymmetry on earnings management through the proportion of the board of commissioners and the size of the board of commissioners as an intervening variable in SOE companies in Indonesia. Regression test result of panel data on 76 SOE companies during 2017-2018 shows that information asymmetry has no effect on earnings management and information asymmetry has no effect on earnings management

through the role of corporate governance, namely the proportion and size of the board of commissioners. Based on these results, it can be stated that the proportion of the board of commissioners and the size of the board of commissioners cannot reduce earnings management practices in SOE companies in Indonesia. This is because the SOEs' ownership is related to the public funds, so that agents must know the boundaries of ethical and moral, legal, government policies, environmental, social, cultural, political and economic issues in making decisions. The results of this study are in line with the study of Hermiyetti & Manik (2013) and the study of Sun & Al Farooque (2018) which stated that corporate governance has no effect on earnings management. However, the result of this study differs to the result of Peasnell, et al. (2001), Midiastuty & Machfoedz (2003), Wilopo (2004), Masulis, et al. (2007), Alareeni (2017) and Yeung & Lento (2020) which state that corporate governance is able to reduce earnings management practices. The limitations of this study refer to the short sample period, only two years, so that the results are not optimal. Therefore, further research should extend the research sample period in order to find out the role of corporate governance before and after the change of board of commissioners' regulations for SOE companies in Indonesia.

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