THE ANALYSIS OF EFFECTS OF *VOLUNTARY DISCLOSURE* TO THE RELATIONSHIP BETWEEN *CORPORATE GOVERNANCE* AND EARNINGS MANAGEMENT

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ABSTRACT

This study is aimed at examining the relationship between corporate governance mechanisms and earnings management with voluntary disclosure (voluntary disclosure) as a moderating variable. Corporate governance is proxied and measured by Managerial Ownership (MGR) Institutional Ownership (INST), board size (BSIZE), and the independent Commissioner (KI). Voluntary Disclosure of Earnings Management proxied in this study uses the value of discretionary accruals, and Voluntary Disclosure is proxied by the disclosure index. The population of this study is all listed manufacturing companies in Indonesia Stock Exchange from 2006 to 2011.

The results of this study are first, there is an empirical evidence to suggest that there are negative effects of discretionary accruals managerial ownership, institutional ownership and a positive influence on the size of the board of directors. Overall, these results are consistent with research conducted by Pranata (2003) and Rajgopal (1998) that managerial ownership and institutional ownership become a constraint on earnings management practice. Second, testing the relationship between voluntary disclosure mechanism between corporate governance and discretionary accruals indicate that the earnings management practices will be carried out if the company is getting a lot of information. These results are consistent with the research conducted by Aryati (2003). Third, the composition of the independent commissioner was not statistically significant to the earnings management measures, and voluntary testing of these revelations on the relationship between the practice of earnings management and corporate governance mechanisms remains to show that the composition of an independent commissioner is not significant. This gives evidence that the ineffectiveness of the company's independent commissioner.

KEYWORDS: Earnings management, Voluntary Disclosure, Corporate Governance

A. INTRODUCTION

Several accounting studies have examined the relationship between *corporate governance* mechanisms and earnings management. Warfield et al. (1995) found a negative relationship between managerial ownership and *discretionary accruals* as a measure of earnings management and a positive relationship between managerial ownership with the content of information in earnings. Midiastuty (2003) replicates the study by Warfield et al. (1995) that examined the relationship between *corporate governance* mechanisms and earnings management, and tested the quality of the reported earnings of the Indonesian capital market. *Corporate governance* mechanism is tested on managerial ownership, institutional ownership, board size and earnings management that affect the behavior and the quality of earnings. As a result, managerial ownership and institutional ownership are negatively related to earnings management, while the size of the board of directors is positively related to earnings management. The opposite result was found by Gabrielsen et al. (1999) who found a positive effect between managerial ownership on earnings management and information content of earnings by using the Danish stock market data, the opposite result may be caused by different ownership structures among companies in the United States and in Denmark. Ownership structure in Denmark is characterized by concentrated ownership structures, while in the United States it is pread further.

Khomsyiah (2003) provides an evidence of an association between the levels of implementation of *corporate governance* disclosure. Companies that implement *good corporate governance* will provide more information, in order to reduce information asymmetry. The information provided indicated the level of disclosure, the better the implementation of *corporate gorvenance* by a company, the more information is revealed. This study was aimed at examining the relationship between *corporate governance* mechanisms and earnings management with voluntary disclosure as a moderating variable. Research Trueman and Titman (1988) revealed that the information asymmetry is a necessary condition to perform earnings management. Richardson (1998) found an evidence that information asymmetry as measured by the difference in the supply and sale prices *(bid-ask spread)* and the difference with the predictions of analysts is positively related to the level of earnings management. Therefore, when information asymmetry is high, shareholders do not have the resources, encouragement, or access to relevant information to monitor the actions that can bring earnings management practices.

B. LITERATURE REVIEW

Jensen and Meckling (1976), and Scott (2000) describe the relationship of agencies as a relation that arise, because of the contract specified shareholder *(principal)* that uses the management *(agent)* to perform services of interest to *principal*, in this case there is a separation between ownership and control of the company's contractual relations to run smoothly, the principal will delegate decision-making authority to the agent, and this relationship also needs to be in a contract that typically use accounting figures stated in the financial statements as the basis. In terms of the contract appropriate to align the interests of *agents* and *principals* that will bring up a conflict of interest, this is what is at the core of agency theory (Scott, 2000) Healy and Wahlen (1998) reveal that earnings management occurs when certain management uses *judgment* in financial statements and transactions to alter financial reports as a basis for the company's performance that aims to mislead the owners or shareholders or to influence contractual outcomes that rely on accounting figures reported.

Corporate governance is a mechanism used to ensure that the shareholders of the company to obtain the return of the activities undertaken by the manager, or how shareholders exercise control over managers (Schleifer and Vishny, 1997). Khomsyiah (2003) conducted a study that examined the relationship of simultaneous implementation of corporate governance with the level of information disclosure in annual reports of public companies listed on the JSE. These results provide evidence of an association between the level of disclosure to the implementation of corporate governance, the better the implementation of Corporate Governance is done by a company, the more information is revealed. Conversely, companies that provide high disclosure in the annual report will show the implementation of corporate governance in the company. Information asymmetry that occurs between managers and shareholders as users of financial statements because shareholders can not observe all the performance and prospects of the company perfectly. In situations where the shareholders have less information than managers, managers can use the flexibility to perform *their owned earnings management.*

Trueman and Titman (1998) reveals that the asymmetry of information is a necessary condition to perform *Earnings management.* Richardson (1998) finds an evidence that information asymmetry, as measured by the difference in the supply and sale prices *(bid-ask spread)* and the difference with analysts' forecasts, is positively related to the level of *earnings management.* So, when information asymmetry is high, *stakeholders* do not have the resources, encouragement, or access to relevant information to monitor the actions of managers, who can bring the practice of earnings management. Based on some of the results of the above studies, alternative hypotheses formulated in this study are:

H1: **Managerial ownership, institutional ownership, size and composition of the board of directors of independent commissioners have a significant effect on *discretionary accrual***

H2: **With the voluntary disclosure it will reduce the association between *discretionary accruals* for managerial ownership, institutional ownership, size and composition of the board of directors of independent commissioners**

C. RESEARCH METHODS

1. Sample Selection

The data used in this study is a secondary data obtained from the annual report, the publication of the Business Data Centre Indonesia (PDBI), Capital Markets Data Center (PDPM), Gadjah Mada University Yogyakarta and other JSE publications includeing Managerial Ownership, size of the board of directors, Institutional Ownership, Independent Commissioner, financial statement data to calculate *discretionary accruals and non-discretionary accruals, market value of equity, leverage, earnings before extraordinary items, earnings per share* and *net income,* voluntary disclosure of *data.* The population of this study is all listed manufacturing companies in Indonesia Stock Exchange (ISE) from 2006 to2011. The sampling technique was done by using *purposive sampling.*

1. Independent Variables

Mechanism Corporate governance is proxied and measured:

- Managerial ownership (MGR) is the percentage of shares owned by management who actively participates in decision-making process (commissioners and directors)
- Institutional ownership (INST), ie the percentage of shares owned by institutional investors. Institutional bias comes from the government or non-government as a company that has a great importance to the investment
- Size of the board of directors (BSIZE), ie the number of board members
- The Independent Commissioner (KI), the number of independent commissioners who joined the company commissioner. This study uses a dummy variable that is 0 for the companies with independent ownership and 1 for the commissioner which does not have.

2. Dependent Variable

Earnings Management can be achieved from a variety of events, such as the value of discretionary accruals or change in method of accounting. This study used a value of discretionary accruals. It used the Modified Jones' model (Dechow, 1995) to measure the level of earnings management or discretionary accruals (DTAC). This model uses total accruals (TAC) classified as discretionary component (DTAC) Dannon discretionary (NDTAC). It is defined as follows:

TAC = NDTAC + DTAC TAC = + DTAC NDTAC

The first step taken for the measurement of *discretionary accruals* is the value of total accruals as the dependent variable in the regression aimed at getting the parameters for calculating the non-discretionary accruals value.

TAC = net income *(net income)* - Operating cash flow *(cash flow from operation)* ..... (1)

Next is to compute non-discretionary accruals estimated using the model of Jones (1991) estimated by OLS regression equation: The total value of the accrual of the estimated *OLS* regression equation as follows:

$$\mathbf{TAC_t / N_{t-1} = a_1 [1/TA_{t-1]} + a_2 [\Delta\, REV_t / N_{t-1]} + a_3 [PPE_t / N_{t-1]} + \varphi \ldots\ldots\ldots (2)}$$

By using the above regression coefficients, it can be determined parameters ($a_{1,}$ a_2 and $a_{3)}$ of each company. The value of *non-discretionary accruals* (NDTAC) can be calculated by the formula:

$$\mathbf{NDTAC = a_1 [1/TA_{t-1]} + a_2 [(\Delta_t\, REV - REC\ \Delta_{t)} / N_{t-1]} + a_3 [PPE_t / N_{t-1]} \ldots\ldots (3)}$$

$$\mathbf{DTAC = TAC_t /TA_{t-1} - TAC\ DTAC = {}_t / N_{t-1} - NDTAC \ldots\ldots (4)\ NDTAC \ldots\ldots\ldots (4)}$$

Where:
TAC = total *accruals* in period t
NDTAC= Value of *non-discretionary accrual*
DTAC= *Discretionary accrual*
ΔREV $\mathbf{\Delta_t}$ = Changes in net sales in the period t
ΔREC $\mathbf{\Delta_t}$ = Changes in net receivables in period t
PPE = *Property, Plan, and Equipment*
$\mathbf{a_1\ a_2\ a_3}$ = coefficient of regression equation (2)
$\mathbf{a_1\ a_2\ a_3}$ = *Fitted coefficient* obtained from the regression equation (2)

3. Moderating Variables

Voluntary Disclosure
For each sample firm, voluntary expression index is obtained by comparing scores with the scores obtained by the company that may be acquired. The company was given a score of 1 if it expresses items of information in the instrument and given score 0 if it is not revealed.

Method of Data Analysis

Normality Test was done prior to hypothesis testing, to determine the distribution of the data to test the model Kolmogorov Smirnov normality. **Regression Model** study used multiple regression to examine the relationship between the dependent variable, moderating variable and independent variable.Overall, the *OLS* regression equation models used are:

Model analysis for *Discretionary Accruals*

$$DTAC_{i,t} = \alpha_0 + \alpha_1 MGR + \alpha_2 INST + \alpha_3 BSIZE + \alpha_4 CI\ \upsilon_{it} \ldots.(6)$$

Model analysis for the three components of *corporate governance* and earnings management are moderated by the voluntary disclosure.

$$DTAC_{i,t} = \gamma_0 + \gamma_1 MGR + \gamma_2 INST + \gamma_3 BSIZE + \gamma_4 CI + \gamma_5 index + \gamma_6 index * MGR + \gamma_7 index * INST + \gamma_8 index * BSIZE + \gamma_9 index * CI + \varepsilon_i \ldots\ldots. (7)$$

D. Results

Descriptive Statistics

The result of the normality test shows that significant *Kolmogorov-Smirnov*> 0.05 for institutional *ownership.* So it can be concluded that the data were normally distributed in this study only for institutional ownership data, while discretionary accruals and managerial ownership and board size were not normally distributed. If the data by the number N> 30 was not normally distributed by *Central Limit Theorems,* then testing can be obtained by using parametric test. (Gujarati, 2004) Since all probabilities are below 0.05 unless the composition of an independent commissioner, it means that the correlation between *discretionary accruals* with managerial ownership and institutional ownership and board size shows a negative relationship, meaning that managerial ownership, institutional ownership and board size the higher the discretionary accrual will be smaller and vice versa.

Hypothesis Test 1

This hypothesis was tested by using multiple regression test that showed the value of $_{\text{t-test}}$ for *accrual discretionarry* the managerial ownership is 0.451 with a *probability value* = 0.000 two-sided. The effect was statistically significant at the level of 0.05. *Discretionarry accrual* demonstrates the value of institutional ownership as 1.324 with a $t_{\text{-test}}$ *probability value* = 0.044 two-sided. The effect was statistically significant at a level of 0.05. Coefficient indicates a negative value is -1.120, which means that the direction is negative. The effect was statistically significant at the level of 0.05. This means that statistically favor the alternative hypothesis, that there is a negative effect of *discretionary accruals* on Institutional Ownership. *Discretionarry accrual* of property size board shows the value of $_{\text{t-test}}$ with a *probability value* = 0.761 0.012 two-sided. The effect was statistically significant at a level of 0.05. Coefficient indicates a positive value as 0.067. This result means that it statistically favor the alternative hypothesis, that there is a positive effect of *discretionary accruals* on Board Size, while *discretionarry accrual* to independent commissaries $t_{\text{-test}}$ showed the value of -1.61 with a *probability value* = 0.873 two-sided. This result means that statistically it does not support the alternative hypothesis, that there is no effect of *discretionary accruals* on the composition of an independent commissioner.

Testing Hypothesis 2

This hypothesis was tested by multiple regression test that showed the value of $_{\text{t-test}}$ for the *accrual discretionary* for managerial ownership, institutional ownership, and board size was statistically significant less than 0.05. The effect was statistically significant at the level of 0.05. With the moderating variables, ie voluntary disclosure to *discretionarry accrual* for institutional ownership, managerial ownership, board size showed a statistically significant influence on the whole below 0.05, at a rate of 0.05. This result means that statistically it favors the alternative hypothesis, namely *discretionary accruals* as a voluntary disclosure is smaller. However, the composition of independent commissioners remained statistically significant above 0.05 or not statistically significant.

Discussion

The results indicate rejection of the null hypothesis that the empirical evidence supports the alternative hypothesis that there is a significant influence on the mechanisms of *discretionary accruals* for govenance corporate or managerial ownership, institutional ownership and the size of the board of directors, while the composition of an independent commissioner shows that it supports the null hypothesis or not there is an influence between the accrual discretionary composition of an independent commissioner. These results are consistent with the results of the research conducted by the Flower Institutions (2003), from the results of testing the dependent variable *(discretionary accrual)* with managerial ownership, institutional ownership and the size of the board of directors showed a negative effect. These results suggest that managerial ownership in Indonesia to become good corporate governance mechanisms that can reduce the problem of misalignment between the interests of managers with owners or shareholders. These results are also consistent with the research conducted by Jensen and Meckling (1976) and Warfield et al (1995) in the United States.

For managerial ownership this study is consistent with the results of the study by Pranata (2003) which proved that Institusonal Owners also have a significant negative effect on *discretionary accruals.* It means that the greater the number of board of directors is, the higher the earnings management is. It means that the small size of the board of directors will be more effective in carrying out the functions of monitoring over financial reporting, thereby reducing the incentive for managers to manipulate earnings. These results are also consistent with the research done by Jensen (1993) and Vafeas (2000). The composition of independent commissioner showed no significant results. It means that the composition of an independent commissioner can not be used as a tool to prevent opportunistic managers from performing actions. This is because in Indonesia the number of independent commissioners composition may not affect the company's performance, consistent with the results of the research by Aryati (2005) which states that the independent commissioner is not able to affect the company's financial performance, even in Indonesia there are still many companies that do not have an independent commissioner The results of testing the second hypothesis implies that it statistically supports an alternative hypothesis, namely the smaller *discretionary accruals* as a voluntary disclosure. However, the composition of an independent commissioner remains statistically insignificant despite voluntary disclosure. These results are consistent with the result of the research by Veronica (2003) that prove that the disclosure of financial statements has a significant negative correlation. Companies with low levels of disclosure tend to do a lot more earnings management and vice versa, the company does a lot of earnings management tend to disclose less information.

E. Conclusion

Based on the hypothesis testing and discussion, it is concluded as follows. **First,** there is an empirical evidence that supports the alternative hypothesis, which states that there is a negative effect of discretionary accruals on managerial ownership, institutional ownership and a positive effect on the size of the board of directors. Overall, these results are consistent with the researches conducted by Pranata (2003), Rajgopal (1998), and Jensen and Meckling (1976) mentioning that managerial ownership, institutional ownership as a constraint on earnings management practice. **Second,** the relationship testing between voluntary disclosure mechanism *corporate governance* and *discretionary accruals* indicates that the practice of earnings management will be smaller if the company is getting a lot of information. These results are consistent with the research conducted by Aryati (2003). **Third,** the composition of the independent commissioners was not statistically significant to the earnings management measures, and voluntary testing of these revelations on the relationship between the practice of earnings management and corporate governance mechanisms remains to show that the composition of an independent commissioner is not significant. This gives an evidence of the ineffectiveness of the company's independent commissioner.

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Correlation

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Stand. Coefficients Beta	t	Sig.
1	(Constant)	-.134	.066		-2.032	.445
	MGR	-8.765	1.276	-1.041	.451	.000
	INST	-10.447	7.894	-1.120	1.324	.044
	BSIZE	4.897	3.245	.067	.761	.012
	CI	-.007	.041	-.014	-.161	.873

Testing Hypothesis 1

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Stand. Coefficients Beta	t	Sig.
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	MGR	-8.765	1.276	-1.041	.451	.000
	INST	-10.447	7.894	-1.120	1.324	.044
	BSIZE	4.897	3.245	.067	.761	.012
	CI	-.007	.041	-.014	-.161	.873

Testing Hypothesis 2

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Stand. Coefficients Beta	t	Sig.
1	(Constant)	-.096	.056		-.708	2.090
	MGR	.768	.803	-.042	-.296	-.001
	INST	.204	.601	.175	.277	.001
	BSIZE	.180	.587	.160	.350	.012
	CI	.236	.749	-.155	-.192	-.059
	Inter MGR	.628	.603	.071	.486	.002
	Inter BZISE	.591	.601	-.100	-.539	-.001
	Inter INSZ	.473	.711	-.127	-.721	-.008
	Inter CII	.305	.130	.141	.030	.134