The Effect of Profitability, Financial Leverage, and Accounting Expertise of The Board of Commissioners on Earnings Management

Dwi Marlina Wijayanti

1Department of Islamic Accounting, Faculty of Islamic Economics and Business, UIN Sunan Kalijaga Yogyakarta

Corresponding author: dwi.wijayanti@uin-suka.ac.id

Abstract

Purpose: This study examines the impact of profitability, financial leverage, and accounting expertise of the board of commissioners on earnings management practices. Earnings management is a serious problem for some companies with unstable financial conditions. Therefore, it is important to know the factors that can encourage earnings management.

Methodology: This research is quantitative research. The sample in this study were 92 manufacturing companies listed on the IDX in 2015 – 2019. Data analysis used panel data regression through E-views.

Findings: The results of this study indicate that profitability and financial leverage are determinants of earnings management. Other results show that the accounting expertise of the board of commissioners has no effect on earnings management practices.

Novelty: Most of the previous research focused on the aspect of the number of the board of commissioners in mitigating earnings management, this study tries to analyze a more specific factor, namely the accounting expertise of the board of commissioners because board members who understand accounting will more easily find errors in financial statement disclosures.

Keywords: Leverage, Earnings Management, Profitability, Financial leverage, Accounting Expertise

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Introduction

Currently, earnings management is the center of great attention among accounting practitioners. Many major accounting scandals are related to earnings management practices and this is an act that cannot be justified because it resembles fraud such as Enron case. Fudenberg & Tirole (1995) mentions that earnings management is a deliberate fraud by manipulating the timing of revenue recognition and expenses to achieve a stable level of income. Earnings management can be identified as a deliberate intervention in the financial reporting system for personal gain (Saona, 2019). Earnings management practices have led to some companies going bankrupt and will be more detrimental to the company and its shareholders and creditors in the future if no restrictions are issued and enforced to reduce the practice (Obeidat, 2021). In fact, earnings management affects the decision-making process by all company stakeholders, including investors, regulators, and analysts (Reguera-alvarado et al., 2019). Therefore, earnings management is of great concern to corporate stakeholders and is commonplace in today's business world.
Previous research has tried to explore the factors that can affect earnings management. The first factor is profitability. Profitability is the company's ability to generate profits and is one of the considerations for investors in choosing a company to invest in (Bora & Saha, 2015). According to Yanti & Dwirandra (2014), companies that have a high profitability value tend to practice earnings management, because the profitability value of a company can reflect the company's performance. Shareholders want profitability that always increases while management wants profit maximization to be done through compensation contracts (Mitnick, 2011). In addition, a manager must also consider the information received properly and carefully so that the financial statements presented can be accepted by stakeholders (Douthit & Majerczyk, 2019).

In addition to profitability, the second factor that can affect earnings management is financial leverage. The financial leverage ratio shows the proportion of the use of debt in financing the investments made. If the debt it has is getting bigger, then the risk borne by the company will also be greater, so investors will ask for big profits too so that the company will carry out earnings management because companies that have high leverage values can be said to be threatened with default (Rasinih & Munandar, 2016). Indrawan & Damayanti (2020) states that the greater the liability of the company, the higher the risk borne by investors. But if the company has a relatively stable profit, the company can be said to have a small risk (Nalarreason et al., 2019). Companies that have a high level of financial leverage will make managers carry out policies that can stabilize earnings, namely earnings management (Dewantari & Badera, 2015; Yogisworo et al., 2018).

In addition to financial factors, good corporate governance practices are also required through the accounting expertise possessed by the board of commissioners. The board of commissioners as the party that monitors the financial statements will be able to carry out their duties properly when there is an interaction between the board of commissioners who have accounting expertise and the board of commissioners who have financial expertise. This is due to the background of the board of commissioners who have accounting skills will be better able to find irregularities in the financial statements. Al-absy et al. (2017) and Dwiharyadi (2017) mentioned that the accounting expertise of the members of the board of commissioners and the financial expertise of the members of the board of commissioners have a negative effect on the company's earnings management (Dwiharyadi, 2017). Accounting expertise of the members of the board of commissioners and the financial expertise of the members of the board of commissioners have a negative effect on the company's earnings management.

Based on the explanation above, this study tries to prove the influence of profitability, financial leverage, and the accounting expertise of the board of commissioners on earnings management practices. This research also contributes practically and theoretically.

**Literature Review**

**Earnings Management**

Earnings management is a form of earnings manipulation that can reduce the reliability of earnings. The lower the revenue reliability, the less useful company data is (Khosheghbal et al., 2017). Gunawan & Hardjunanto (2020) mentions that earnings management is the practice of manipulating earnings to even out the level of profit so that a company can be said to be normal. Companies often carry out earnings management through a pattern of increasing profits when the company’s performance decreases, while in companies that report taxes, companies carry out earnings management by lowering profits, so that less taxes are paid. (Syahirah & Mohd 2017).

The emergence of earnings management can be explained by using agency theory. The agency conflict in question is the action of the management that meets the expectations and sacrifices the interests of the shareholders or principals. According to Moloi & Marwala (2020), Agency conflict can occur because it is caused by moral hazard. Moral hazard is an action taken by an agent in a transaction that affects the principal's assessment, but the principal is not able to supervise the activity (Rivera,
2020). Agency theory is important because it has a role to determine the optimal contract to regulate the relationship between shareholders and management and reduce earnings management actions in the business world (Yimenu & Surur, 2019).

**Profitability**

The profitability value is used as a parameter in measuring the company's performance. The relationship between profitability and earnings management occurs when the profitability obtained by small companies will force the company to take steps to practice earnings management by increasing the income earned and vice versa (Aghnitama et al., 2021). The size of the profitability of a company shows how much the company's ability to get the profits from the investments made (Bestivano, 2018).

According to agency theory, the relationship between profitability and earnings management occurs when the company can generate profits well then shareholders know the source of profitability received from sales or company investment activities (Fitriani, 2018). Companies with high profitability tend to practice earnings management compared to companies with low levels of profitability. This happens because profit is fundamental for companies to achieve going concern (Thoharo & Andayani, 2018). Dewi & Latrini (2016) mentions that high profitability indicates that the company has a good and stable performance in generating profits so that earnings management practices are chosen to ensure that the profits earned every year have a stable positive trend. Yanti & Dwirandra (2014), Maotama & Astika (2020), and Indrawan & Damayanthi (2020) in his research found the same results, namely profitability has a positive effect on earnings management. Therefore, the hypothesis is formulated as follows.

**H1=** Profitability has a positive effect on earnings management

**Financial Leverage**

Financial leverage is the company's obligations to other parties that have not been fulfilled (Wijayanti et al., 2008). Companies that have high leverage values will carry out earnings management because they are threatened with default (Rasinih & Munandar, 2016). If the debt owned by the company is large, the risk borne by the company will also be greater (Cahyani, 2019). This makes investors ask for large profits as well. Therefore, the company will carry out earnings management to reduce the financial leverage ratio (Kasmir, 2011). The higher the financial leverage of a company, the higher the risk obtained, because the company still has obligations that must be completed. This causes management to make policies to increase company profits (Budiasih, 2009). If the company's debt is high but the profit earned is stable, then investors think that the company is able to manage its debts (Gunawan & Hardjunanto, 2020). Therefore, the financial leverage ratio shows the proportion of the use of debt in financing the investments made. The results of previous research conducted by Doidge et al. (2020) mentions that financial leverage has a positive effect on earnings management. Therefore, the hypothesis is formulated as followst.

**H2=** Financial Leverage has a positive effect on earnings management

**Accounting Expertise of Board of Commissioners**

The board of commissioners must practice good corporate governance because it has the responsibility to advise and supervise the board of directors (Sari, 2017). Therefore, accounting expertise is needed to be able to carry out the functions of the board of commissioners properly. Hariani et al. (2020) mentions that the expertise that is directly related to the financial statement cycle and accounting policy is accounting expertise. To know and understand the company's financial reporting, the board of commissioners must have expertise in accounting or finance so that shareholders receive reliable information from management. Supported by the results of research conducted by Hariani et al. (2020) which states that the accounting expertise of the board of commissioners has an effect on
earnings management. Likewise with research Dwiharyadi (2017) which proves that the accounting expertise of the members of the board of commissioners and the financial expertise of the members of the board of commissioners have a negative effect on the company's earnings management. According to Demerjian et al., (2020), high ability of the board of commissioners will have superior business knowledge and more easily detect unethical practices. Therefore, the hypothesis is formulated as follows.

H3= Board of commissioners' accounting expertise has a negative effect on earnings management

The rationale that drives or underlies a company to implement a hedging policy is financial distress. There are two indicators that can be raised in the rationale of financial distress, namely the leverage ratio and the profitability ratio. Second, the rationale that drives or underlies a company to implement a hedging policy is the underinvestment problem. The researcher chose firm size as an indicator for the rationale for the underinvestment problem. Third, the rationale that drives or underlies a company to implement a hedging policy is the asset substitution problem. Researchers choose liquidity as an indicator for the rationale for the asset substitution problem.

**Leverage and Hedging Decisions**
Leverage is defined as a ratio to calculate or measure the extent to which the company is able to manage its funding through debt. In this study, the calculation of leverage is carried out using the Debt to Equity Ratio (DER), which is the ratio used to see how far the use of equity is to the company's long-term debt. When there is an increase in DER, it means that the proportion of equity funds used is greater. Research by Saraswati and Suryantini (2019), Hadinata and Hardianti (2018), Ariani and Sudiartha (2017) and Dewi and Purnawati (2016) shows that leverage has a positive effect on hedging decisions. This means that when the level of the leverage ratio is getting bigger, the tendency to use hedging policies will also increase. Based on the description above, the hypothesis on this variable is:

H1: Leverage has a positive influence on hedging decisions.

**Company Size and Hedging Decisions**
Company size is defined as the classification or classification of companies based on the total number of assets recorded. Calculation of company size is carried out using the natural logarithm of total assets (LnTA). Research conducted by Saraswati and Suryantini (2019), Megawati et al. (2016), and Guniarti (2014) get the results that the relationship between firm size and hedging decisions is significantly positive. This means that when the size of the company gets bigger, the tendency to use hedging policies will also increase. Based on the explanation above, the hypothesis on this variable is:

H2: Firm size has a positive effect on hedging decisions.

**Profitability and Hedging Decisions**
Profitability is defined as a measure of how capable the company's resources are to generate profits. Profitability calculations are carried out using Basic Earning Power (BEP) with the aim of knowing how much the company's ability to maximize profit before interest and taxes from all company operations with total own capital. Several previous studies have shown that profitability has a significant positive relationship to hedging decisions, including Saraswati and Suryantini (2019), Hadinata & Hardianti (2018), and Jiwandhana and Triaryati (2016). Based on this, the hypothesis for this variable is:

H3: Profitability has a significant positive effect on Hedging Decisions.

**Liquidity and Hedging Decisions**
Liquidity is defined as a ratio that shows how capable the company's short-term obligations can be paid using current assets. In this study, the calculation of liquidity is carried out using the current ratio (CR), where current assets are divided by current liabilities. Research conducted by Hadinata and Hardianti
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(2018), Ariani and Sudiartha (2017), Aslikan and Rokhmi (2017), Guniarti (2014), and Ameer (2010) shows that the liquidity ratio has a significant negative effect on hedging decisions. This means that a high liquidity ratio is inversely proportional to the possibility of companies using hedging policies. Based on the explanation above, the hypotheses for this variable are:

H4: Liquidity has a significant negative effect on Hedging Decisions.

Methodology

This study uses quantitative methods through a correlational approach (correlational research). The object of this research is a manufacturing company listed on the Indonesia Stock Exchange (IDX). The type of data in this study is secondary data, namely data obtained by researchers indirectly. Secondary data can be in the form of historically structured records or reports. The data is obtained from the annual reports of manufacturing companies listed on the Indonesia Stock Exchange (IDX) from 2015 to 2019. The annual reports are obtained from the IDX website with the website address www.idx.co.id. The hypothesis testing method in this study uses panel regression analysis and is tested using the EViews (Econometric Views) application.

Variabel Measurement

The dependent variable is the dependent variable or its value has been influenced by other variables. This study uses the dependent variable in the form of earnings management. Earnings management in this study is calculated using the Jones Model (1991) which estimates descretionary accruals (DA) containing the characteristics of accruals derived from management opportunism. So to measure earnings management the following model is used:

$$\frac{TAC_{it}}{TA_{it-1}} = \beta_1 \left(\frac{1}{TA_{it-1}}\right) + \beta_2 \left(\frac{\Delta S_t}{TA_{it-1}}\right) + \beta_3 \left(\frac{PPE_{it}}{TA_{it-1}}\right) + \varepsilon_{it}$$

Information:

$TAC_{it}$ = Income before extraordinary items minus cash flow from operations

$TA_{it-1}$ = Total assets in the last one year

$\Delta S_t$ = Revenue in year t minus revenue in year l

$PPE$ = Gross property, plant and equipment in year t

$\varepsilon_{it}$ = Regression error condition

The independent variables in this study are Profitability, Financial Leverage, and Accounting Expertise of the Board of Commissioners. Profitability in this study was measured using Return on Assets (ROA). ROA is often used as a tool to measure the rate of return on total assets after interest and taxes (Heikal, 2014). In this study, the following formula is used to calculate Return on Assets.

$$ROA = \frac{Net \ profit}{Asset \ Total}$$

Financial Financial leverage is the use of company funds with a fixed burden which is expected to increase earnings per share for the use of these funds (Lestari & Murtanto, 2017). Financial leverage in this study is measured by the following formula:

$$Financial \ leverage = \frac{Liability \ Total}{Asset \ Total}$$

The accounting expertise of the board of commissioners, as the third independent variable, is measured by using the ratio of the board of commissioners who have financial expertise to the number of boards of commissioners in the company (Dwiharyadi, 2017).
\[ KA = \frac{x}{y} \]

Information:

- \( KA \) = Board of commissioners ratio
- \( x \) = Board of commissioners with accounting expertise
- \( y \) = Number of commissioners

Results and Discussion

The data in this study were obtained through the financial statements of manufacturing companies listed on the BEI. The year of observation carried out is 5 years from 2015 to 2019. Based on the results of data collection, obtained 92 manufacturing companies whose data can be processed. Several companies were removed from observation because they did not meet the researcher's criteria, namely the incomplete information presented or the unpublished financial statements. Based on these 92 manufacturing companies, the total observations are 460 data. The data in this study is in the form of panel data. The following are the results of hypothesis testing using panel data regression.

### Table 1. Panel Data Regression Results

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROF</td>
<td>0.159045</td>
<td>0.015502</td>
<td>10.25950</td>
<td>0.0000</td>
</tr>
<tr>
<td>LEV</td>
<td>0.005517</td>
<td>0.002523</td>
<td>2.186852</td>
<td>0.0293</td>
</tr>
<tr>
<td>AE</td>
<td>-0.001624</td>
<td>0.007674</td>
<td>-0.211669</td>
<td>0.8325</td>
</tr>
<tr>
<td>C</td>
<td>-0.012208</td>
<td>0.003570</td>
<td>-3.419144</td>
<td>0.0007</td>
</tr>
</tbody>
</table>

Source: The Processed Data

Based on table 1, profitability has a coefficient of 0.159045 with a probability of 0.0000. This shows that profitability has a positive effect on earnings management. The higher the profitability obtained by the company, the higher the agent performs earnings management. Furthermore, financial leverage has a coefficient of 0.005517 with a probability of 0.0293. That is, financial leverage has a positive effect on earnings management. The higher the level of leverage owned by the company, the more likely the agent to perform earnings management. Finally, the accounting expertise of the board of commissioners has a coefficient of -0.001624 with a probability of 0.8325. These data indicate that the accounting expertise of the board of commissioners has no effect on earnings management.

The results of data processing also show \( R^2 \) data which explains the magnitude of the combination of independent variables that together affect the value of the dependent variable. The number \( R^2 \) is between 0 and 1. The closer to the number 1, the better the combination of the proposed research model. This result is quite low. Here are the results of the \( R^2 \) test in this study.

### Table 2. Test result of \( R^2 \) test

<table>
<thead>
<tr>
<th>( R^2 )</th>
<th>0.188512</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted ( R^2 )</td>
<td>0.183162</td>
</tr>
</tbody>
</table>

Source: The Processed Data

Finally, the researcher saw the results of the F test which was intended to see the results of the simultaneous test between the independent variable and the dependent variable. The results show that the probability is 0.000000, which means that the dependent variable is significantly affected by the independent variables together. Here are the results of the F test.

### Table 3. F-Test Result

<table>
<thead>
<tr>
<th>( F )-statistic</th>
<th>35.23285</th>
</tr>
</thead>
<tbody>
<tr>
<td>( Prob(F\text{-statistic}) )</td>
<td>0.000000</td>
</tr>
</tbody>
</table>

Source: The Processed Data
Discussion

This study examines the effect of profitability, financial leverage, and the accounting ability of the board of commissioners on earnings management practices. The test results show that profitability has a positive effect on earnings management. These results support the research conducted by Yanti & Dwirandra (2014), Maotama & Astika (2020), and Indrawan & Damayanthi (2020). Previous research states that the higher the profitability obtained by the company, the more managers will try to reduce the level of profitability so that it is not too significantly different from the previous year. This happens because of the agency's interests described in agency theory. One measure of manager's performance is the level of profitability generated so that managers will prefer a positive upward trend but remain stable. This is triggered by the manager's opinion that achieving profits that are too high for the following year is difficult. Therefore, having a stable and non-fluctuating profitability is the best choice for managers. This led to the emergence of earnings management practices.

Other results show that financial leverage has a positive effect on earnings management. These results are in line with research conducted by Kasmir (2011), Budiasih (2009), and Doidge et al. (2020) who succeeded in proving that the higher the financial leverage, the higher the earnings management practice. Companies that have a high level of financial leverage will tend to practice income smoothing to make profits look more stable (Rasinih & Munandar, 2016). This is inseparable from the agent's interest in managing the company so that it looks good in the eyes of investors or company owners. Agency theory has explained that conflicts of interest will lead to conflicting behaviors between agents and principals.

The test results also show that the accounting expertise of the board of commissioners has no effect on earnings management. This result contradicts the research conducted by Hariani et al. (2020) and Dwiharyadi (2017). The board of commissioners with accounting background is not enough to be a factor that reduces earnings management. This happens because of the different division of tasks in supervising the main functions of the company which are often different from the expertise possessed. In addition, the board of commissioners who have accounting expertise are quite few in several companies so that they are still less effective in mitigating earnings management. Another reason is the involvement of the board of commissioners in several company committees which are prone to conflicts of interest.

Conclusions

This study aims to explore factors that can improve earnings management practices as well as factors that can mitigate earnings management using profitability, financial leverage, and the accounting expertise of the board of commissioners. Based on the analysis, profitability and financial leverage can encourage managers to perform earnings management. This is due to the agent's interest in evaluating the manager's performance. Managers prefer a steady upward trend in profitability over volatile gains. The reason is because the current performance will be compared with the past performance. An increase that is too high will make it difficult to achieve and even surpass this achievement in the following year. Likewise with financial leverage, companies with high financial leverage ratios are more risky and are avoided by investors. This causes the company to be able to control the level of leverage to normal limits in order to still be able to show good debt performance. Therefore, if the value of financial leverage increases, the company will try to reduce the ratio by doing earnings management. The interesting thing that is known through statistical testing is that the accounting expertise of the board of commissioners is not able to reduce earnings management practices. This can be caused by several factors including the not yet optimal number of members of the board of commissioners with accounting backgrounds and there are several boards of commissioners who have duality within the company, causing conflicts of interest.
This study also has limitations, namely not testing internal factors that can reduce earnings management practices. Further research is expected to develop this research to be more complete by comparing internal and external factors that affect earnings management. Nonetheless, this study contributes theoretically related to the addition of earnings management literature. Practically, this research is a suggestion for investors to be more careful in owning a company by looking at the real performance and moral hazard that may occur.

References


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