The Role Of Good Corporate Governance In Minimizing Earning Management To Increase Value Of Firm

Mardiani Tanjung, Sucherly, Sutisna, Rahmat sudarsono

Abstract: The theory of an agency problem describes about the conflict of the agent's interests and the principal which influence the value of a firm. The gap of information between them puts an agent in certain places to become more superior than the principal to do earning management. Good corporate governance is as a controlling mechanism and a balancing system in the company in accommodating the interest of the agent and the principal. The purpose of this paper is to present a conceptual model of best corporate governance role, earning management, the value of the firm by adding a compensation as another variable to minimize earning management. Good corporate governance consists of the three mechanisms which are Institutional shareholders, Independent commissioner and executive compensation.

Keyword: Good corporate governance, earning management, value of firms

Introduction

In the process of maximizing a value of the company, there would be the conflict of interests between managers and shareholders (owners of the company), often called the Agency Problem. It happens due to the fact that managers give priority to personal interests. On the contrary, shareholders do not like the self-interests of the managers. It can increase the cost of the company, result in a decrease in corporate profits and effect on stock prices, thus lower the value of the company (Value of the Firm), (Jensen and Meckling 1976). Nevertheless, the information gap between the Manager and the Principal (Shareholders) has made a party manager tend to be more superior in the control of the information. The existence gap of information between the agent and the principal will give the opportunity to the manager to perform Earnings Management (Richardson, 1998). Earnings management is the selection of accounting policies in the preparation of the financial statements by the management to achieve certain goals (Scott, 2009). Earnings management is done by abusing accrual components in the financial statements. Efforts to eliminate Earnings Management in the management of the business world is by realizing good corporate governance, which is expected to seek a balance between the various interests that can provide benefits for the company as a whole and ultimately increase the value of the firm. The purpose of this paper is to provide a conceptual overview of the relationship between Good corporate governance, Earnings Management, and Value of the firm.

Literature Review

Agency Theory

Jensen and Meckling (1976) look at the contract between shareholders and managers as an agency relationship (Agency Relationship), which is the principals as shareholders that have an authority of a manager as an agent to manage the company on behalf of shareholders. The manager assumed to obtain a satisfaction that can be got in the form of money (pecuniary Benefits) and in the form of non-finance (Non pecuniary Benefits) eg relaxing at work, wasting of corporate finance for their own interests. The Satisfaction of a non-productive and a non-financial nature, then these activities will result in the value of the company down and of course in this case the shareholders harmed.

- *Mardiani Tanjung, Sucherly, Sutisna, Rahmat sudarsono*
  Padjadjaran University, Bandung, Indonesia

Earnings Management

In general, there are two types of earnings management (Earnings Management), they are an accrual-based earnings management and a real operation earnings management, Khotary et al. (2005). Earnings management is an ability to increase or decrease a net income report. It means that earnings Management includes a business management to maximize or minimize an income, and an income smoothing in accordance with the wish management. Earnings Management influences investors' perceptions, especially in influencing a buying decision, it can be affected by the value of a stock company and the company itself. Mulford and Comiskey (2002), citing various definitions of Earnings Management as follows:

1. The reflection of earnings Management is carried out to improve the impression of a performance company, it is not intended to obscure the meaning profit, Eg Earnings Management is conducted to obtain a realistic profit and it can be used as an earning indicator in the future. In addition, this definition does not specify whether earnings management is harmful or beneficial to investors.
2. A broader definition in which management uses a flexibility in choosing an accounting policy within the scope which is permitted by the accounting standard to maximize their interests. This definition means indicates that it is important to consider managerial incentives that lead to a behavioral manipulation. In a certain limit the practice of earnings management is not disputed by the Security and Exchange Commission (SEC)
3. Earnings Management can lead to the wrong interpretation of a company's performance. This

type may cause the problem and could receive sanctions from the SEC. It means that earnings Management is treated as a fraudulent behavior in manipulating earnings designed to serve the management's purpose. The role of the SEC and the regulatory agency is to detect whether a company doing earnings management or not, and whether it still can be tolerated or not. (Mulford and Comeskey 2002)

Nuryaman (2008), " Earnings management is an opportunistic action to maximize the management's satisfaction by selecting certain accounting policies, so that corporate profits can be set, increased or decreased in accordance with the management's wishes. In the various definitions, we can conclude some fundamental aspects related to the definition of Earnings Management namely: Efforts to affect the financial statements are done in various ways, according to the manager's interests, the manager's interests are often called Pattern of Earnings Management.
According to Scott (2009), there are several patterns of Earnings Management namely:

1. Taking a bath, It occurred during organizational pressures at the moment of lifting the new leader. If the company had to report a loss, management would feel compelled to report huge losses. Consequently, management will remove assets and provide the expected costs in the future. It will increase the probability of reported profits in the future. In other words, taking a bath is done in order to get higher profits in the next period than it should be.
2. An income minimization, this pattern is similar to taking a bath, but it is not as extreme as taking a bath. This pattern can be selected by the company during the period has a high profit politically. An income policy is in the minimization including the rapid elimination of capital assets and intangible capital, advertising and charging research and development expenditure, business bookkeeping successful oil and gas exploration costs, and others. In other word, the income minimization is done in order to get profits for the lower period than it should be.
3. An income maximization, a positive accounting theory, a manager that usually does this pattern will receive a bonus at the moment, other than that the company is close to debt covenant violations which could also maximize revenue. In other words, an income maximization is done in order to get higher profits in the current period than it should be.
4. An income smoothing, is the most interesting pattern from the perspective of a contract. A manager prefers an averse risk to get the flow of the bonus varies slightly. Consequently leveling profit managers all the time, so it gets a compensated constant.

Earnings Management Motivation

Here there are some of the motives underlying the onset of earnings management among others. Scott, (2009):

1. Bonus Scheme (Bonus Reason).
   The existence of information asymmetry regarding the company's financial management can set the net income to maximize bonus.
2. Debt Covenant (Contract Long Term Debt).
   The closer to the company's creditors, a management will tend to choose a procedure that can " move" earnings the next period to the current period. It aims to reduce the probability of a company's failure in a debt repayment
3. Political Motivation
   Large companies in strategic industries (such as oil and gas) get more attention by lowering the profitability of the company to reduce its visibility. For example by doing practices or financial statement recording procedures, especially during periods with the higher levels of a prosperity
4. Taxation Motivation (Motivation Tax)
   One of the incentives that may lead managers to make a profit is engineered to minimize the taxes so you have to pay the company.
5. Chief Executive Officer (Substitution of Directors).
   A lot of motivations which appear when a change of CEO. One of them is to maximize profits by increasing a bonus when the CEO approaches a retirement
6. Initial Public Office (IPO)

The new company gave a first offer for the market price, so it can be a problem how to set the value of the shares being offered. Therefore, a net income information can be used as a signal to potential investors about the value of the company, so that the management company will go public and tend to perform earnings management to obtain a higher price for the shares will be sold.

Good Corporate Governance

The term of Good Corporate Governance (GCG) was first introduced in 1992 by the Cadbury Committee in its report, known as the Cadbury Report. The report is seen as a crucial turning point in the corporate governance mechanisms in the whole world. According to the Cadbury Committee on the corporate governance is the direct principle of controlling the enterprise in order to achieve a balance between the power and authority of the company in providing an accountability to the shareholders in particular, and stakeholders. Good Corporate Governance is a means or mechanism to provide an assurance to investors in obtaining an appropriate return to investments which have been planted. Shleifer and Vishny (1997). Good corporate Governance is a set of rules that governs the relationship between the shareholders, trustees (managers), companies,creditors, government, employees, stakeholders and other internal and external related to the rights and obligations or in other words, a system that controls the company. Forum for Corporate Governance in Indonesia (FCGI) (2001). Based on some of these definitions, it can be concluded that good corporate governance is a set of systems or government regulations which regulate and control the company so that it can maintain

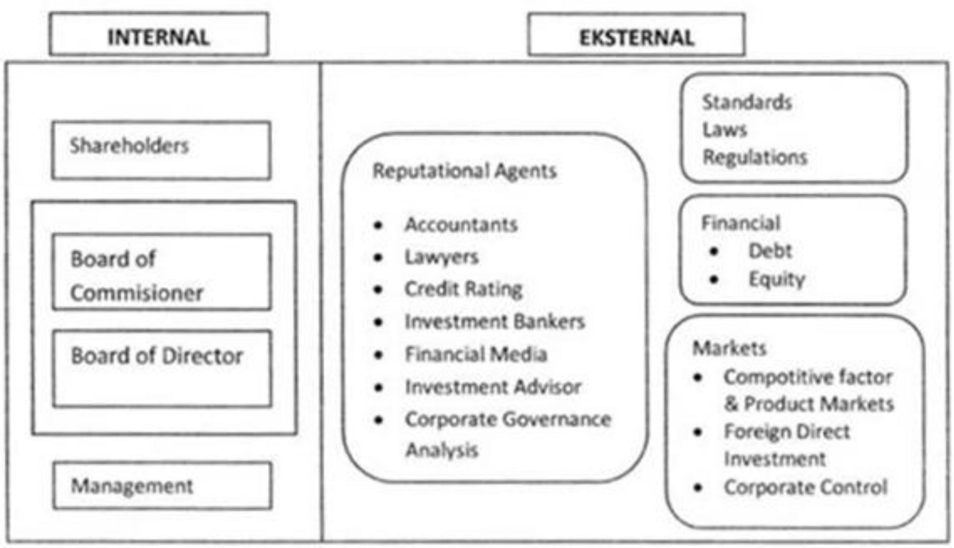
the balance of the various parties, include minority parties while creating an added value.
The principles developed by the OECD include five (5) of the following:

1. The protection of the rights shareholders (The Rights of Shareholders).The framework which is built into the Good Corporate Governance should be able to protect the rights of shareholders, include minority shareholders.
2. The equal treatment of all shareholders (The Equitable Treatment of Shareholders). This framework is built into the Good Corporate Governance, it should ensure an equal treatment of all shareholders, include minority and foreign shareholders
3. The role of stakeholders relating to the company (The Role of Stakeholders)
   The framework is built into the Good Corporate Governance, it must give a recognition to the rights of stakeholders, as determined by law. It can encourage an active cooperation between companies and stakeholders in order to create jobs, welfare, and sustainability (Going Concern)
4. Disclosure and transparency (Disclosure and Transparency). The framework is built in the good corporate governance, a disclosure and transparency should be ensured timely and accurately for any problems related to the company. Management is required to ask the external auditors (a public accounting firm) conducting independent audits of financial statements

The responsibility of the commissioners / directors boards (The Responsibilities of the Board)

With the good corporate governance, the minority shareholders will be protected from frauds, the company will be more transparent in the disclosure of information, the existence of an effective control is able to ensure the management accountability so that many companies will comply with the law. It will lead to management opportunities to perform an opportunistic Earnings Management can be limited. Good Corporate Governance is composed of two mechanisms, namely internal and external mechanisms. Agrawal and Knoeber (1996) explain that the controlling mechanism of good corporate governance consists of two divisions, namely internal and external mechanisms described by outsiders. An internal mechanism includes institutional shareholders, Outside Block Holdings, and a takeover activity. An external control mechanism is not only the capital market, but also as injector bank funds, the public as customers, suppliers, labors, the government as a regulator, as well as other stakeholders.

Figure 2.3
Internal and external Good Corporate Governance



Institutional Ownership Structure

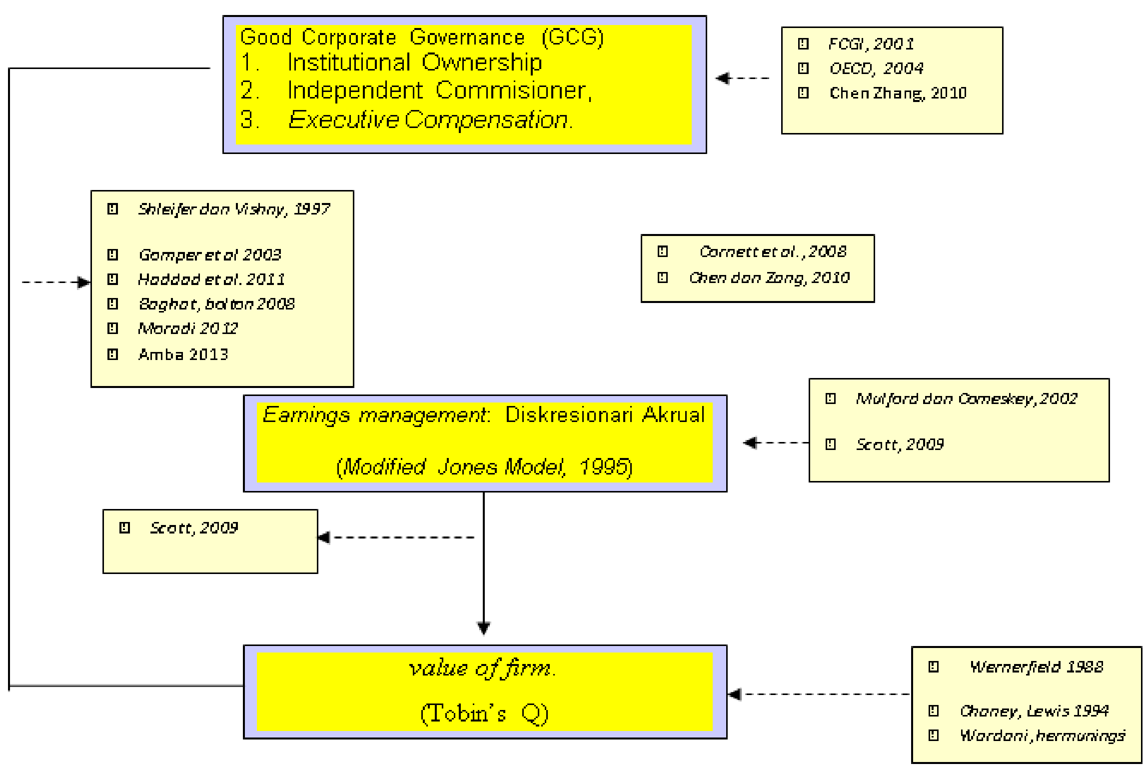
Jensen and Meckling (1976) stated that Institutional Ownership has a very important role in minimizing agency conflicts that occur between managers and shareholders. The existence of Institutional Investors considered capable of being an effective monitoring mechanism in any decisions made by managers. It is due to Institutional Investors involved in strategic decision-making so that Institutional Investors are not easy to believe the earnings manipulation. Institutional ownership can be measured by using indicators of the share percentage owned by institutional sides from the number of whole shares in the company (Gideon, 2005; Nuryaman, 2008) According to Shleifer and Vishny (1999) that the Institutional Shareholders on a large decision-making shareholders have an incentive to monitor a decision-making corporate. Based on the definition above, it can be concluded that Institutional Ownership is a proportion of a stock ownership by institutions as the company's founder, it is not the institution of public shareholders, as measured by the percentage of shares held by institutional investors intern

Independent Commissioner
Independent Commissioner is a commissioner who is not a member of a management, the majority shareholder, officer or otherwise associated directly or indirectly with the majority shareholder of a company that oversees the management of the company to be able to protect minority shareholders, (Zhen and Chang, 2010).

Executive Compensation
According to Scott (2011) the definition of an executive compensation, namely: the agent contract between the company and the managers who seek to align the interests of owners and managers with a basing compensation manager at one or more steps in the efforts of the company's operation manager. The existence of the Executive Compensation as a driver of performance managers to improve the welfare of the company through various efforts and through profitable business decisions. In addition bonuses are also useful as a success measure in leading a management company as an executive compensation. Scott, (2011). Executive Compensation is given to managers more seen as one way to address the agency problem as noted. The view is what gave birth to the term " Optimal Contracting Approach " as a research Laux and Laux, (2006)

Value of Firm
The value of the company is reflected in its stock price. The market price of a stock company formed between the buyer and the seller when the transaction occurred, it is called the market value of the company, and Hermuningsi Wardani, (2013), because the market price of the stock is considered a reflection of the true value of the company's assets. There are several ratios to measure the market value of the company, one that assessed the ratio can provide the best information is Tobin 's Q. Tobin 's Q ratio can explain various phenomena in corporate events, such as the cross-sectional differences in investment and diversification decisions. Claessesns and Fan, (2003), the relationship between a management stock ownership and a corporate value, the relationship between a performance management and a profit . Gompers, (2003). Wernerfield, (1988) concluded that Tobin 's Q can be used as a measure in determining the performance of the company. Value of Tobin's Q is the ratio of the stock closing price at the end of the fiscal year multiplied by the number of shares outstanding plus the book value of debt divided by total assets. The greater the value of Tobin 's Q ratio indicates that the company has good growth prospects and greater Intangible Assets. It can happen because the larger the market value of the company's assets, the greater the attraction of investors to spend more sacrifices to have the company. Brealey and Myers (2000) states that a company with a high Tobin 's Q brand image usually has a very strong company, while the company that has the value of Tobin 's Q is low generally located in a highly competitive industry or an industry began to shrink. Based on the above understanding, Value of Firm can be defined as the market value of the company which has the company's long-term goal to create a brand image, reflected in the company's high stock price.

Conceptual Model of Good Corporate Governance, Earning Management and Value of Firm



Effect of Good Corporate Governance on Earnings Management

To eliminate Earnings management is by realizing good corporate governance. Sulistyanto, (2008). The Mechanism of good corporate governance by running mechanism consists of Institutional Ownership Structure, Independent Commissioner, Executive Compensation (Gideon, 2005; Chen and Zang, 2010). Some studies also found that corporate governance can limit Earnings Management, including Chtourou and Courteau (2001), Siregar (2005), Cornet et al., (2008). Cornertt et al ., (2008) found no evidence to suggest that the control measures carried out by a company and an institutional investor can restrict the behavior of the managers. The company revealed that the control measures by the institutional investors may encourage managers to focus more attention on the performance of the company so it will reduce the selfish behavior (opportunistic). If the Institutional Ownership does the high-level effort, it will cause a greater security by the institutional, MECA and Balesta (2009). Some studies also found that the owners can limit Institutional Earnings Management. Cornett et al. (2008) in his study of companies listed in the United States found that an institutional ownership structure has a negative influence on Earnings Management. Institutional Ownership structure means to restrict Earnings Management. Richardson (1998), Nuryaman and Rusmin (2008), found that institutional ownership may limit the Earnings Management because it can affect the management. Chen and Zang (2010) in his study of all companies listed on China's two stock exchanges in Shanghai and Shenzhen are from the 2003-2006 found that the structure of institutional ownership is negatively related to Earnings Management that means to limit the institutional ownership structure Earnings Management. Independent commissioner is the commissioner who is not a member of management, major shareholders, officers either directly or indirectly linked to the majority shareholder of a company that oversees the management of the company, and protects the minority party, Chen and Zhang (2010:14). Fama and Jensen (1978) stated that the Non-Executive Director (Independent Commissioner) may act as a mediator in a dispute between internal managers, oversee the management policy and provide advices to management. Independent Commissioner is the best position to carry out the monitoring function in order to perform good corporate governance in the company. The results of the study Dechow (1995), Chtourou and Courteau (2001), Shah (2009), give the conclusion that the proportion of companies that have a board member from out of the company or out of Director may affect earnings management measures. Thus, if the commissioners from out of the company improved control measures, it would be influence also to the use of Discretionary Accruals lower. Cornett et al., (2008). Independent Commissioner is expected to be able to supervise well the activities of the company management because they have no conflict of interests. Independent Commissioner is the best position to carry out the monitoring functions in order to ensure a transparency and a disclosure of financial statements, also create a balance of interests of various parties. Chtourou and Courteau (2001) in research above listed companies in the United States in 1996 found that the independent commissioner will limit the Earnings Management. Similar results were found by Chen and Zang (2010), according to the results of the studies mentioned all companies listed on China's two stock exchanges in Shanghai and Shenzhen ie from 2003-2006 found that the independent commissioner can limit Earnings Management. Executive Compensation is given to motivate the executive management in order to provide the best for the company. Cornet et al., (2008) found that research results stated the Executive Compensation can limit the increase of Earnings Management, Laux and Laux (2009), also found that the increase in an Executive Compensation limiting to Earnings Management can be improved and reinforced by an Independent Commissioner to adjust its control in response to changes in an incentive executive.

Effect of Good Corporate Governance to Value of Firm

The corporate governance mechanisms will provide effective protections to the minority shareholders or creditors to obtain a reasonable return on investment precisely, and as efficient as possible. Shleifer and Vishny (1997) describe good corporate governance as part of a means or a mechanism to convince the investors to obtain returns that correspond to the investments made. Companies that perform good corporate governance will increase the value of the company compared to companies that do not practice good corporate governance, Khatab (2011). Companies with strong shareholders would have a high value of the company, and could be reflected from higher profits, a higher growth sales and lower capital costs. The company will not undertake acquisitions, Gompers et al. (2003). Gomper et.al (2003), in his research on companies listed on the New York Stock Exchange, Haddad et al (2011) on Jordan's firm, Moradi (2012) at the Tehran's company , Amba (2013) in 49 companies in Bahrain Find that institutional ownership affects the Value of Firm. Independent commissioner is a party that has the responsibility to encourage the adoption of the good corporate governance principles to ensure that a transparency and a disclosure of financial statement, the fairness to all stakeholders, and the disclosure of all information, although there is still the conflict of interests. Therefore, independent directors have more opportunities to control in every line for managers to an executive level. With the existence of the function of independent directors in overseeing managers will make the greater the confidence investors because the investors will get a return for a guarantee, in other words that the company has an added value. Baghat and Bolton (2008), researching the companies in America. One of the variables which studied are an Independent. The results showed an Independent Commissioner affects the company 's performance. Executive Compensation is given to motivate the executive management in order to provide the best performance for the company, so it can improve the brand image for the company. Haddad et al. (2011) examines the Tehran company. The results show that firms which practice good corporate governance is relatively more profitable, valuable and beneficial to shareholders. Good corporate governance as measured by the Executive Compensation provides a significant relationship to the value of the firm.

Effect of Earnings Management on the Value of Firm

A management profit (Earnings Management) conducted by a manager at the company's fundamental factors, with interventions on the financial statements based on an accrual accounting. Though the company's fundamental performance used by investors to assess the company's prospects as a reflection in the stock's performance. Earning Management is conducted by a manager on the financial statements so it will affect the company's financial performance, the performance of the stock. It may increase or decrease the value of the company. Investors (stakeholders) will compare the return to compare actual profits or expected profits provided by various investments at the desired rate return. The decision-making investment of the most commonly used by an investor is to look at the financial statements of the company so that it can assess the financial position and performance of the company, but with the Earnings Management course could mislead investors in making decisions. Investors will tend to undervalue the company. Earnings Management will lead to interest investors in a company. The company's good performance that affects the value of the firm. The discovery that supports, namely: Cornett et al. For companies in America, and Hermuningsi Wardani (2013) on Malaysian companies, research results revealed that the presence of the control of earnings management is able to give an impact on improving the value of the firm.

Conclusion

By applying good corporate governance mechanism will be able to reduce opportunist attitudes that carried by the manager of the company so it will increase the performance as reflected in stock prices, ultimately good corporate governance has an impact on the value of the company.

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