THE EFFECT OF CORPORATE GOVERNANCE MECHANISM ON EARNINGS MANAGEMENT: THE COMPARATIVE STUDIES BETWEEN FIRMS LISTED ON SHARIA INDEX (JII-70) AND CONVENTIONAL INDEX (LQ-45)

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ABSTRACT

This research aimed to examine the effect of corporate governance mechanism on earnings management. The independent variables are board of commissioner size, board of commissioner meeting, board of commissioner independence, Board of competence, managerial ownership, and institutional ownership. In contrast, the dependent variable is earnings management. The sampling method was employed by purposive sampling. The research sample consisted of 305 companies in Indonesia. It contains 110 Sharia companies listed on JII-70 and 195 conventional companies listed on LQ-45 from 2015 until 2019. This research used multiple linear regression to examine the effect of independent variables on the dependent variable. The results show that board of commissioner size negatively affects earnings management, while the other corporate governance mechanism variables, which are board of commissioner meeting, board of independent commissioner size, board of commissioner competence, managerial ownership and institutional ownership have no effect on earnings management. In addition, the classification of company which measured by dummy variable is positive and significant, it means that the effect of corporate governance mechanism between companies listed on JII-70 and LQ-45 is different, and the effect is greater in companies listed on JII-70 than companies listed on LQ-45.

Keywords: Corporate Governance Mechanism, Earnings Management.

ABSTRAK

Penelitian ini bertujuan untuk menguji pengaruh mekanisme tata kelola perusahaan terhadap manajemen laba. Variabel independen dalam penelitian ini adalah jumlah komisaris, frekuensi rapat dewan komisaris, independensi dewan komisaris, kompetensi dewan komisaris, kepemilikan manajerial, dan kepemilikan institusional. Sedangkan variabel terikat adalah manajemen laba. Metode pengambilan sampel dilakukan dengan purposive sampling. Sampel penelitian terdiri dari perusahaan di Indonesia. Berisi 110 perusahaan tergabung JII-70 dan 195 perusahaan konvensional tergabung dalam indeks LQ-45 dari 2015 sampai 2019. Penelitian ini menggunakan multiple linear regression analisis untuk menguji pengaruh variabel independen terhadap variabel dependen.Hasil penelitian menunjukan bahwa jumlah komisaris berpengaruh negatif terhadap manajemen laba, sedangkan variabel mekanisme tata kelola perusahaan lainnya yaitu frekuensi rapat komisaris independensi dewan komisaris, kompetensi dewan komisaris, kepemilikan manajerial dan kepemilikan institusional tidak berpengaruh terhadap manajemen laba. Selain itu, pengelompokan perusahaan yang diukur dengan variabel dummy memiliki pegaruh positif dan signifikan, sehingga dapat ditarik kesimpulan bahwa pengaruh tata kelola perusahaan terhadap manajemen laba pada perusahaan yang tergabung dalam indeks JII-70 dan LQ-45 adalah berbeda dan pengaruhnya lebih besar di perusahaan yang tergabung dalam kelompok JII-70 dibandingkan perusahaan yang tergabung di LQ-45

Kata Kunci: Tata Kelola Perusahaan, Manajemen Laba.

INTRODUCTION

Indonesia has two types of capital market that operate in parallel, the Islamic and conventional capital market. All listed companies in Indonesia Stock Exchange (IDX) must comply with certain regulations, accounting standards, and best practice of corporate governance mechanisms. All listed companies must follow the accounting standard (SAK) that issued by Instituted of Indonesian Chartered Accountant (IAI) as well as carry out the practice of corporate governance mechanism set by the Financial Service Authority (OJK). Both Islamic and conventional capital market use the same set of accounting standards and corporate governance mechanisms. Additionally, Islamic capital market has a specific requirement that differs from conventional capital market.

The Indonesia capital market has increased significantly in 2019. According to OJK (2019), IHSG recorded positive growth of 2.18% to 6,329.31. The number of stock investors reached 2.48 million investors, and it increased 40% from 2018. Foreign investor funds also increased significantly compared to last year, which reached IDR 49.19 trillion YTD (December 27, 2019). The rush of foreign investor funds also occurred in the SBN market, posting a net buy of IDR 171.59 trillion (as of December 26, 2019) and corporate bonds, which posted a net buy of IDR 5.48 trillion (as of December 27, 2019). The SBN market throughout 2019 also strengthened with a decrease in the average yield on SBN by 96.57. In the sharia sector, the growth in the number of shares included in the list of sharia securities was 441 with a capitalization value of Rp.3.767.93 trillion. The number of sukuk outstanding as of December 27, 2019, was 143 with an emission value of Rp.29.83 trillion or a growth of 40.05%. There were 264 sharia mutual funds in circulation as of December 26, 2019, with a NAV value of Rp.55.39 trillion or a growth of 60.59%.

Financial statements are the main source for investors to make an investment decision. Investors assess the company's performance and predict future dividends based on the profits that disclosed in the financial statement. Financial Accounting Standards (SFAS) No.1 (2015) stated that the objective of financial statements is to report the company's performance during the period and management accountability in using the resources. The component of a financial statement that is often used to measure a company's performance is profit or loss statement. Profit or loss statement is important information because it a primary source to asses of company performance. The high quality profit or loss statement is demanded to invest and finance decisions. However, the quality of profit or loss statement may be affected by earnings management behavior. Healy & Wahlen (1999) consider earnings management could mislead stakeholders, and it can influence the contractual outcomes because the reported accounting number used.

The issue of earnings management has been debated for a considerable period. Began when Watts and Zimmerman (1986) came out with positive accounting theory behind accounting method choices. The choice enables a flexible response to change in the firm's environment and unforeseen circumstances, allowing for opportunistic management behavior. The issue of earnings management becomes more obvious because of publicity associated with large corporate bankruptcies in the United States, such as Enron, Xerox, and WorldCom. There are several definitions of earnings management in the literature, the most common comes from Healy & Wahlen (1999), who state that *"earnings management happens when managers alter financial reports with the intention to either mislead readers of those statement or to influence contractual outcomes that rely on the accounting number reported in the financial statement*." On the other hand, earnings management could involve selecting accounting procedures and estimates that conform to generally accepted accounting principles (GAAP). Firm practicing earnings management would stay within acceptable accounting manipulation and would not be indulging in fraudulent behavior.

Although there is a thin line between earnings management and fraud, the difference is clearly identified. Erickson et al. (2006) state that earnings management is normally within the scope of GAAP, but fraud is outside the GAAP. Parfet (2000) differentiates earnings management into two categories; "good" and "bad". It is bad, if it hides real operating performance by creating artificial accounting entries and it is good, if it involves reasonable and proper practices that are part of operating a well-managed business. Meanwhile, Brooks (2011) states different definitions of earnings management from previous literature by classifying them as white, grey, and black. It is considered beneficial earnings management (white) if it enhances the report's transparency. It is grey if the manipulation of report is within the boundaries of compliance with bright

line standards, which could be either opportunistic or efficiency enhancing and pernicious. It is black if it involves outright misrepresentation and fraud.

There is an issue that has been discussed about the Sharia status of the company. The question is, does Sharia status influence the quality of information disclosure, especially from earnings management behavior, and whether the information disclosed by Sharia companies is more truthful than information disclosed by conventional companies. Sharia companies operate not only under regulations but also to the restrictions and permission of Islam. Furthermore, Sharia-compliant firm is expected to have a high degree of earnings quality and ethics than Non-Sharia-compliant firm. Omran (2009) argues one of the reasons why investors invest in Sharia-compliant firms is the Islamic image reflected by these firms. Based on robust evidence, Farooq (2015) notes that Sharia companies engage in lower earnings management than conventional companies. Nonetheless, several studies claim that there are companies influenced by religion, specifically Islam, and still perform unethical conduct, including earnings management behavior (Alsaadi et al. 2017). Furthermore, Drennan (2004) argues that improving the legislation and regulation, together with the introduction of codes of corporate governance mechanism reduce the risk of opportunistic managerial behavior.

One of the factors that lead to earnings management is the lack of implementation of a corporate governance mechanism. The East Asian Crisis of 1997 particularly affected Indonesia, and lacked corporate governance mechanism had been identified as one contributing factor. The index of corporate governance mechanism in Indonesia in 1998 was (2.88) far below Singapore (8.93), Malaysia (7.72), and Thailand (4.89). Implementation a corporate governance mechanism starts with a proposal to improve the listing regulations on the Indonesia Stock Exchange (IDX), which regulates the regulations for companies listed. The first regulation is to require an independent commissioner and form an audit committee in 1998, so the corporate governance mechanism began to be introduced to all public companies in Indonesia. The regulations issued by IDX require all listed companies to implement corporate governance mechanism. In addition, to protect the investor, IDX also requires a system that guarantees transparency and accountability in business transactions between companies that have potential conflict of interest. Furthermore, the mechanism of corporate governance agency conflict is reduced, and managers have more incentive to signal private information to users while having less incentive to manage earnings (Xie et al. 2003). Chtourou et al. (2005) reveal that consistent application of corporate governance mechanism can be a barrier to performance manipulation, resulting in financial statements that do not contain the companies' real information.

In Islam, the practice of corporate governance mechanisms such as accountability, transparency, integrity, ethics, and morality are important values in daily activities. Porta et al. (1997) define corporate governance as "*the ways in which suppliers of finance to corporation assure themselves of getting a return on their investment.*" The principle of corporate governance mechanism is consistent with Islamic teaching ensuring that requiring timely and accurate disclosure is made on all situations concerning corporations (Dadgar & Naderi, 2011). According to Healy & Wahlen (1999), *"earnings management happens when managers alter financial reports with the intention to either mislead readers of those statements or to influence contractual outcomes that rely on the accounting number reported in the financial statement."* It reflects the opportunistic behavior of management, where earnings management facilitates such behavior through accounting choices and accounting estimates. This behavior is prohibited in Islam as it is stipulated in Islam code of conduct. The Islamic law prescribes the nature of allowable trade and services which generally requires fairness, honesty, and justice in all business transaction.

This research selects corporate governance mechanism as the independent variable. The corporate governance mechanism variables include board of commissioner characteristic, and the effectiveness of board of commissioner is reflected with variable board commissioner size, frequency of board commissioner meeting, board independent commissioner, and board commissioner competence. The second corporate governance mechanism is the ownership structure. The ownership structure consists of managerial ownership and institutional ownership. The dependent variable is earnings management, which is measured by Kothari models. This research also compare the effect of corporate governance mechanism between companies listed on JII-70 and companies listed on LQ-45.

Research Scopes

This research is limited to the Sharia companies listed on JII -70 and the conventional companies listed on LQ – 45 index. The data observation is from 2015-2019.This research tests the effect of corporate governance mechanism on earnings management and compare correlation of corporate governance mechanism on earning management in Sharia companies (JII-70) and conventional companies (LQ-45).

Research Question

1. Does board of commissioner size affect earnings management?
2. Does the frequency board of commissioner meeting affect earnings management?
3. Does board of independent commissioner size affect earnings management?
4. Does board of commissioner competence affect earnings management?
5. Does managerial ownership affect earnings management?
6. Does institutional ownership affect earnings management?
7. Does the effect of corporate governance mechanism on earning management between Sharia companies listed in JII 70 and conventional companies listed in LQ-45 are different?

Research Objective

1. To examine whether board of commissioner size affect earnings management.
2. To examine whether board of commissioner frequency meeting affect earnings management.
3. To examine whether board of independent commissioner size affect earnings management.
4. To examine whether board of commissioner competency affect earnings management
5. To examine whether managerial ownership affects earnings management
6. To examine whether institutional ownership affects earnings management
7. To examine whether the effect of corporate governance mechanism on earning management between Sharia companies listed on JII 70 and conventional companies listed on LQ-45 are different.

LITERATURE REVIEW

Agency Theory

Jensen & Meckling (1976) define agency relationship as a contract under one or more persons (the principal) engage another person (the agent) to perform some service on their behalf, which involves delegating decision making authority to the agent. By this theory, the investor believes that managers benefit from the reciprocal of the investments given and not deviate to the advantage of the investment. The problem in this concept is the separation between the owners and management rights. Conflicts arise when managers are not performing any works that can provide benefits to owners or shareholders. Jensen & Meckling (1976) state the principal can limit divergences from his interest establishing appropriate incentives for the agent and by incurring monitoring cost designed to limit the agent's aberrant activities. In most agency relationships the principal and agent will incur positive monitoring and bonding cost. In addition there will be some divergence between the agent decision and those decision that would maximize the welfare of the principal. Agency theory predicts that asymmetry information causes the effect of earning management. The dollar equivalent of the reduction in welfare experienced by the principal due to this divergence is a cost of the agency relationships. Therefore, the agency costs are the sum of the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss.

Positive Accounting Theory

Positive accounting theory is formulated by Watts & Zimmerman (2006). Positive accounting theory is an accounting theory consisting of a border set of principles or concepts that can explain or the answer applicable accounting practices and predict phenomena that occur where accounting is applied to construct theories and verify theories. Positive accounting theory aims to emphasize the importance of empirical research to justify various accounting methods and practices. Watts & Zimmerman (2006) assumed that individuals act to maximize their utility and consequently, management lobbies on accounting standards based on their self-interest. They suggest their purpose to identify factors that are likely to be important predictors of lobbying behavior. Watts & Zimmerman (2006) argue that "managers have greater incentives to choose standards which report lower earnings due to tax, political and regulatory consideration than to choose accounting standard which report higher earnings and increase their incentive compensation. In small (low political cost) we would expect that managers do have incentives to select accounting standards which report higher earnings if the expected gain in

incentives compensation is greater than the forgone expected tax consequences."

Earnings Management

Experts have different definitions of earnings management. Although the meaning of earnings management was defined in various ways, the previous literature generally agree that managers engage earnings management because of opportunist behavior. The most common definitions are from Healy & Wahlen (1999) and Schipper (1986). According Schipper (1986), earnings management is "*an involvement in the process of preparing financial statements, purposely to acquire personal benefits.*" A corresponding definitions of earnings management as an opportunistic behavior is expressed by Healy & Wahlen (1999),*"earnings management occurs when managers use judgment in financial reporting and in structuring to alter financials reports to either misleads some the stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting number"* (1999, p. 368).

Although there is a thin line between earnings management and fraud, the difference between them are clearly identified. Erickson et al. (2006) state that earnings management is normally within the scope of GAAP but fraud is outside the GAAP. However, these two matters share the same objective. From the previous literature, we can conclude that earnings management involves the choice of accounting procedures and estimates according to generally accepted accounting principles (GAAP). Explicitly, companies that conducted earnings management are still classified as within the limits of manipulation accepted accounting procedures as conservative accounting, and neutral earnings and aggressive accounting are all within the standards (GAAP). Whereas, fraud is an activity that misrepresents financial reports and violates GAAP, and the misrepresentation could result in some unauthorized benefit. Even though earnings management and fraud have a difference in terms of action, these two matters have the same effect on the financial report. According to Perols & Lougee (2011), firms will commit fraud because of earnings management constraints. They found firms that have managed their earnings before are more likely to perform the fraud. The accuracy of the financial reporting is dependent on the existence of this behavior, such as earnings management.

Managers may engage in a variety of earnings management. According to Scott (2003), there are some earnings management patterns, that it were often performed by managers.

1. Taking bath: this technique occurs during periods of organizational stress or reorganization. If a firm must report a loss, management may feel it might as well report a large one, it has little to lose at this point. Consequently, it will write off assets, provide for expected future costs, and generally "clear the desks" because of reversal. This enhances the probability of future reported profits.
2. Income minimization: this pattern may be chosen by the politically visible firm during periods of high profitability. Polices that suggest income minimization include remove capital goods and intangible assets, the imposition of advertising expense, and rapid development. It can minimize the profit because of political motivation or minimize taxes.
3. Income maximization: according to positive accounting theory, managers may engage in a pattern of maximization of reported net income for receiving a large bonus. This action can also be done to avoid a breach of the long-term debt contract.
4. Income smoothing: companies prefer to report the stable earnings growth trend rather than earnings drastically changing. From a contracting perspective, risk-averse managers prefer less variable bonus stream, other things equal. Consequently, managers may smooth reported earnings over time to receive relatively constant compensation.

Corporate Governance Mechanism

Corporate governance mechanism is the set of mechanisms governing relationships between shareholders, corporate managers, creditors, governments, employees, and other internal and external interest holders relating to the right and obligation (Krehnke, 2007). The idea of corporate governance mechanism raises the interest of the company to ensure the investors that the fund which was invested by investors are used appropriately and effectively. "*Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment*" (Shleifer & Vishny, 1997, p. 737).

Corporate governance mechanism may be determined by the scope and nature of the associated agency problem of firms. Furthermore,

La porta (1998) argues corporate governance mechanism is needed for better access to external financing at a lower cost. This indicates that firms need of a good deal of external financings, such as rapidly growing firms, have an incentive to improve their corporate governance mechanism. Himmelberg et al. (2001) state that firms faced large information asymmetry because of other characteristics their firm may signal to the market regarding their intent to protect investors better by adopting corporate governance mechanism. This might be the case for large firms, new firms, or large intangible assets firms. However, Klapper & Love (2004) stated that the effect of corporate governance mechanism on firm performance may vary depending on the country-specific level of investor protection. In more detail, firms with corporate governance mechanisms are valued more highly by investors in countries where investor protection is generally poor. Many experts categorized the type and criteria of corporate governance mechanism differently. Gillan (2006) provides a broad framework of corporate governance mechanism split into two classifications, which are internal and external governance.

Earnings Management and Corporate Governance Mechanism

The literature about the impact of corporate governance mechanisms on earnings management is more varies. The early research was initiated by Dechow et al. (1996), and the paper stated that certain attributes of corporate governance mechanisms are generally associated with earnings management. Furthermore, several studies have provided empirical evidence that certain attributes of corporate governance mechanisms are significantly related to earnings management, such as Xie et al. (2003), Chtourou et al. (2005), and Peasnell et al. (2005). Some studies about corporate governance mechanism on earnings management evidence in Indonesia have done by Murhadi (2012), and Saftiana et al. (2017).

Previous research from Xie et al. (2003) entitled “earnings management and corporate governance: the role of board and audit committee find evidence that board meeting, board composition, audit committee have a negative effect on earnings management. Meanwhile, CEO duality and executive committee have no significant effect on earnings management. Furthermore, previous research about the effect of corporate governance on earnings management is evident in Indonesia. The research was conducted by Saftiana et al. (2017). The research results shows that all corporate governance variables, institutional ownership, managerial ownership, the frequency of board commissioner meeting, and audit committee meeting, have no significant effect on earnings management.

Islamic Capital Market

Indonesia has a unique capital market that operated in parallel with the Islamic and conventional. The Islamic capital market has developed over the years. This evidence is strengthened by data that showed the large portion of Sharia stock in Indonesia Capital Market. Yuliana et al. (2015) state that Sharia stock in Indonesia is relatively large, and the proportion is more than 60%. Therefore, the ICM is not a separate system from the capital market system as a whole. In general, Islamic Capital Market activity has no difference with the conventional capital market. Still, Islamic Capital Market has some special characteristics, the products and the transaction mechanism do not against Islamic principles.

The Islamic Capital market is being developed by adopting and making some of regulation to harmonize and address the Sharia compliance issues to increase the quality of the Islamic Capital Market. According to POJK number 15/POJK.04/2015 about the implementation the principle of Sharia in capital market, Sharia securities is defined in capital market law and implementing regulation which its contract and issuance method fulfills the Sharia principles in Indonesia Capital Market. The Sharia securities issued in Indonesia Capital Market consist of Sharia stock, Sharia obligation (sukuk), Sharia mutual funds, Sharia asset-backed securities, Sharia exchange traded fund, and Sharia real estate fund.

Sharia Public Company

According to POJK number 35 /POJK.04/2017, Sharia public company is a public company whose articles of association stated that the activities and types of business and the way of managing their business are based on Sharia principles in the capital market. The company can be categorized as Sharia-compliant if it is not involved in any uncertainty (*gharar*) or interest (*riba’*) activities as they run their main business activity. The business must comply with Sharia code of conduct. The

screening process will be taken place in order to regulate the status of the company.

Theoretical Framework

As a basis for formulating a hypothesis, the theoretical framework shows the influence of independent variables such as board commissioner size, board commissioner meeting, board commissioner independence, board commissioner competency, managerial ownership and institutional ownership on the dependent variable that is earnings management. The theoretical framework is drawn as follows:

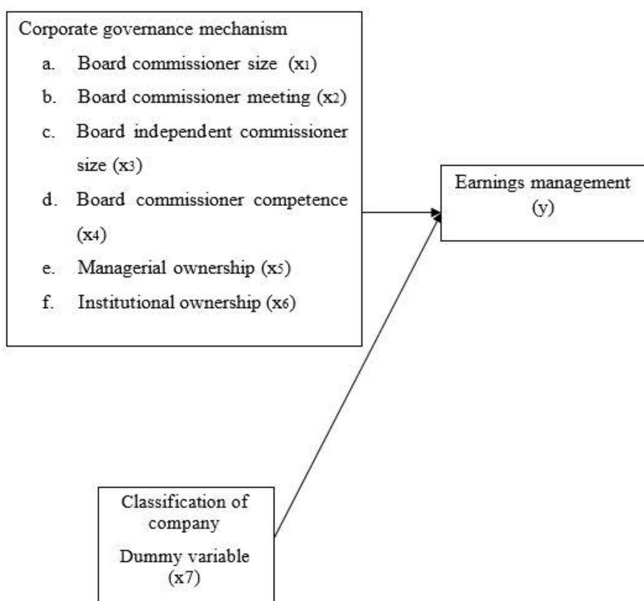

Figure 1.1: Conceptual Framework

Hypothesis Development

The Effect of Board Commissioner Size on Earnings Management

According Jenesen (1993), smaller boards perform their monitoring and controlling roles better than larger boards, which CEOs can more easily influence. Xie et al. (2003) argue that a larger board brings together a greater number of experienced board, and resulting combined expertise plays a role in limiting earnings management. Furthermore, Xie et al. (2003) find that the board size coefficient is negative and significant at 0.05. It indicates that larger board are associated with lower levels of earnings management. According to previous research, we hypothesize that:

H1: Board Commissioner Size has negative effect on earnings management.

The Effect of Frequency Board Commissioner Meeting on Earnings Management

Board commissioner meeting is a medium communication and coordination between the commissioners in conducting oversight of the management. Chen et al. (2006) state that board with more frequent meetings can reduce the occurrence of fraud, because when companies meet regularly, the board can identify and solve problems related the quality of financial reporting. Xie et al. (2003) find that the number of board meeting has a negative coefficient that is marginally significant at the 0.10 level, indicating when board meets more often, earnings management are lower. According to previous research, we hypothesize that:

H2: The Frequency of Board Commissioner Meeting has negative effect on earnings management.

The Effect of Board Independent Commissioner Size on Earnings Management

From an agency perspective, the ability of the board to act as an effective monitoring mechanism is dependent upon its independence from management (Dechow et al., 1996). Peasnell et al. (2005) find evidence in UK firm that board independence has significant correlation with earnings management. Furthermore, Xie et al. (2003) find that the percentage outside director is negatively related to the discretionary accruals at the level 0.10. It indicates that the presence board independence is associated with a reduced level of earnings management, accordingly, we hypothesize that:

H3: Board Independent Commissioner Size has negative effect on earnings management.

The Effect of Board Commissioner Competence on Earnings Management

Competencies of board commissioner member are an important factor for the effectiveness of the board functions. The effectiveness of board commissioner members monitoring role are depend on their experience, knowledge, and educational backgrounds. Thus, they have capability to understand the company’s business operation. Furthermore, board of commissioner must also have the competence in understanding company’s financial statement because financial statement is one of the information used in evaluating management actions. Xie et al. (2003) stated that having a corporate and financial

background is essential for board to be effective in monitoring a firm, especially in issues that relate to financial reporting as they have better understanding of earning manipulation. They find that a company who has board with a financial background is negatively related to earning management. Thus, we hypothesize that:

H4: Board Commissioner Competence has negative effect on earnings management.

The Effect of Managerial Ownership on Earnings Management

Managerial ownership is a privately owned share or shares owned by subsidiary concerned and affiliates (Saftiana et al., 2017). High ownership would make managers have greater responsibilities in managing the company and presenting the financial statement with the correct information for shareholders and themselves. Murray et al. (2006) find managerial ownership negatively related to earnings management and suggest that factor may effectively monitor managerial opportunism. Nevertheless, Johari et al. (2009) provide evidence that managerial ownership is positively related to earnings management and claim that excessive managerial ownership may induce managers to act opportunistically. So, we hypothesize that:
H5: Managerial ownership has positive effect on earnings management.

The Effect of Institutional Ownership on Earnings Management

Institutional ownership are shares held by the government, financial institution, institutional legal entities, foreign institution and other institution. Institutional investors are organizations that largely hold shares on behalf individual, such as insurance companies, pension funds, and professional fund managers (Chung & Zhang, 2011). Shleifer (1986) asserts that institutional shareholders are more efficient in preventing managers from pursuing their own interests because they have exclusive access to technology acquainting them with profitable operational strategies. The study about correlation between institutional ownership and earnings management had been done by Ajay (2015) and it was found that institutional ownership has a significant negative relationship with discretionary accrual at the 1 and 10 percent levels. It indicates that the more institutions own the company shares, the less earnings management will be conducted. Thus, we hypothesize that:
H6: Institutional ownership has negative effect on earnings management.

The Comparison an Effect of Corporate Governance Mechanism between Companies listed on JII-70 and Companies Listed on LQ-45.

Noreen (1988) sees religion as one of the enforcement tools for better ethical conduct in business organizations. He argues that apart from supplying a supernatural enforcement mechanism, religion helps to sustain behavioral norms critical in enforcing ethical behavior. Consistently, Dyreng et al. (2012) examine whether companies subject to significant religious influence are less likely to be involved in aggressive financial reporting than companies with less religious influence. They argue that religious, ethical codes may evoke reminders of individual norms such as morality and honesty. Thus, we postulate that the effect of corporate governance mechanism on earnings management between Sharia companies listed on JII-70 and conventional companies listed on LQ-45 is different.
H7: The effect of corporate governance mechanism on earnings management between Sharia companies listed on JII-70 and conventional companies listed on LQ-45 is different.

RESEARCH METHOD

Type of Research

In this research, we used a quantitative method to examine the relationship to several variables and determine cause and effect .According to Bryman (2001), quantitative research emphasizes on numbers and figures in the collection and analysis of data. The quantitative research is well suited to questions of prevalence, generalizability, and calibration (Lee et al., 1999). The quantitative method is aimed to test the hypothesis. Furthermore, Sekaran and Bougie (2016) stated that hypothesis testing is undertaken to explain the variance in the dependent variable or to predict organizational outcomes.

Population and Sample

Sekaran and Bougie (2016) define a population as the whole group of people, events, or thing of interest that the researcher wanted to investigate. Furthermore, sample is a subset of the population. Salhin et al. (2016) stated that samples are therefore used to make inferences about the population. . The population in this study are public company listed in Indonesia Stock Exchange (IDX), and sample in this study are companies listed in Jakarta Islamic Index 70 (JII 70) for Sharia companies and LQ-45 index for conventional companies. The sample of

this study used one type of nonprobability sampling method, which is purposive sampling. According to Salhin et al. (2016), nonprobability sampling involves a specific sample chosen on the basis of particular characteristics or similar differentiating features relevant to the study.

Data Collection Method

The sample in this study are companies listed in Jakarta Islamic Index 70 (JII 70) for Sharia companies and LQ-45 index for conventional companies. The sample of this study used one type of nonprobability sampling method, which is purposive sampling. This study obtained the data from the official website of Indonesian Stock Exchange (IDX) www.idx.co.id. This study collected information from the annual report and financial report from 2015 – 2019, which has related information about earnings and corporate governance mechanism of specific companies.

Table 1: Data Selection

Sample selection procedure	
Total population : firms listed on IDX in 2019	668
Firms that are not listed on JII-70 and LQ-45 index	(553)
Firms listed on JII-70 and LQ-45 that were not listed completely on IDX from 2015-2019	(11)
Firms listed on both JII-70 and LQ-45 index	(31)
Incomplete data	(12)
Total sample	61
Data observation	
Total data observation from 2015 - 2019	305

The following criteria are applied in selecting firms for the sample as follows:

1. For Sharia companies, the companies have been listed on Jakarta Islamic Index 70 (JII 70) in last December 2019.
2. For the conventional companies, the companies have been listed on LQ-45 composite index in last December 2019.
3. The company has been listed on the JII 70 for sharia companies and LQ- 45 for conventional companies. They publish annual financial report audited per 31 December and complete in 2015 – 2019, and they are not delisted from the IDX during year observation.
4. The company which has complete data for research variables has been predetermined.

Measurement

Earnings Management

In this study, the earnings management was calculated using Kothari models. Kothari et al. (2005) stated that the model is another model for estimating discretionary accruals, and they argued that the firm's performance plays an important role in managing discretionary accruals and, therefore, should be taken into consideration. Kothari et al. (2005) proposed a model which similar to Jones, but it is expanded to include return on asset (ROA) for effect on the performance of discretionary accruals. In this study we used jones model adjusted by return on asset (ROA). The model can be written as follows:

Total Accruals *(TAC)* = net income – cash flow from operating

We calculate the estimated total accrual with Ordinary Least Squares (OLS) as follows:

$$TAC_{it} / TA_{it-1} = a_0 + \hat{\alpha}_1[1/TA_{it-1}] + \hat{\beta}_1[\Delta REV_{it}/TA_{it-1}] + \hat{\beta}_2 PPE_{it}/TA_{it1} + \hat{\beta}_3 ROA_{it} + \varepsilon_{it}.$$

The estimated parameters ($\hat{\alpha}, \hat{\beta}_1, \hat{\beta}_2, \hat{\beta}_3$) from the previous regression were plugged into the equation to generate Non-Discretionary Accruals *(NDAC)*:

$$NDA_{it} = a_0 + a_1[1/TA_{it-1}] + \beta_1[\Delta REV_{it} / TA_{it-1}] + \beta_2 PPE_{it}/TA_{it1} + \beta_3 ROA_{it}$$

The discretionary accruals (DAC) can be calculated as follows:

$$DA_{it} = TAC_{it} / TA_{it-1} - NDA_{it}$$

Where:

TAC_{it}	=	The total accruals year t
NDA_{it}	=	The non-discretionary accruals year t
DA_{it}	=	The discretionary accruals in year t
TA_{it-1}	=	The total asset in year t-1
ΔREV_{it}	=	The changes in revenues in year t
PPE_{it}	=	The property, plant, and equipment in year t
ROA_{it}	=	The Return on Asset t
α_{it}	=	The slope coefficient in year t
β_{it}	=	The coefficient

Board of Commissioner Sze

In this study, board size is an independent variable. Abed et al. (2011) provide evidence that having large board would assist in hindering the incidence of earnings management as in large board size, there is varied experience among its member. It could assist in identifying any

misconduct arisen. According to Mansor et al. (2013), board size can be measured as follows:

Total number of board commissioner

The Frequency Board Commissioner Meeting

In this study, board meeting is an independent variable. Chen et al. (2006) stated that the board, which has more frequent meetings, could reduce the occurrence of fraud. Because when companies meet regularly, the board can identify and solve problems related the quality of financial reporting. According to Mansor et al. (2013), board size can be measured as follows:

Total board commissioner meeting in one year

Board of Independent Commissioner Size

Board independence in this study is an independent variable. Fama & Jensen (2019) argued that including outside board as professional referees enhances the viability of the board and also reduces the probability of top management colluding to expropriate shareholders wealth. According to Veronica (2005), board independence can be measured as follows:

$$\frac{\textbf{Total board of independent commissioner}}{\textbf{Total board of commissioner}}$$

Board of Commissioner Competence

Board of Commissioner Competence in this study is an independent variable. According to Xie et al. (2003) having a corporate and financial background is essential for board to be effective in monitoring a firm, especially in issues that relate to financial reporting as they have better understanding of earning manipulation. According to Abdullah (2013), board of commissioner competency can be measured as follows:

$$\frac{\textbf{Board of commissioner with financial competency}}{\textbf{Total board of commissioner}}$$

Managerial Ownership

Managerial ownership in this study is an independent variable. According to Saftiana et al. (2017), high managerial ownership would make managers have greater responsibilities in managing a company and presenting the financial statement with the correct information for the benefit of shareholders and themselves. According to Saftiana et al. (2017), managerial ownership can be measured as follows:

$$\frac{\textbf{Number of shares is owned by management}}{\textbf{Total outstanding shares}}$$

Institutional Ownership

Institutional ownership in this study is an independent variable. According to Bushee & Noe (2000), institutional investors create less incentive for management to cut expenditures to attain short term target. It indicates that institutional investors play a role in monitoring management actions. DeFond & Jiambalvo (1994) find that absolute discretionary accruals have a negative association with institutional ownership. According to Saftiana et al. (2017), institutional ownership can be measured as follows:

$$\frac{\textbf{Number of shares is owned by institutional}}{\textbf{Total outstanding shares}}$$

Classification of Company

In this study we used dummy variable to compare the correlation between the effect of corporate governance mechanism on earnings management in Sharia companies (JII-70) and Conventional companies (LQ-45). We classified the companies using dummy variable, 1 for companies listed in JII-70 and 0 for companies listed in LQ-45 index.

Dummy variable: 1 for JII-70 index, and 0 for LQ-45 index

RESULTS AND DISCUSSION

Descriptive Analysis

, the results of the descriptive analysis are provided and discussed. The results function to summarize and provide information related to each variable that has been used in this study consisting of discretionary accruals (DA), board commissioner size, frequencies of board commissioner meeting,

board of independent commissioner size, board commissioner competence, managerial ownership, and institutional ownership. The descriptive statistic results contain information of maximum, minimum, mean, and standard deviation.

Table 2: Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation
DAC	-0.22	0.39	0.03	0.06
Board Commissioner Size	2	12	5.58	1.96
Board Commissioner Meeting	2	51	10.84	9.08
Board of Independent Commissioner Size	0.2	0.8	0.42	0.11
Board Commissioner Competence	0	1	0.48	0.20
Managerial Ownership	0	0.73	0.01	0.08
Institutional Ownership	0.01	1.00	0.39	0.27

Table 3: Descriptive Statistics for Dummy Variable

Classification of Companies	Frequency	Percent
"1" for Companies listed on JII-70	110	36,1
"0" for Companies listed on LQ-45	195	63,9
Total	305	100

Regression Analysis

The multiple regression analysis is used to examine the relationship between corporate governance mechanisms such as board commissioner size, frequencies of board commissioner meeting, board of independent commissioner size, board commissioner competence, managerial ownership, institutional ownership and earnings management.

The purpose of H1 is to investigate the effect of board commissioner size on earnings management. Based on Table 4.5, the coefficient of board size is negative and significant (h1 = -0.01, $p < 0.01$), and p value in variable board commissioner size is 0.00 < α =0.05. T statistic of board size is 3.405, while t-table is 1.645. Since, the t-statistic is > t-table or p value is < α =0.05. It means that the influence of board commissioner size on earnings management is negative and significant. So, *H1* is supported.

The purpose of H2 is to investigate the effect of frequency board meeting on earnings management. According to Table 4.5, the t-statistic of a board meeting is 2.193. T statistic < t table, which is 2.193 >1.645 or p value is 0.02 < 0.05 since p <0.05 and t > 1.645. It can be concluded that the influence of frequency board meeting on earnings management is positive and significant. Because, we hypothesized that frequency board meeting has negative effect on earning management. So, *H2* is not supported.

The purpose of H3 is to investigate the effect of board independent commissioner size on earnings management. Based on Table 4.5, the t-statistic of board independence is 1.500. T statistic < t table, which is 1.500< 1.645 or p value is 0.13 > 0.05. It can be concluded that the influence of board commissioner independence on earnings management is not significant. So, *H3* is not supported.

The purpose of H4 is to investigate the effect of board commissioner competence on earnings management. According to Table 4.5, the t-statistic of board commissioner competence 0.934. T statistic < t table, which is 0.914 < 1.645 or p value is 0.35 > 0.05. It can be concluded that the influence board commissioner competence of on earnings management is not significant. Thus, *H4* is not supported.

The purpose of H5 is to investigate the effect of managerial ownership on earnings management. Hence, the t-statistic of managerial ownership is 0.317. T statistic < t table, which is 0.317 < 1.645 or p value is 0.75 > 0.05. It can be concluded that the influence of managerial ownership on earnings management is not significant. Thus, *H5* is not supported.

The purpose of H6 is to investigate the effect of institutional ownership on earnings management. Hence, the t-statistic of institutional ownership is 0.922. T statistic < t table, which is 0.423< 1.645 or p value is 0.67 > 0.05. It can be concluded that the influence of institutional ownership on earnings management is not significant. Thus, *H6* is not supported.

The purpose of H7 is to investigate the effect of corporate governance mechanism on earnings management between companies listed on JII-70 and LQ-45 is different. Based on Table 4.3, and p value in dummy variable is 0.04 < α =0.05. T statistic of board size is 2.055, while t-table is 1.645. Since, the t-statistic is > t-table or p value is < α =0.05. It means that the dummy variable is significant. So, *H7* is supported.

Table 4: Regression Analysis

Variables	Coefficient	t-Statistic	Explanation
Constant	0.06	(2.869)	
Board of Commissioner Size	-0.08***	(-3.405)	HI is supported
Frequency of Board Commissioner Meeting	0.01	(2.193)	H2 is not supported
Board of Commissioner Independence Size	-0.05	(-1.500)	H3 is not supported
Board of Commissioner Competence	-0.01	(-0.93)	H4 is not supported
Managerial Ownership	-0.01	(-0.31)	H5 is not supported
Institutional Ownership	-0.06	(-0.42)	H6 is not supported
Classification of Companies	0.01**	(3.055)	H7 is supported

Notes: *** $P < 0.01$, ** $P < 0.05$, * $P<0.1$

The Effect of Board Commissioner Size on Earning Management

The result of these study stated that board commissioner size negatively affects earnings management, with coefficient -0.01 and significant at level 0.00. Which means the board of commissioner with large size is more effective to decrease the practice of earnings management. Our result is in line with the previous research from Xie et al. (2003), which stated board size has a negative effect on earnings management. Furthermore, Yu (2008) finds that the small size of the board is more prone to failure in detecting earnings management. This finding also show the implicitly that small size of board tend to be easily influenced by management or majority shareholders, while the large board commissioner size is more capable to monitor the practice of earnings management.

The Effect of Frequency Board Commissioner Meeting on Earnings Management

The result of these study stated that the frequency board commissioner meeting positively affects earnings management, with coefficient 0.01 and significant at level 0.00. It means that if the board commissioner meeting is held frequently, it can lead to increased the practice of earnings management. This result is in line with the previous research from Sastrawati & Hatane (2016). We assumed that the phenomenon is related with the effectiveness of the meeting. Board commissioner meeting usually discuss things that are strategic, and do not focus on technical issues. While, technical issues such as examining the financial statement and detecting the practice of earning management are handled over to audit committee.

The Effect of Board Independent Commissioner Size on Earnings Management

The result of this study stated that board commissioner independence does not affect earnings management. Based on statistical regression, the p value is 0.13 ($p > 0.05$), which means that the board independence does not significantly reduce earnings management. This result is in line with previous research from Siregar & Utama (2008) which stated independent board do not necessarily lead to more efficient in earnings management. According to Siregar & Utama (2008) the minimum requirement that declared by OJK for independent board membership is 30%. This portion may not be enough to exert significant influence on the board.

The Effect of Board Commissioner Competence on Earnings Management

The result of this study stated that the board commissioner competence does not affect earnings management. Based on statistical regression, the p value is 0.35 ($p > 0.05$), which means that the board commissioner competence does not significantly reduce earnings management. This result is in line with the previous research from Abdullah (2013). Furthermore (Prastiti & Meiranto, 2013) stated board of commissioners do not involve directly in the examination of financial statement which include the process of detecting earnings management, except if they are involved in the audit committee within the board.

The Effect of Managerial Ownership on Earnings Management

The result of this study stated that the managerial ownership does not affect earnings management. Based on statistical regression, the p value is 0.75 ($p > 0.05$), which means that the managerial ownership does not significantly reduce earnings management. This result is similar with previous research from Saftiana et al. (2017). According to Saftiana et al. (2017), management who own the company share will be opportunistic, where the management will try to increase profit by manipulating earnings for their self-interests.

The Effect of Institutional Ownership on Earnings Management

The result of this study stated that institutional ownership does not affect earnings management. Based on statistical regression, the p value is 0.67 ($p > 0.05$), which means that the institutional ownership does not significantly to reduce earnings

management. This result is similar with previous research from Saftiana et al. (2017). Based on this results, institutional ownership do not act as sophisticated investors, that is capable of monitoring the management of a company to create value in the long term, but investors are acting as the owner while focusing on current earnings (Yang et al., 2009). It is possible to lead managers compelled to meet the profit goals of the investors, and then they do earnings management.

The Comparison an Effect of Corporate Governance Mechanism on Earnings Management Between Companies listed on JII-70 and LQ-45

Classification of company which measured by dummy variable positively affects earnings management. The result shows that the p value is 0.04 with the coefficient 0.01. It means that the effect of corporate governance mechanism on earnings management between company listed on JII-70 and LQ-45 is different. Furthermore, the coefficient of the regression is positive, which is 0.01. Thus, it can be concluded that the effect of corporate governance mechanism on earnings management between company listed on JII-70 and LQ-45 is different, and the effect is greater in companies listed on JII-70 than companies listed on LQ-45.

CONCLUSION AND RECOMMENDATION

Conclusion

This study was conducted on 65 firms listed on Indonesia Stock Exchange (IDX). It contains 22 Sharia companies listed on JII-70 and 43 conventional companies listed on LQ-45 index. The data observation is from 2015 until 2019. Thus, the total sample is 305. This study was conducted to examine the effect of corporate governance mechanisms on earnings management. Furthermore, we compared the effect of corporate governance mechanism on earning management between companies listed on JII 70 and companies listed on LQ-45 index.

The results of these study prove that board of commissioner size negatively affects earnings management. It means the board of commissioner with large size is more effective to decrease the practice of earnings management. While, the other corporate governance mechanism variables such as the frequency of board commissioner meeting, board of independent commissioner size, board of commissioner competence, managerial ownership, and institutional ownership do not affect earnings management. It means whether there is the existence of those variables or not, and they do not affect the practice of earnings management.

Furthermore, classification of company which measured by dummy variable positively affects earnings management. It means that the effect of corporate governance mechanism on earnings management between company listed on JII-70 and LQ-45 is different. Furthermore, the coefficient of the regression is positive. Thus, it can be concluded that the effect of corporate governance mechanism on earnings management between company listed on JII-70 and LQ-45 is different, and the effect is greater in companies listed on JII-70 than companies listed on LQ-45.

Limitation

The limitation of this study was the accuracy of measurement for some corporate governance mechanism variable such as board of independent commissioner size and board commissioner competence. Board of commissioner competence was measured by the educational background (from accounting and finance major) of commissioner which the accuracy of measurement is still questionable, because the competence is not only measured by education but the real practice of the competency of commissioner in preventing earnings management. The author do not have access to observe the actual performance of board commissioner such as independency and competency in preventing the practice of earnings management. Thus, it can be the limitation of this research.

Recommendation

According to the result and conclusion that have been stated above, the author provides several suggestions. Firstly, the study measures the effect of corporate governance mechanisms on earnings management from 2015 until 2019. Future research may consider a longer time frame with the resulting impact of other regulations related to Sharia firms, corporate governance mechanism, and earnings management. Comparative research could be conducted to examine the pre- and post-regulation related to corporate governance mechanisms and earnings management. Secondly, more variables in the external of corporate governance mechanisms could be explored, such as the role played by auditors in association with earnings management and the existence of big four auditors. Thirdly, in future, research may use different methods to calculate discretionary accruals.

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