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Independent Board, Earnings Management, and Audit Quality

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Abstract:
This study aims to examine the effect of independent board on earnings management with auditor quality as moderating. Auditor quality is the focus of this study, because the auditor's reputation is predicted to reduce the level of earnings manipulation. Auditor quality is measured using industry specialties that describe the market share of audit services in the same industry and auditor size (big four). Both auditor quality measurements encourage researchers to examine the difference in influence between the quality of industry specialization auditors and big four auditors.

The study was conducted on manufacturing companies listed on the Indonesia Stock Exchange in the period 2013 - 2016 with 130 companies and the number of observations was 322 cases. The research design uses the Moderating Regression Analysis with audit quality variables as moderating. The results of this analysis conclude that the interaction of independent boards with big four auditors increases the effectiveness of monitoring and monitoring the financial reporting process. This is likely related to the auditor's selection decision as the authority of the board of boards, while the independent board reinforces the decision of the choice of a reputable auditor (big four auditor). This study aims to examine the effect of independent board on earnings management with auditor quality as moderating. Auditor quality is the focus of this study, because the auditor's reputation is predicted to reduce the level of earnings manipulation. Auditor quality is measured using industry specialties that describe the market share of audit services in the same industry and auditor size (big four). Both auditor quality measurements encourage researchers to examine the difference in influence between the quality of industry specialization auditors and big four auditors.

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I. INTRODUCTION

This study aims to examine the influence of the role of the Board of Director on earnings management with auditor quality as moderator. Auditor quality is the focus of this study, because the auditor's reputation is predicted to reduce the level of earnings manipulation. Auditor quality is measured using industry specialties that describe the market share of audit services in the same industry and auditor size (big four). Industrial specialization auditors and big four auditors describe audit quality, this is because the auditor's experience and mastery of certain industries and auditor reputation are predicted to be more effective in carrying out audit functions so that they can provide better assurance of the credibility of financial statements. Both auditor quality measurements encourage researchers to examine the difference in influence between the quality of industry specialization auditors and big four auditors

The practice of earnings management is done when there is information asymmetry between owners, investors as well as parties outside the company with the management. The negative impact of earnings management is low quality reported earnings (Velury and Jenkins, 2006), resulting in reduced relevance of accounting information (Habib, 2004).The problem of earnings management in the Indonesian context is important because Indonesia is in a cluster of countries with weak investor protection, thus triggering high earnings management practices (Leuz, Nanda, Wysocki, 2003). This is reinforced by the findings of Adiasih and Indra (2011) and Dwiatnyana and Jati (2014) that the financial statements of public companies in Indonesia still contain elements of earnings management. Empirical facts also indicate the occurrence of scandalous financial reports in some companies in Indonesia. This phenomenon shows that the practice of manipulation of financial statements is still proven by some companies in Indonesia. This condition certainly has an impact on economic decision making for the users of financial statements, because it can risk causing material losses, so that required an effective supervision of the opportunistic actions undertaken management.

The supervisory function of the company is carried out by the Board of Director (UU Nomor 40/2007 danPeraturan OJK nomor 33/POJK.04/2014). In the context of agency theory, the Board of Director is an internal governance mechanism that is expected to maintain the sustainability of the company (Rejeb, 2014). The Board of Director as the top of the internal control system has final corporate responsibility (Jensen, 1993; Azeez, 2015). The existence of independent members in the composition of the Board of Director is expected to increase its independence, as it is asserted that the presence of a number of independent boards

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has greater oversight and control over management (Roy, 2014; Hasan and Omar, 2015).

In addition to the Board of Director, assisted by the committees under it, there are also external auditors who also carry out the supervisory function. External auditors in the context of governance are reputational agents who have an important position beyond the other in the supervision of the company. As an external and independent party, the auditor has access to the company's books. External auditors can obtain private information about a company that can not be obtained by other parties (Kim and Nofsinger, 2003). The weak function of market mechanism and the lack of internal governance mechanism in Indonesia causes the role of external auditor is needed as an alternative mechanism by appraising and attesting to the accuracy of financial statements (Lukviarman, 2016: 200). Thus, the function of the external auditor is to provide assurance (assurance) that the financial information presented has met the accounting standards. External auditors are expected to ensure the quality of financial statements of profit management actions that violate the provisions of accounting standards as well as regulatory / legal provisions. This condition indicates that the Board of Director and external auditors are synergies in overseeing the company's financial statements.

Several studies related to the role of the Board of Director resulted in diverse findings. Osma (2008); Alzoubi (2012); Lo, Wong, and Firth (2010).shows that the characteristics of the Board of Director affect the earnings management. The results of these studies are not entirely influential to reduce, but there is also no effect on the action of earnings management. The results of previous studies show that results are still not consistent, so it is important to do in-depth research on the matter. The inconsistent results encouraged this study to include other variables into the model. The variables included are external auditor variables.

This research will besides examine the role of external auditors in enhancing the role of the Board of Director in monitoring earnings management. The role of the Board of Director will focus on its degree of independence, and the role of the auditor will be focused on its industry specialization. The results of this study are expected to contribute to the development of the concept of bundle of governance and contribution for practitioners and regulators as information for decision making or refinement of regulations.

II. INDEPENDENCE OF THE BOARD OF DIRECTOR AND EARNINGS MANAGEMENT

The independence of the Board of Director can be achieved by the inclusion of members from outside the company called independent board. Independent board can enhance the ability of the Board of Directors and be more efficient in monitoring management (Fama and Jensen, 1983). Independent board have effective management monitoring incentives because of the need to develop a reputation as an expert in decision making. According to Beasley (1996) the inclusion of boardwho have affiliation with management may undermine the independence of the Board of Director. Independent board must come from outside who have no business relationship or affiliation with the company.

Expectations on the role of independent board in earnings management monitoring are supported by several previous empirical studies. Members of the Board of Directors from outside the company can improve the effectiveness of management monitoring (Fama and Jensen, 1983). Sharma (2004) found that an increase in the proportion of independent board may reduce fraud. Osma (2008) found that independent boards hinder the manipulation of R & D spending. Lo, Wong, and Firth (2010) found that firms with a high proportion of independent board could reduce the manipulation of transfer pricing. While

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Prastiti and Wahyu's research results (2013) show that the independence of the Board has a negative effect on earnings management. While Saleh, Takiah, and Rahmat (2007) found no significant correlation between the proportion of independent Board's members and earnings management. Siregar and Utama (2008) also found no evidence of an independent boards relationship with earnings management.

III. AUDITOR QUALITY, INDEPENDENT BOARD, AND EARNINGS MANAGEMENT

Nugroho and Umanto (2011) argued that independent auditors tasked with external supervision of the company's financial statements. The auditor provides an assessment of the financial statements and inspects inconsistency records in the report and reports them to the Board of Directors. Auditors in the context of corporate governance include external monitoring mechanisms. The Board of Directors is assisted by the Audit Committee to monitor the financial reporting process, while the auditor assures (assurance) that the financial statements have been presented correctly in accordance with the financial accounting standards. Auditors are expected to provide good audit quality so as to improve the quality of financial information. The auditor should be able to ensure that reported earnings are reasonable in accordance with accounting standards and describe the actual financial situation. In this case, the auditor plays a role in strengthening the corporate governance mechanism, which is internal monitoring conducted by the Board of Directors, especially monitoring the earnings report

In the context of this study, the operation of two interrelated governance mechanisms, namely independent boards and auditor quality, are expected to be more effective in monitoring earnings management. Auditors are expected to provide guarantees on the credibility of earnings reports that are often used basic economic decision-making by interested parties. The auditor also has a reputational agent function, namely the company's reputation guarantee agent in the eyes of investors and other stakeholders.

As explained earlier, interaction between Board of Diectorswith independent auditors is a synergy predicted to improve the effectiveness of monitoring (complementary effect). Members of the Board of Directors who are from outside and have no affiliation with the company (and majority shareholders) are expected to have an independent attitude, that is not influenced by any party in carrying out their duties, so that when interacting with the quality of auditors will improve the effectiveness of monitoring on earnings management. Based on the above argument, the hypothesis of this research is expressed as follows:

H1: Auditor quality strengthens the negative influence of independent boards *on earnings management*

IV. RESEARCH METHODS

Based on the selected criteria, the sample members are 130 companies and the number of observations is 322 data. The data collected is a combination of time series and cross section data. Methods of data collection using documentation method or direct quotation from various document sources. The data used are secondary data consisting of: (1) The names of manufacturing companies listing in Indonesian capital market; (2) auditor's profiles practicing in the Indonesia Stock Exchange; (3) prospectus of a manufacturing company listing in Indonesia capital market; (4) The annual report of a manufacturing company comprising: a report of the board of director, a statement of financial position (balance sheet), profit / loss statement and cash flow statement, notes to the financial statements. All data is taken from Indonesian

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Capital Market Directory publication, Indonesian Stock Exchange.

Variables in this study are grouped into independent variables, dependent variables, moderating variables, and control variables. Each variable and its measurements are presented in Table 1 below.

Tabel 1.Variable's Measurement

Type of variabel	Name of variabel	Proxy
Dependent	Earnings management	*Discretionary accruals* based on Dechow, DichevdanMsNichols (2002), Francis *et al*. (2005)danFeng*et al*. (2011)
Independent	Independent board	The proportion (percentage) of independent boards to the number of members of the board of directors.
Moderating	Audit's quality	1. Public Auditor's Firm that specializes in the client's industry, is measured using the same auditor market in the same industry. The measurement is the ratio of total client assets to the total assets of all firms within the same industry (Balsam, et al., 2003) 2. Public Auditor's Fimr in the category Big4. Measurements using dummy variables ie Big4 rated 1, others 0
control	*Growth*	Percentage of profit growth
	Leverage	ratio of total debt to total assets
	Internal control	The internal control functions disclosed in the financial statements (annual)

This study uses inferential statistical analysis is an analysis conducted to test the research hypothesis of a number of samples in order to generalize the population. The method of analysis using Moderating Analysis Regression (MRA), where model equation is:

$$EM = \alpha + \beta_1 IndepBoard + \beta_2 Control + \varepsilon \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \quad (1)$$

$$EM = \alpha + \beta_1 IndepBoard + \beta_2 AudQuality + \beta_3 Control + \varepsilon \quad \ldots\ldots\ldots\ldots\ldots\ldots \quad (2)$$

$$EM = \alpha + \beta_1 IndepBoard + \beta_2 AudQuality + \beta_3 IndepBoard * AudQuality + \beta_4 Control + \varepsilon \quad \ldots\ldots\ldots\ldots \quad (3)$$

Notification:

α	:	Constant
β	:	Regression Coeffisien
EM	:	Earnings Management (Proksi Kualitas Laba)
IndepBoard	:	Independent board
AudQuality	:	Audit's quality

IndepBoard* AudQuality	:	Interaction of Independent boards and Audit's quality
Growth	:	Percentage of profit growth
Lev	:	Leverage
ε	:	Error term

V. RESULT

The results of descriptive analysis illustrate that the average number of independent boards and the number of independent boards shows a value of more than 30%. This means that one-third of the members of the Board of Directors are independent boards. Good governance provisions state that at least one-third (30%) of members of the Board of Directors are independent members have been met. Independent boards are external members who have no relationship with the company, either with the owner of a business relationship and / or an affiliate relationship. In the context of governance, independent boards are essentially representatives of outside parties, especially minority shareholders who have a role of supervision and monitoring of the company's operations. The existence of independent boards is expected to improve the effectiveness of monitoring of management, especially in the management and presentation of financial statements.

Auditor quality is measured using industry specializations that illustrate the auditor market in the same industry sector and auditor size (big four). Theoretically the industry specialist auditor and / or big four auditor describes the quality of the audit. The results of the analysis show that auditors performing auditing functions in manufacturing companies are mostly non-specialist and non-big four auditors while the rest are industry specialist auditors and big four auditors. The special audit auditor of the industry and / or big four auditor describes the quality of the audit, as the experience and control of the auditor of a particular industry and the auditor's reputation is predicted to be more effective in performing audit function so as to provide better assurance on the credibility of the financial statements

The result of hypothesis analysis and test (equation 1) shows that independent boards negatively affects earnings management (Table 1). The proportion of independent boards in membership of the board of boards effectively prevents the practice of earnings management. The higher the number of independent boards further decreases earnings management practices. The results of this study support the findings of Prastiti and Wahyu (2013) that the independence of the Board of Directors has a negative effect on earnings management. The results of this study are also in line with the findings of Fama and Jensen (1983), Sharma (2004), Osma (2008), Lo, Wong, and Firth (2010) that members of the board of directors from outside the company can improve the effectiveness of management monitoring. An increase in the proportion of independent boards may reduce fraud. independent boards can hinder the manipulation of R & D spending. High proportion of independent boards can reduce the manipulation of transfer pricing. However, the results of this study differ from the findings of Hasyim and Devi (2008) that there is a positive relationship of independent boards with earnings management. Saleh, Takiah, and Rahmat (2007) and SiregarUtama (2008) found no evidence of

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independent boards relationships with earnings management.

In the concept of governance, independent boards have effective role in management monitoring, including earnings management practices (Fama and Jensen, 1983). Independent boards have effective management monitoring incentives because of the need to develop a reputation as an expert in decision making. Therefore, independent boards must come from outside who have no relationship with the company, either with owners, management, or affiliation / business relationships. Based on the theoretical arguments and empirical findings of this study, we argue that independent boards have a higher level of independence than non-independent boards so as to perform more effective oversight and monitoring tasks.

Table 2.Results of Hypothesis Analysis and Testing

Variabel	Analysis of Industrial Specialization			Analysis of BigFour		
	Coefficient	Sig.		Coefficient	Sig.	
Indendent boards	-0,319	0,013	**	-0,320	0,012	**
Auditor quality	-0,093	0,088	*	0,128	0,538	
IndepBoard* AudQuality	-0,729	0,189		-0,881	0,007	***
Growth	-0,043	0,538		-0,037	0,592	
Leverage	0,086	0,001	***	0,093	0,000	***
Internal Control	-0,076	0,002	***	-0,078	0,002	***
R	0,382			0,391		
R Square	0,146			0,153		
Adjusted R Square	0,116			0,123		
F Change	4,811			5,075		
Sig. F Change	0,000			0,000		

The results of previous inconsistent research encouraged this study to include auditor quality variables into the model, as a moderating variable. The result of interaction analysis (equation 3) also shows that the independent boards influence stronger to decrease earnings management when interacting with big four auditors. However, when an independent boardsinteracts with the industry specialization auditor its influence is insignificant. The results of this analysis conclude that the interaction of independent boards with big four auditors increases the effectiveness of monitoring and monitoring of financial reporting processes. This may be related to the decision of the selection of the auditor to be the authority of the board of boards, while the independent boards strengthen the decision of the election of a reputable auditor (auditor big four).

In the concept of bundle of governance, the auditor serves as an alternative monitoring mechanism (substitution) when the market mechanism and internal mechanism are not

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optimal (Lukviarman, 2016: 200). However, auditors can also serve as strengthening (complementary) in order for internal monitoring mechanisms to be more effective (Gana and Krichen, 2013). As a strengthening mechanism, auditors interact with internal governance mechanisms in earnings management monitoring. This is in accordance with the opinion of Filatotchev (2008) that auditors and audit committees are two mutually interacting mechanisms.

Based on the theoretical arguments and empirical findings of this study, we argue that the role of big four auditors increases the effectiveness of monitoring and monitoring of independent boards on the financial reporting process. Big four auditors and industry specialization auditors that represent auditor quality. Both strengthen monitoring and monitoring of financial reporting processes when we interact with independent boards complementary in preventing opportunistic profit management practices.

VI. CONCLUSION

Based on the results of the analysis and discussion, we conclude that the interaction of independent boards with auditor quality negatively affects earnings management. The quality of the auditor has a strengthening (complementary) role to the monitoring and monitoring of earnings management mechanisms conducted by independent boards.Our results contribute to the concept of bundle of governance, which is a governance concept that runs through multiple mechanisms. Various governance mechanisms interact to form a "bundle of governance" in the monitoring and monitoring of the company's operations. In our research context we are shown by corporate governance mechanisms run by independent boards as internal governance mechanisms that interact with external mechanisms of auditors in monitoring and monitoring financial reporting (earnings management).

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