






“The influence of earning targets, independent board, and audit committee on earnings management in the Indonesian banking sector”

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THE INFLUENCE OF EARNING TARGETS, INDEPENDENT BOARD, AND AUDIT COMMITTEE ON EARNINGS MANAGEMENT IN THE INDONESIAN BANKING SECTOR

Abstract

This study investigates the influence of the independent board of commissioners and audit committee on earnings management to achieve earning targets in Indonesian banking. The research sample was drawn from 33 banks listed on the Indonesia Stock Exchange from 2012 to 2022 to evaluate the time frame of the study and its relevance to current banking trends in Indonesia, as well as to examine the data sources used and their reliability. The data analysis method used in this study is a dummy variable regression model. The findings reveal significant insights into the motivations behind earnings management practices. Specifically, this study finds that managers engage in earnings management to meet profit targets, thereby signaling strong performance to stakeholders and potentially securing bonuses. Notably, the influence of corporate governance structures varies: while the independent board of commissioners demonstrates no significant effect on earnings management ($p = -0.01$), the audit committee plays a pivotal role, significantly influencing earnings management practices ($p = -0.017$). Moreover, the analysis uncovers that company size has a significant impact on earnings management ($p = 0.002$), while return on assets (ROA) does not. This study provides empirical evidence demonstrating the efficacy of audit committees in curbing managerial incentives for earnings management to meet targets. Furthermore, by quantifying the influence of corporate governance mechanisms and firm characteristics on earnings management, this study sheds light on key dynamics in the Indonesian banking industry.

Keywords earnings management, earning target, independent commissioner board, audit committee

JEL Classification G34, M41, G21

INTRODUCTION

In 2020, PT. BTN Bank (Persero) faced allegations of financial irregularities, specifically concerning the manipulation of its 2018 Financial Report. These allegations underscored broader concerns regarding the transparency and integrity of financial reporting in the Indonesian banking sector. Such instances of suspected "window dressing" highlight the critical importance of understanding and mitigating earnings management practices in ensuring the reliability of financial information for stakeholders (Safitri & Sukmana, 2020).

Earnings management, the strategic manipulation of financial reports to convey a desired image of a company's performance, can have significant implications for stakeholders, ranging from misleading inves-

tors to undermining market integrity. This practice often stems from management's incentives to meet certain financial targets, potentially at the expense of long-term shareholder value.

In response to these challenges, corporate governance mechanisms emerge as crucial tools in safeguarding against earnings management practices. By ensuring transparency, accountability, and ethical conduct within organizations, effective corporate governance can mitigate the agency problems that incentivize managerial opportunism.

While prior research has explored the relationship between corporate governance and earnings management, particularly in equity incentive policies for executive officers, there remains a gap in understanding the effectiveness of corporate governance mechanisms, particularly within the context of the Indonesian banking industry. This industry-specific focus is important given its systemic significance and the unique regulatory landscape it operates in.

This study seeks to close this gap by examining the function of corporate governance in reducing the use of profit management techniques in the Indonesian banking industry. By evaluating how well corporate governance practices support financial transparency and accountability, this study aims to shed light on the mechanics of profit management and its consequences for stakeholders in the Indonesian banking sector.

1. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

The application of Prospect Theory to earnings management motivation is that when the manager operates in conditions above the specified earning target, the manager is in an earningable position (gain), so he will make decisions in a risk-averse way to carry out earnings management. On the other hand, when a manager operates in conditions below the specified earning target, the manager is in an unearning position (loss), so he will make decisions by looking for risks (risk-taking) to manage earnings. Managers are motivated to manipulate revenues to achieve predefined goals (Assenso-Okofu et al., 2020).

Numerous studies have revealed that businesses base their yearly incentive programs' earning objectives on historical performance data. Businesses will rather extend their earnings objectives to zero than establish negative expectations, even if doing so makes it more difficult for them to reach. It is also possible to read a company's hesitation to establish an earning aim below zero as a promise to stay away from a negative earning target. According to another research, top managers control reported accounting performance to meet

pay targets. Executive managers who get bonuses based on a single indicator are likelier to experience this impact than those who receive incentives based on many criteria. This effect is present in earning-based performance. Target-oriented incentives and those with non-equity rewards are particularly affected by this. Compared to corporations that only miss their EPS objectives, those that only surpass them have larger anomalous accruals and smaller R&D spending. Companies that exceed their earning targets have lower selling, general, and administrative costs than those that miss them. Several researchers found that most companies barely meet or achieve earning targets. The companies manage earnings to meet or achieve earning targets. Companies that engage in earnings management around these dilutive events experience a relative decline in future earning ability over the next four quarters. The companies also examined the market reaction to the next earnings announcement date and found that the market reacted negatively to companies experiencing dilution and engaging in earnings management. This study wants to know how the influence of earnings targets motivates managers to implement earnings management.

Board independence is one of the key factors influencing a board's efficacy in limiting managers' freedom in handling profits (Alareeni, 2018).

Therefore, agency theory proposes adding independent (non-executive) members to the firm board to boost the efficacy and activity of the board of directors in terms of its monitoring role. The presence of an independent board diminishes earnings management by giving the corporation's board more power (Alareeni, 2018). Independent directors' presence will increase the independent board's effectiveness (Bzeouich et al., 2019). Independent directors have to oversee management on behalf of stockholders. To properly oversee the actions of opportunistic managers, independent directors must actively participate in resolving this conflict of interest (Alareeni, 2018; Bzeouich et al., 2019). According to agency theory, the presence of an independent director will boost the efficiency of the business's management performance monitoring system. That happens because independent directors do not have special relationships with internal parties in the company to increase the board's independence. Thus, independent directors have strong incentives to act as competent monitors.

Accordingly, research has discovered a negative correlation between earning management and board independence (Asmara et al., 2021). When observing managers, independent boards of directors have fewer conflicts of interest. Apart from that, an independent board of commissioners with good professional independence can perform their supervisory function well. Excellent independent commissioner supervision of bank operational policies will prevent managers from managing earnings, thereby improving company performance (Asmara et al., 2021). The following hypothesis can be ascertained by drawing upon theory and prior study. According to the explanation provided in the presentation, this study aims to determine how the effect of an independent board of commissioners affects income management procedures.

The audit committee is another important mechanism for monitoring the quality of financial reporting (Mardjono & Chen, 2020). Agency theory describes audit objectives as a significant bonding mechanism within a company that serves to more closely identify managers' interests with those of shareholders. The audit committee supervises and ensures that managers, internal auditors,

and external auditors act in the significant interests of a company (Zulfikar et al., 2020) and cannot commit fraud in preparing financial reports (Mardjono & Chen, 2020). Therefore, the internal audit process is assumed to be a monitoring tool that will reduce managers' incentives to carry out earnings management.

Numerous investigations have assessed the influence of audit committees on earnings management. Studies reveal that sessions of the audit committee are detrimental to income management (Ittonen et al., 2017; Kumari & Pattanayak, 2017). An audit committee's attendance at board meetings can aid in more efficient oversight of the organization's operational activities. Furthermore, the audit committee members' backgrounds and audit experience also play a part in the efficient oversight of management accounting processes. Directors of audit committees with professional auditing expertise can enhance the financial reporting standard within the financial sector (Ittonen et al., 2017). An audit committee consisting of at least two members who have management knowledge and accounting expertise, namely, the chairman and at least one member, will improve monitoring and ensure high-quality financial reporting as well as increase efficiency and ability to detect and prevent earnings management (Al-Absy et al., 2018).

Several recent empirical findings find a negative relationship between audit committees and earnings management (Zehri & Zgarni, 2020). Audit committee activities, size, and independence effectively reduce earning management practices. That means that size is an integral factor for audit committees to supervise company disclosure practices. Based on theory and previous research, several hypotheses can be put forward. In explaining the relationship between the last variables, this study wants to know how the influence of an audit committee reduces earnings management practices.

In the context of this study, the application of Prospect Theory suggests that managers' behavior in manipulating earnings follows predictable patterns. Specifically, managers tend to exhibit risk-averse tendencies when operating above-specified targets and take risks when operating below them.

This behavior often leads managers to manipulate earnings upward to meet predetermined targets, a phenomenon supported by previous research findings. Additionally, companies tend to use past performance information to set earnings targets, avoid negative targets, and stretch them to zero, impacting various operational aspects such as R&D expenditures and selling costs. Furthermore, there exists a negative relationship between board independence and earnings management, indicating that the presence of independent directors can effectively reduce managerial discretion and monitor opportunistic behavior. Similarly, the audit committee plays a crucial role in monitoring the quality of financial reporting, with its activities, size, and independence shown to decrease earnings management practices significantly.

Overall, these findings lay the groundwork for hypotheses formulated to guide the investigation into the interconnected pathways influencing earnings management practices, as follows:

H1: Earnings target has a positive effect on banks' earnings management practices.

H2: Independent board of commissioners negatively influences banks' earnings management practices.

H3: Audit committee has a negative influence on banks' earnings management practices.

2. RESEARCH METHODS

The study population consists of banks listed from 2012 to 2021 on the Indonesia Stock Exchange. The study sample was chosen using purposeful sampling, which employs criteria based on particular assessments. The research sample is displayed in Table 1.

Table 1. Summary of the research sample: banking companies listed on the Indonesia Stock Exchange (2012–2021)

Number	Criteria	Total
1	Banks listed on the Indonesia Stock Exchange from 2012–2021	45
2	Banks that have yet to publish consecutive annual reports from 2012–2021	9
3	Non-conventional banks.	3
Companies used in the research sample		33
Total research observation data for 10 years		330

This type of research data is secondary data consisting of company annual reports. Research data were obtained via www.idx.co.id and other sites related to research data. The data analysis method used is dummy variable regression.

The dependent variable in this study is earnings management. Accounting techniques are used by earnings management to modify the desired earnings. Discretionary Loan Loss Provisions (DLLP) are the earnings management proxy employed in this study. The ability of bank management to arrange or assess Loan Loss Provisions (LLP) flexibly is known as DLLP. DLLP can be identified in two stages. The first stage uses special accruals to measure artificial earning management, which more specifically uses the main accruals in the banking sector, namely LLP. LLP consists of two components, namely Non-discretionary LLP (NDLLP) and Discretionary LLP (DLLP) (Embuningtyas, 2018). NDLLP is estimated using the following equation.

$$LLP_{it} = \beta_0 + \beta_1 NPL_{it-1} + \beta_2 \Delta NPL_{it} + \beta_3 \Delta TL_{it} + \varepsilon_{it}. \quad (1)$$

DLLP consists of the prediction error LLP estimated through the residuals obtained from equation (1). The next stage is evaluating the non-discretionary LLP (NDLLP) component.

$$NDLLP_{it} = \beta_0 + \beta_1 NPL_{it-1} + \beta_2 \Delta NPL_{it} + \beta_3 \Delta TL_{it}. \quad (2)$$

In the final stage, the DLLP component is obtained by calculating the difference between the total LLP and the estimated NDLLP. The basic estimation equation is as follows:

$$DLLP_{it} = LLP_{it} - NDLLP_{it}. \quad (3)$$

The study's independent variables are the audit committee and the independent board of com-

missioners. Indonesia has a two-level board system in place. There is a strict separation between the supervisory board's monitoring function and the executive board's management function, and members of one board cannot be members of the other. A company's supervisory board supervises the executive board to ensure that the executive board has implemented the right system for running the corporation. The term of service, attendance at board meetings, and the independent board members' expertise and experience in accounting and auditing comprise the independent board of commissioners variables utilized in this study. According to agency theory, the efficacy and activity of the board of directors in terms of its monitoring role can be increased by adding independent (non-executive) directors to firm boards. The grading system for the independent board of commissioners is shown below.

- Independent members of the commissioners' board who have studied finance, accounting, and auditing in school. If appropriate, it will be given the number 1, and if the independent board member does not have an educational background in accounting, finance, and auditing, it will be given the number 0.
- The education level of members of the independent board of commissioners is a minimum of graduate level two. If appropriate, it will be given a score of 1, and if the education level of an independent board member is only a first-degree pass, it will be given a score of 0.
- Work experience more than 5 years. If appropriate, the number 1 and if the work experience is less than 5 years, the number 0 will be given.
- Independent commissioner board meetings held 1-4 times a year will be given the number 1, board meetings held 5-8 times will be given the number 2, board meetings held 9-12 times will be given the number 3, and above 12 times will be given the number 4. Then, the number is divided by 4.

$$DKI = \frac{\text{number of score items}}{4} \quad (4)$$

The audit committee variables used in this study consist of expertise in finance and audit, educa-

tional level, work experience in finance and audit, and the level of audit committee attendance at meetings. Accounting-savvy heads of audit committees are crucial in spotting management's shady activities. If at least one audit committee member has accounting experience, the audit committee chair with accounting competence will make the best choice (Al-Absy et al., 2018). Below is the scoring used in audit committee measurements.

- Audit committee members with an educational background in accounting, finance, and auditing. If appropriate, it will be given the number 1, and if the audit committee member does not have an educational background in accounting, finance and auditing, then it will be given the number 0.
- The minimum educational level of audit committee members is graduate level two. If appropriate, it will be given the number 1, and if the audit committee member's educational level has passed first grade, it will be given the number 0.
- Experience working in audit and finance. If appropriate, it will be given the number 1, and if it has no experience in auditing and finance, it will be given the number 0.
- Board meetings held 1-4 times a year will be given the number 1, 5-8 times will be given the number 2, 9-12 times will be given the number 3, and above 12 times will be given the number 4. Then, the number is divided by 4.

$$KKA = \frac{\text{number of score items}}{(4)} \quad (5)$$

The study also uses return on assets (ROA) and firm size as control variables. Total assets of company are used to calculate the firm size, and ROA is calculated as net profits divided by total assets.

3. RESULTS AND DISCUSSION

First of all, this study groups the sample into samples identified as managers carrying out earnings management practices to achieve earning targets and samples identified as managers not carrying out earnings management practices to achieve

earning targets. The grouping procedure used is based on earnings per share (EPS). Investors' interest in EPS can motivate managers to carry out earnings management to exceed the EPS target limits that have been previously set. Apart from that, minority investors are very interested in the size of EPS when compared to the ROA value because EPS will determine the amount of dividends that will be distributed by the company and as a measure to provide additional compensation to the CEO (Armstrong et al., 2023). The grouping of identified and unidentified samples carrying out earnings management to achieve earning targets is presented in Table 2.

Table 2. Samples identified engaging in earnings management to meet earning targets

Year	Identified Samples	Unidentified Samples
2012	11	22
2013	12	21
2014	6	27
2015	9	24
2016	8	25
2017	9	24
2018	16	17
2019	5	28
2020	2	31
2021	7	25
Total	85	237

As previously explained, this study will investigate earnings management practices based on Prospect Theory, which uses reference points in making decisions. The amount by which the EPS value changed from the prior year to the current one serves as the research's reference point. One of the most popular success metrics in CEO annual cash bonus plans is earnings per share (EPS), which gives CEOs incentives to meet EPS targets set by their boards to avoid termination and get cash payouts (Armstrong et al., 2023; Bennett et al., 2017). Several practitioners in banking say that companies determine earning targets based on the previous year's earnings. The targeted earning is usually around 10% higher than the previous year. Based on these conditions, researchers estimate that the earning limit managed by managers is approximately 10 to 35% higher than the determined earning target because managers are more careful when carrying out earnings management. The threshold for determining a sample identified as car-

rying out earnings management practices is a sample with a change in the EPS value between 0.1 and 0.35.

Based on the results of simple regression analysis for testing hypothesis 1 presented in Table 3, significantly earning targets affect managers' motivation to manage earnings. These results indicate that managers will carry out earnings management so that earning targets are achieved. Managers who can achieve earning targets show that the manager's performance is very good and they will get a bonus for this achievement. The study findings of Indjejikian et al. (2014), which demonstrate that businesses with limited earning capacity typically raise earning targets when their managers reach or surpass the goals from the prior year, corroborate this conclusion. Consistent with Bennett et al. (2017) research results, managers will manage their earnings to meet or achieve earning targets in companies that do not achieve the specified earning targets. To receive compensation for their work, managers are motivated to control earnings.

Managers are more interested in managing their profits through real activities because they have the opportunity to manipulate financial information to meet profit targets. Profit has been used as a target in assessing the business performance of a department in particular (manager) or a company (organization) in general. The level of profit obtained is often related to management's achievements, besides it is a common thing that the amount of bonus a manager will receive depends on the amount of profit obtained. Banking managers will get a bonus if the company's profits are greater or the same as last year's profits. This will benefit managers, so managers will be motivated to carry out earnings management to maintain the bonuses they receive. This means that giving bonuses can motivate managers to use accounting policies to report higher profits. In this study, Earnings Per Share (EPS) is used to describe management that carries out earnings management practices to meet profit targets. Shareholders or company owners focus more on EPS than other accounting data. EPS calculations are influenced by estimates, accounting policies, and judgments from the CEO, and EPS is also often associated with compensation for company managers (Putri & Wirawati, 2023).

Table 3. Simple regression analysis for testing Hypothesis 1

Variables	Results
Const	-0.064
Dum_EPS	-0.003*
SIZE	0.057
ROA	0.001*
F-value	10.009*
R ²	0.084

Note: * Significant at Alpha 5%.

Table 4 shows the empirical findings for the two hypotheses in the investigation. First, independent commissioners' hypothesis testing analysis lessens the need for earnings management techniques. These findings suggest that implementing an independent board of commissioners has no discernible impact on reducing earnings management strategies driven by the need to meet earnings objectives. Earnings management practices persist because an external board can add to problems with the emergence of free-riders (Alam et al., 2020). Therefore, independent boards cannot regulate managers' discretionary reporting methods and keep an eye on the financial reporting process (El Mokrani et al., 2021). In addition, independent boards of commissioners recruited to have less experience in their field can also improve earnings management practices because they need help understanding the financial reporting presented by managers. An independent board of commissioners is not the factor most considered in efforts to minimize earnings management practices (Putri & Wirawati, 2023). This indicates that the number of commissioners on a company's board, whether large or small, has no impact on the methods used to manage earnings. Because the appointment of independent commissioners is primarily done to satisfy relevant statutory requirements rather than to maintain sound corporate governance, there are situations in which the independent board of commissioners has no control over profit management. However, the dominant shareholder continues to significantly influence the board's performance, both positively and negatively. The founders of a firm and the dominant shareholders possess a significant degree of power, which reduces the independence of the board of commissioners. Therefore, the supervisory task of the independent board of commissioners becomes ineffective. Commissioners were often appointed

simply because of family ties, respect, or other kinship ties. This causes their function as a board to be hampered due to their lack of expertise and integrity (Juita, 2021).

Table 4. Linear regression analysis results

Variabels	Results
Const	-0.069
Board of Independent Commissioners	-0.001
Audit Committee	-0.017*
Company Size	0.002*
ROA	0.054
Dum_EPS	-0.003*
R ²	0.124
F-value	9.131*

Note: * Significant at Alpha 5%.

Examining audit committee hypothesis testing also lessens the use of earnings management techniques. These findings suggest that audit committees significantly impact reducing earnings management. These results show that the audit committee's job and organizational function operate efficiently. Audit committee members with advanced degrees and years of expertise in audit, accounting, and finance will better comprehend firm management's financial reporting. In addition, a high frequency of meeting attendance for each audit committee member will make it easier to monitor the operational activities of managers in the company. Thus, earnings management practices in companies will decline further.

Audit committees in accounting and industry can assist in identifying unusual changes to income and cost accounts in earnings management procedures. If anomalies are discovered in the financial accounts, the audit committee will immediately discuss the matter and examine management-related company processes. An audit committee's experience is anticipated to improve a company's financial reporting (Cohen et al., 2014). If there is at least one member of the audit committee with financial competence, it is thought that earnings management methods would decline. Furthermore, the audit committee's independence may influence a company's decision to reduce profits management procedures (Galal et al., 2022). The audit committee is responsible for monitoring managers' conduct as corporate managers. By

monitoring the reporting and internal control procedures, the audit committee helps to curtail earnings management techniques.

Additionally, a company's size significantly and favorably affects its ability to control earnings. It implies that the practice of earnings management

increases with firm size. Because bank size indicates the amount of a company's overall assets, it has a beneficial impact on earnings management (Embuningtyas, 2018). The statistical results for ROA demonstrate that ROA has a noteworthy adverse impact. The company's earnings management is inversely correlated with its ROA number.

CONCLUSION

This study aims to ascertain how banks' corporate governance affects earnings management and the drive to meet earnings goals. The research results show that banks that manage earnings achieve earning targets by increasing earnings through LLP discretion. Banks' managers will manage earnings when the company's earning targets are not achieved. Empirical data are presented in this study to support the claim that a banks' independent board of commissioners does not influence profit management. The enormous size of the banks' independent board of commissioners makes it less effective in monitoring managers' use of earnings management techniques. The inability of the banks' independent board of commissioners to supervise operational activities more closely is caused by members' incompetence and lack of experience in their respective fields, particularly accounting and finance, as well as their poor attendance at meetings. This study also provides empirical evidence that banks' audit committees in companies can reduce managers' motivation to carry out earnings management practices to achieve earning targets. The function of the banks' audit committee is effective in providing supervision to managers in operationalizing the company. Banks' audit committee members must have high competence and experience in audit, accounting, and finance. Furthermore, frequent, in-depth discussions between the audit committee and the board of directors may deter management from controlling profits.

This study makes several contributions. First, it identified managers carrying out earnings management to achieve earning targets based on changes in earnings per share with a threshold of 10%-35%. Second, it enriches the prospect theory literature in explaining earnings management motivation, especially in achieving earning targets. Third, the results of this study can help shareholders assess the risks of managerial policies and detect earnings management practices carried out by bank managers. In addition, regulators and standard setters can provide insight into strengthening financial regulations in banking to prevent opportunistic manager behavior and improve the quality of financial reports.

This study has the following limitations: 1) The proxy used to measure the Board of Independent Commissioners is still weak, so stronger items are needed to measure the Board of Independent Commissioners, such as the proportion of the number of members of the Board of Independent Commissioners; 2) Future research can use other management motivations such as to avoid losses or reduce earnings when exceeding earning targets so that they can provide more comprehensive empirical evidence.

AUTHOR CONTRIBUTIONS

Conceptualization: Dewi Puji Rahayu, Nurkholis, Imam Subekti, Sari Atmini.

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Writing – original draft: Dewi Puji Rahayu, Sari Atmini.

Writing – reviewing & editing: Dewi Puji Rahayu, Nurkholis, Imam Subekti, Sari Atmini.

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