E-ISSN : 2721-1126, P-ISSN : 2721-1118
Available online at:
https://ejournal.itbwigalumajang.ac.id/index.php/ijamr

Discretionary Accruals: Detecting the Quality of Earnings Using Corporate Governance, Firm Size and Leverage

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ARTICLE INFO

Date of entry:
4 August 2023
Revision Date:
2 September 2023
Date Received:
22 September 2023

ABSTRACT

This research is designed to explain the influence of leverage, size and corporate governance proxied by the audit committee independent commissioners on earnings quality as measured using discretionary accruals directly and through the moderating variable family ownership. Data was obtained from the financial reports of companies that met the sample criteria of 644 manufacturing companies in 2019-2022. The data analysis method uses descriptive analysis. The results showed that each variable has a different effect, such as the audit committee and leverage variables, there is no effect on earnings quality, this shows that the presence or absence of an audit committee and high or low does not encourage companies to make discretionary accruals, while the independent commissioner variable has a negative and significant effect on earnings quality, then company size has a positive effect on earnings quality. This research provides insight into the importance of corporate governance and its practical implications to assist company stakeholders in optimising corporate governance policies and earnings management strategies.

Keywords: Corporate Governance, Discretionary Accruals, Earnings Quality, Leverage, Size

Cite this as : Melasari, M., & Widyanti, Y. (2023). Discretionary Accruals: Detecting the Quality of Earnings Using Corporate Governance, Firm Size and Leverage. *International Journal of Accounting and Management Research*, *4*(2), 94–106. https://doi.org/10.30741/ijamr.v4i2.1350

INTRODUCTION

Profit information in financial reports is a parameter used to measure company management performance. This profit information influences investors' behavior when investing in the company. Financial reports are a form of information needed by the market that investors often use in addition to the market situation and business prospects of an issuer. However, entity performance is also the primary indicator that investors consider because company performance can reflect a company's fundamental condition and value. Investor behavior in the capital market is reflected in how investors make investment decisions, one of which is by responding to profits reported by the company.

E-ISSN : 2721-1126, P-ISSN : 2721-1118
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Discussing the quality of profits in a company cannot be separated from implementing corporate governance practices. Corporate governance is implemented to ensure accountability. Companies hope that implementing corporate governance can guarantee the quality of their financial reports, including the quality of profits presented (Paramita et al., 2020).

One stream in accounting research is positive accounting theory, which refers to the flow of positive philosophy and uses empirical facts to find existing truths. This research reviews the positive accounting theory Watts and Zimmerman (1978) developed. The concept of Positive Accounting Theory (PAT) departs from agency theory (Jansen & Mackling, 1976) and the efficient market hypothesis (Fama, 1965). Agency theory explains the relationship between the principal (company owner) as the party who provides authority and the agent (company management) as the party who exercises authority, assuming that the agent works according to the principal's wishes. Meanwhile, the efficient market hypothesis (EMH) is a theory with the assumption that current stock prices reflect all existing information.

One thing that can minimize earnings management is implementing good corporate governance. Corporate governance is a concept based on agency theory that is expected to provide investors with confidence that they will receive returns commensurate with the funds invested. Earnings management can be done in two ways: accrual-based and real earnings management (Sinurat & Ilham, 2020). Accrual-based earnings management focuses on the choice of accounting methods carried out by management to manipulate financial reports. In contrast, real earnings management focuses on management actions that deviate from general business practices to influence transactions that occur to fulfill/achieve the desired goals/results (Roychowdhury, 2006).
Earnings quality has become an interesting research object for many researchers, especially regarding the use of measurement, condition issues, and determinants of earnings quality (Biddle & Hilary, 2006; Barth et al., 2008; Chen, 2011; Byrce et al., 2015). Financial reports representing good quality information are interesting research trends influencing stakeholders' decisions. Like Mazzioni and Klann (2018) conducted research on aspects of earnings quality in an international context. Earnings quality in this research is based on company rankings, consisting of four earnings attributes: accrual quality, earnings persistence, earnings predictability and income smoothing. The results of this study show that companies located in countries with a low tax burden, a solid legal environment, a significant economic and financial development index, adhering to a standard law system and a high level of internationalization have a higher average and significant differences in terms of aggregate in earnings Quality ranking. In addition, research findings also show that the accounting standards used also influence the position in the aggregate ranking of earnings quality.

Several previous studies have been conducted on the influence of corporate governance on earnings quality. Corporate governance is proxied by managerial ownership, institutional ownership, the number of boards of commissioners, the composition of the independent board of commissioners (ratio of the independent board of commissioners to all members of the board of commissioners) and the audit committee. Research by Yasmeen et al. (2015) shows that managerial ownership, the size of the board of commissioners, and the composition of the independent board of commissioners and audit committee do not significantly affect earnings quality. Research by Guna and Herawati (2010) revealed that the composition of the independent board of commissioners, the size of the board of commissioners and the audit committee do not affect earnings quality. These results are in contrast to research by Nasution and Setiawan (2007) and research by Oktaviani and Rahmawati (2015), the results of which show that the composition of the independent board of commissioners and audit committee has a significant negative effect on earnings quality.

Based on the description of the problem's background and previous research, this research aims to analyze the influence of the audit committee, independent commissioners, firm size and leverage on earnings quality.

METHODS

A purposive sampling technique was used to study the population of 195 manufacturing companies listed on the Indonesia Stock Exchange for 2019-2022. A total of 34 companies did not meet the sampling criteria, so 161 companies were used as samples. In the span of the research years, the total sample was 644 companies. This research is quantitative research that measures social phenomena using variables and indicators.

Quality of Earnings

The measurement of earnings quality uses a discretionary accruals proxy calculated using the modified Jones model (1995). Modified Jones model parameters are estimated using cross-sectional OLS regression for each industrial sector. Discretionary accruals are an accrual component that allows managers to intervene in preparing financial reports so that the profits presented in the financial reports do not reflect the actual value or condition of the company (Dechow et al., 1995).
The following are the steps for determining the Discretionary accruals value:

1) The first step is to determine the total accrual value of the sample company using the operational cash flow approach with the following formula: $TA_{it} = NI_{it} - OCF_{it}$ …………………………………..………………. (1)

   Description:
   TA_{it}: *Total accruals* of company i in year t
   NI_{it} : *Net Operating* Income in period t
   OCF_{it} : *Operating Cash Flow* in period t
2) Calculate the regression coefficient parameter values to obtain the numbers β_1, β_2, and b3. The dependent variable is total accruals, and the independent variables are total assets from the previous year (t-1), changes in income and total gross fixed assets of the company in year t.
   $TA_{it}/A_{it-1} = \beta_1 (1/A_{it-1}) + \beta_2 (\Delta REV_{it}/ A_{it-1}) + \beta_3(PPE_{it}/ A_{it-1}) + \varepsilon$ ….…. (2)
   Description:
   TA_{it} : *Total accruals* of company i in year t
   A_{it-1} : *Total assets* of company i in year t
   ΔREV_{it} : Change in company's income from year t-1 to year t
   PPE_{it} : fixed assets *(gross property plant and equipment)*
   ε : sample error
3) Calculate the non-discretionary accruals component, which is formulated as follows:
   $NDA_{it} = \beta_1 (1/A_{it-1}) + \beta_2 (\Delta REV_{it}/ A_{it-1}-\Delta REC_{it}/ A_{it-1}) + \beta_3(PPE_{it}/ A_{it-1}) + \varepsilon$ ……………………………………………………………….……(3)
   Description:
   NDA_{it} : *non-discretionary accruals* of the company i in period t
   A_{it-1} : total *assets* of the company i in year t
   ΔREV_{it} : Change in company's income from year t-1 to year t
   ΔREC_{it} : Change in receivables of the company i from year t-1 to year t
   PPE_{it} : fixed assets (*gross property plant and equipment*)
   ε : sample error
4) L The next step is to determine the value of *discretionary accruals* using the modified Jones model, which is formulated as follows:
   $DA_{it} = TA_{it}/A_{it-1} - NDA_{it}$ …………………………………………….. (4)
   Keterangan:
   DA_{it} : *discretionary accruals* of the company i in period t
   TA_{it}/A_{it-1} : *Total accruals* of company i in year t
   NDA_{it} : *non-discretionary accruals* of the company i in period t

Audit Committee

The audit committee has a separate task of assisting the board of commissioners in fulfilling its responsibilities in providing comprehensive supervision. The number of audit committees in a company during the observation period measures the number of audit committees.

Independent Commissioner

An independent commissioner is a member of the board of commissioners who is not an employee or someone who deals directly with the organization and does not represent shareholders. In this study, independent commissioners are the number of independent commissioners of a company in the observation period divided by the total board of commissioners.

The audit committee is a committee that has a separate task: assisting the board of commissioners in fulfilling its responsibilities of providing overall supervision. Audit committees are measured by the number of audit committees in a company during the observation period.

$$KI = \frac{(Independent\ commissioners)}{(Total\ board\ of\ commissioners)}$$

Firm Size

Firm Size is defined as the size of the company, which is measured using the company's total assets. The measurement process is by naturalizing the total assets of the company.

Firm size = Natural log (Ln) Total Assets

Leverage (DER)

Leverage is the company's debt-to-equity ratio, calculated by comparing total debt with total capital/equity. Company leverage is calculated by comparing total debt with total capital/equity.

$$DER = \frac{\text{Total } Debt}{\text{Total } Equity}$$

Regression equation

The regression model is a regression model for testing multiple regression hypotheses to test the influence of audit quality, independent commissioners, and firm size on earnings quality. The following is the regression equation for model 1:

$Y = \alpha + b_1KA + b_2KI_2 + b_3Size + b_4DER + e$

Description:

Y	=	Quality of earnings
α	=	Constant
$b_1 \ldots b_4$	=	Regression coefficient
KA	=	Audit committee
KI	=	Independent Commissioner
DER	=	*Leverage (DER)*

The methodology section contains the approach used in producing scientific articles. Specifically for scientific research articles, the methodology section includes research methods, populations and samples, as well as data analysis steps.

RESULTS AND DISCUSSION

In this section, we will explain the results of the classical assumption test, which consists of data normality, multicollinearity, heteroscedasticity, and autocorrelation tests, as well as the results of the MRA test.

In this section, we will explain the results of the classical assumption test, which consists of data normality, multicollinearity, heteroscedasticity, and autocorrelation tests, as well as the results of the MRA test.

1. Classic Assumption Test

This research uses the classic assumption test before testing the hypothesis with multiple linear regression analysis. In general, this research uses 2 (two) equation models to test hypotheses: an equation model without interaction (direct effect) and a regression equation model involving interactions from family ownership. The prerequisite tests used in this research include normality, heteroscedasticity, multicollinearity, and autocorrelation tests. The following is an explanation of the results of the classical assumption test in this research, as follows:

a. Normality test

Tests are attempted to determine whether the residual value of research data has a normal distribution, so it is recommended that a normality test be carried out. This research uses the P Plot Regression test to test whether the data is usually distributed. The data testing results show that the data distribution is around the diagonal line and follows the diagonal line, thus showing that the residuals in the data are normally distributed. Hence, the data meets the normality assumption.

In the following image, the results of the normality test using the P Plot Regression test are presented:

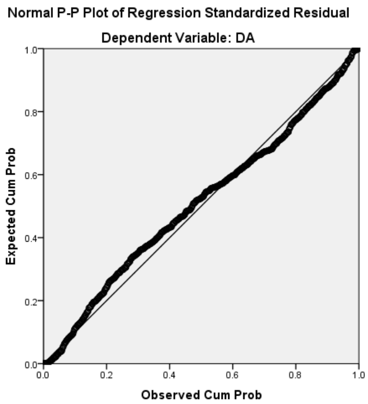

Figure 1. Normality Test Results

b. Multicollinearity Test

The multicollinearity test plays a role in detecting whether there is a relationship (correlation) between the independent variables in the research. Based on the results of the run data, paying attention to the tolerance and VIF values shows that each variable in the regression equation model shows > 0.1 in the tolerance value, and the VIF value is <10. Therefore, it is concluded that the regression equation in this study does not contain symptoms of multicollinearity.

The following are the results of the coefficient test to detect symptoms of multicollinearity using the VIF value.

Table 1. Multicollinearity test results

Variable	Collinierity Statistic	
	Tolerance	VIF
KA	0.903	1.107
KI	0.818	1.222
SIZE	0.759	1.317
DER	0.950	1.052

c. Heteroscedasticity Test

The graphic analysis method involves observing a scatterplot with the predicted standardized values on the horizontal axis and the residual Standardized values on the vertical axis. If the scatterplot forms a specific pattern, this indicates a heteroscedasticity problem in the regression model being formed. Conversely, if the scatterplot spreads randomly, the regression model has no heteroscedasticity problem.

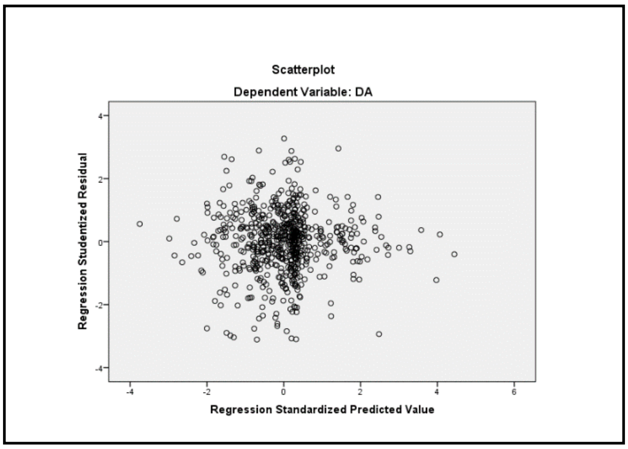

Figure 2. Heteroscedasticity Test Results

The ScaterPlot results above do not appear to form a particular pattern, and the points are above and below the number 0 on the Y-axis, so it can be concluded that there is no heteroscedasticity problem in the regression model.

d. Autocorrelation

The autocorrelation test aims to test whether, in the linear regression model, there is a correlation between the disturbance term in period t and the confounding error in the previous period (t-1). The autocorrelation test can be done using the Darbin Watson (DW) test. Based on the results of the autocorrelation test, it is known that the DW value is 1.554, this value is between dU and 4-dU (dU<dW<4-dU), so it can be concluded that there is no autocorrelation in the data.

The following table of hypothesis test results shows the results of multiple linear regression analysis with the following regression model equation:

Table 2. Hypothesis Test Results

Panel A: Direct effect regression results (audit committee, independent commissioner, firm size, leverage and audit quality)			
Variable	Model 1 Regression Results		Conclusion
	Beta	*Sig.*	
Const.		.165	
KA	-.039	.340	Not significant
KI	-.090	.039**	Significant
Firm size	.111	.014**	Significant
Leverage	-.039	.328	Not significant
F. *Value*		0.041**	Significant

Description:
***, **, * are *significant* at the 1%, 5% and 10% levels.
KA = Audit Quality = Audit
KI = Independent Commissioner = commissioner
Firm size = company size
Leverage =DER

The F. Value results show a significant value of 0.041 (significant at the 5% level). This shows that the model formed is significant, or at least one independent variable affects the dependent variable.
The following table is a summary of the results of direct hypothesis testing for testing four hypotheses:

Table 3. Summary of Hypothesis Test Results

Hypothesis	Hypothesis Statement	Results	Conclusion
Hipotesis 1	The audit committee influences earnings quality	Not *Signifikan*	Rejected
Hipotesis 2	Independent commissioners influence earnings quality.	*Significance*	Accepted
Hipotesis 3	Firm size influences earnings quality	*Significance*	Accepted
Hipotesis 4	Leverage affects earnings quality	Not *Signifikan*	Rejected

Analysis of Research Results

Table 4. Coefficient Test Results

Coefficient direct effect results (audit committee, independent commissioner, firm size, leverage and audit quality)		
Variable	Hasil Regresi Model 1	
	B	*Sig.*
Const.	.841	.165
KA	-.189	.340
KI	-.120	.039**
Firm size	.336	.014**
Leverage	-.046	.328**
F. *Value*		0.011**

Keterangan:
***, **, * are significant at the 1%, 5% dan 10% levels.
KA = Audit Quality = Audit
KI = Independent Commissioner = commissioner
Firm Size = Independent Commissioner = commissioner

Leverage =DER

The following is the regression equation for model 1:

$Y = 0,841 - 0,189KA - 0,120KI_2 + 0,336Size - 0,046DER$

Discussion

Audit Committee Influences Earnings Quality

The existence of an audit committee in a company helps the board of commissioners monitor the company's running to increase effectiveness in implementing good corporate governance. According to agency theory, there is a separation between agents and participants, which results in potential conflicts and can affect the quality of reported profits. Besides that, the existence of an audit committee will make it easier for the company's board of commissioners to supervise the running of the company. The higher the supervision in presenting financial reports, the more the audit committee can reduce earnings management activities that affect earnings quality (Agustin & Rahayu, 2022).

One of the roles of the audit committee is to influence the quality of company profits, which is one of the essential pieces of information available to the public. Investors can use profit information to assess the company because investors, as parties outside the company, cannot directly observe the quality of the company's information system (Teoh & Wong, 1993). So, investors' assessment of the quality of company profits is influenced by perceptions regarding the audit committee's performance. Several research results have reported the relationship between the audit committee and the quality of financial reporting. The research results show that the market assesses that profits reported by companies that form audit committees are of better quality than those reported by companies that do not. Higher earnings quality for companies that form audit committees indicates that the market assesses that the audit committee has carried out its role well, especially in monitoring the financial reporting process.

The research results show that the audit committee does not affect earnings quality. This means that whether or not an audit committee in a company does not influence company management in manipulating company profits. The results of this research are in line with research conducted by Rahmawati (2014), which stated that the audit committee was proven to have no effect on earnings quality. This happens because there is a possibility that the formation of an audit committee in a company is only based on reasons to comply with the regulations of the Financial Services Authority Regulation Number 55/POJK.04/2015 concerning the Establishment and Implementation Guidelines for the Work of an Audit Committee which requires companies to have an audit committee consisting of at least an independent commissioner, an independent party who has expertise in finance or accounting, and an independent party who has expertise in the legal sector so that in practice the audit committee is less effective in carrying out its duties and responsibilities for managing the company's financial reports.

Independent Commissioners Influence the Quality of Profits

Independent commissioners are commissioners who have an affiliate relationship with the company owner but do not own shares in the company. They also come from parties outside the issuer. In carrying out its supervisory function, the Board of Commissioners appoints independent commissioners, namely members of the Board of Commissioners who come from outside the company. Good corporate governance is needed because of the separation of ownership in a company, which causes information asymmetry where the owner needs complete information regarding the management of the company due to the delegation of authority to managers. This research is supported by Pertiwi et al., 2017 which states that independent commissioners have a significant positive effect on earnings quality.

Financial Services Authority Regulation No.33/POJK.04/2014 concerning Directors and Board of Commissioners of Issuers or Public Companies explains that independent commissioners are members of the board of commissioners who come from outside the company and have fulfilled the specified requirements as independent commissioners. This regulation stipulates that independent commissioners constitute at least 30% of the total members of the board of commissioners. Meanwhile, according to the Decree of the Chairman of Bapepam and LK No. Kep-643/BL/2012. Independent commissioners are commissioners with no affiliation with the company owner, do not own company shares, and come from parties outside the issuer.

Independent commissioners have a role in ensuring that the financial reports presented by the company can be trusted by investors, ensuring that managers work in accordance with the company's interests, and ensuring that the interests of shareholders in increasing the company's economic value can truly be fulfilled. Apart from that, independent commissioners must also be able to guarantee the transparency and fairness of the company's financial reporting. This is because of the information asymmetry created by the delegation of authority to management.
Carrying out supervisory duties requires the independence and credibility of independent commissioners. An independent board of commissioners that performs its functions well and is fully functional in the company will minimize management's disclosure of dishonest financial information, including crucial profit information.

The research results by Rona et al. (2015) state that the proportion of independent boards of commissioners influences earnings quality. According to Fama and Jensen, the presence of an independent board of commissioners as non-executive directors can act as a mediator in conflicts that occur between internal managers, as well as providing advice and input on policies taken by management. Therefore, the role of independent commissioners who participate in supervising management's actions can narrow managers' opportunities to carry out opportunistic actions in earnings management. This statement is also supported by the findings of Beasley (1996), who found that companies that commit fraud in financial reporting have a significantly lower percentage of independent commissioners than companies that do not. Cornett et al. (2006) also provide similar findings that with increasing supervisory actions from outside members of the board of commissioners, management's use of discretionary accruals will become lower. So, the monitoring function of financial reporting carried out by independent commissioners can improve earnings quality (Vafeas, 2000).

The results of this test carried out on all 161 companies show that the independent commissioner variable has a negative and significant effect on earnings quality. This proves that the more independent commissioners there are on a company's board of commissioners, the smaller the opportunity for management to take discretionary accruals.

The number of independent commissioners must be able to ensure that the monitoring mechanism runs effectively and in accordance with statutory regulations. OJK determines this amount in Financial Services Authority Regulation No. 57/POJK.04/2007 article 19, namely, the percentage of the number of independent commissioners must be at least 30% of the total number of members of the board of commissioners.

Firm Size Affects Profit Quality
Firm size is a measure of a company's size, which is measured using total assets. Firm size is used to determine the scale and classification of companies. The size of the firm can influence the company's capability to gain profits. This research was conducted on 161 companies during 4 years of observation, which showed that firm size influences earnings quality.

Companies with high profits will reduce managers' opportunities to carry out discretionary accruals on the company's financial reports so that the profits reported by the company are of high quality. The larger the company's size, the more likely the company is to generate stable and optimal profits. This is because large companies have a financial reporting system that uses a reliable system and a monitoring system that is also more accurate. Large companies are better at managing their companies than medium and small ones. Large companies' technical and non-technical capabilities are supported by their resources, as well as better and adequate resources. This research results align with agency theory regarding disputes between managers and shareholders (Jensen & Meckling, 1976). Large companies with financial reports that do not detect discretionary accruals will be more trusted by shareholders, thereby reducing the possibility of disputes between managers and shareholders.

The research results show that company size positively affects earnings quality. The larger the company size, the smaller the discretionary accruals will be. Small discretionary accruals indicate high earnings quality (Wijaya, 2020). In another research, Kurniawan (2017) examined the influence of company size on earnings quality, showing that company size has an influence on earnings quality. A large company size will mean that the profits generated are also more significant than those of small or medium companies, on the other hand, large company profits will increase the company's assets. Large companies do not need to manipulate profits to attract investors to invest their capital. This can minimize agency conflicts because the company can generate profits per the expectations of the principal and agent.

Leverage Affects the Quality of Earnings

Leverage is used to measure how much of a company's assets are financed by debt. The hypothesis test results prove that leverage has no effect on earnings quality. Leverage describes a company's dependence on creditors; companies with high or low leverage do not encourage companies to carry out discretionary accruals. The level of company leverage means that a company with a high debt burden will face a high risk of default, namely, the risk that the company will not be able to fulfill its obligations. Earnings management actions cannot prevent the company from this risk.

Companies that have significant funding sources from debt have a higher risk that the company will not be able to pay off its debt on time. However, the higher the risk the company accepts, the less impact it has on the value of discretionary accruals as a management action to manipulate profits. The amount of debt can be used to predict profit results if shareholders invest their shares. If the amount of debt is high, the company will focus more on paying off its debt compared to paying dividends to shareholders. However, this does not incentivize managers to manipulate their financial reports because leverage is not an accounting method but a financial factor related to the company's loan funds. The company is not worried about losing shareholders even though it has high risks.

CONCLUSION

Based on the description of the results of the analysis and discussion in the previous chapter, The audit committee does not affect earnings quality, meaning that the presence or absence of an audit committee in the company does not influence the company's management in manipulating the company's profit.Independent commissioners have a negative and significant effect on earnings quality. This proves that the more independent commissioners there are on a company's board of commissioners, the smaller the opportunity for management to take discretionary accruals. Firm size has a positive effect on earnings quality, meaning that a company with high profits will reduce managers' opportunities to carry out discretionary accruals on the company's financial reports so that the profits reported by the company are of high quality. Leverage does not affect earnings quality in a positive direction. This means that high or low leverage does not encourage companies to carry out discretionary accruals. Based on the discussion of research results, quantitative analysis results and research weaknesses, the suggestions from this research are Issuers, investors, and the accounting profession can use the results of this research to compare the quality of earnings measured with other proxies so that the information received can be used to carry out analysis and make appropriate investment decisions. The earnings quality variable needs to be tested again to prove that the resulting earnings quality value more closely reflects the actual earnings quality. It is necessary to research factors that directly influence earnings quality because many factors can still influence the market response to earnings quality other than those examined in this research.

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E-ISSN : 2721-1126, P-ISSN : 2721-1118
Available online at:
https://ejournal.itbwigalumajang.ac.id/index.php/ijamr

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