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Can Independence of The Board of Commissioners Improve The Earnings Quality? Evidence From Indonesia

Emillia Nurdin, Hasbudin, Andi Basru Wawo, Muliati Akib
Accounting Department, Faculty of Economic and Business, University of Halu Oleo, Kendari, Southeast Sulawesi, Indonesia
Corresponding Author: Emillia Nurdin

Abstract: *This study aims to examine and explain whether the independence of the Board of Commissioners improve the earnings quality at listed companies on the Indonesia Stock Exchange (IDX). The earnings quality on this research measured using earnings persistence. The population of this research are all listed companies on the IDX. The data selected by using purposive sampling method. The results showed that the independence of the Board of Commissioners has no effect to the earnings quality at listed companies on the IDX. This research result indicates that supervisory function by the independence of the board of commissioners not effective in improving the earnings quality at listed companies on the IDX.*

Keywords: *independence of the board of commissioners, earnings quality, earnings persistence.*

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I. Introduction

Each company must ensure that the principle of Good Corporate Governance (GCG) applied to every aspect of business and the entire company. National Committee on Governance stated that GCG principles of transparency, accountability, responsibility, independence and fairness are needed to achieve sustainability of the company with regard stakeholders.

In managing the company according to the general principles of GCG, the role of the Independent Commissioner indispensable. Commissioners (as supervisor) are the main elements of CG as responsible in monitoring the quality and integrity of the financial statements of the company and overseeing top management, as delegated by the shareholders. One important factor affecting the board's ability to monitor corporate managers is the composition and percentage of independent board of commissioners.

An independent commissioner is a member of the board of commissioners who is not affiliated with the board of directors, other members of the board of commissioners and the controlling shareholder, and is free from any business relationship or other relationship that may affect his ability to act independently or act solely on behalf of the company. The existence of this independent commissioner, as it is not affiliated with the majority shareholder, is expected to represent the interests of minority or public shareholders. Thus, the interest of share investors as public shareholders is more secure (IDX Team: 2012).

The existence of independent commissioners is intended to create a climate that is more objective, independent, and to maintain fairness, as well as provide a balance between the interests of majority shareholders and minority shareholders and the interests of other stakeholders. Independent commissioners are needed by companies in Indonesia especially for public companies. With the independent commissioners of all interested parties get great benefits, especially the formation of suitable situation with *GCG* principles, in which the commissioner can provide insight with a level of independence and accountability of higher (Rifai, 2009).

Earnings is one of the information in the financial report is very important to measure the performance of the company. In recording earnings, the company is given flexibility by accounting standards to choose the accounting method and the estimates to be used. Flexibility will affect the earnings quality generated by the company.

Lee (2013) conducted on a public company listed in Taiwan shows that independent directors can improve the earnings quality. Similarly, the research results conducted Alves (2014) states that independent board members improve earnings quality by reducing earnings management for a sample of Portuguese listed fims. This result suggests that strengthening the independence of boards by appointing more independent board members is a positive step toward improving earnings quality. In contrast to Lee (2013) and Alves (2014), a study done by Mashayekhi and Esmaili (2006) found no significant relationship between board independence and earnings quality. Similarly, Chaharsoughi and Rahman (2013) who found that the independence of the board does not significantly influence the earnings quality at listed companies on the Tehran Stock Exchange (TSE).

Based on the above description, then the formulation of the problem in this research is: can the independence of the board of commissioners improve the earnings quality at listed companies on the IDX?

II. Literature Review

Independence of the Board of Commissioners

Ardiyos (2016) in accounting standard dictionary states that the independence is a neutral, open without heeling to one side. The board of Commissioners is an agency within the organizational structure of a limited liability company, appointed and selected in the general meeting of shareholders. The board of commissioners acts on behalf of the shareholders and oversees all the actions and policies of the board of directors in running the company. The board of commissioners usually consists of a chairman and several members.

In Indonesia, the term "board of directors" has a different meaning from the board of directors depending on the term used. Generally, in Indonesia the board of directors is the executive board, whereas in the western country, the board of directors is the supervisory board. In this study, the term used for the supervisory board is called the board of commissioners.

Board of commissioners may consist of commissioners who are not from an affiliated party known as an independent commissioner and an affiliated commissioner. Affiliated are parties having business and family relationships with the controlling shareholders, members of the board of directors and other board of commissioners, as well as within the company itself. Former members of the board of directors and affiliated board of commissioners and employees of the company, for a certain period included in the affiliated category. (KNKG, 2006)

Based on the above description, the independence of the board of commissioners is a condition in which the board of commissioners is neutral and neutral towards the wishes of the client or other parties in the implementation of the supervisory function, in this case does not have a business relationship and kinship with the controlling shareholders, members of directors and other board of commissioners , as well as within the company itself.

The existence of this Independent Commissioner, as it is not affiliated with the founder or majority shareholder, is expected to represent the interests of minority / public shareholders. Thus the interests of stock investors as public shareholders are more secure.

Recent changes in the *CG* requires companies to maintain a board with a majority of independent board (Petra; 2005). Furthermore Peasnell *et al.* (2005) suggest that a larger proportion of independent directors reduce conflicts between controlling shareholders and minority shareholders. This is in line with research conducted Jackling and Johl (2009) that the proportion of independent board larger add value.

Research conducted Bhutta and Shah (2013) that uses proxy independence of the board, measure by dividing the number of non-executive director with the total number of directors. Further Ifada and Suhendi (2014) use the independence of the board of commissioners measure as follows:

$$\text{The independence of the BOC} = \frac{\text{Number of Independent Commissioners x 100\%}}{\text{Total Number of the Board of Commissioners members}}$$

Earnings Quality

The income statement is a report that measures the operational success of a company for a certain period of time. This report provides information to investors and creditors to predict the amount, timing and certainty of cash flows that can be given by the company in the future (Kieso *et al.*, 2009). In addition, the income statement is also important for management as a tool to measure company performance and personal management performance. Given the importance of the income statement in the company's performance appraisals and managers, as well as the flexibility given to managers in choosing accounting methods and estimates, the quality of the earnings generated in the income statement can vary.

The earnings quality is a multidimensional concept that can be seen from different points of view. In the Statement of Financial Accounting Standards requires that financial information must have some qualities, namely: (1) understandable; (2) relevant; (3) reliable; and (4) comparable. Relevant information has predictive value, feedback value, and timeliness. In addition to relevance, accounting information needs to have reliability, namely: verifiable, faithful representation and neutrality.

The better of the earnings quality will be the maximum utilization of decision maker objectives. Earnings and metrics derived from it, generally used in compensation and credit purposes. Contract decisions based on low quality or defective earnings will lead to undesirable transfer of wealth. (Bandi, 2007)

Francis *et al.* (2004) used seven attribution earnings that have been identified on the earnings quality, are classified into two groups:

1. Accounting-based attributes, consisting of: accrual quality, persistence, predictability, and smoothness. This attribution is measured using only accounting information and assumes that the earnings function is to

allocate cash flows in the appropriate periods using accruals. Therefore, higher-quality earnings are earnings more effective allocation of cash flow;

2. Market-based attributes, consisting of: value relevance, timelines, and conservatism. This attribution is measured using accounting data and market, and assumes that the earnings function is to reflect the economic income as the proxy for stock returns. Thus, earnings have better quality closer to stock return.

This research uses the earnings persistence to measure the earnings quality based on the view that the sustainable earnings are desirable due to recurrence. Analysts sometimes focus on sustainability or recurring earnings. This study measured the earnings persistence as the slope coefficient from a regression of current earnings on lagged earnings. (Francis *et al* .: 2004)

Previous Research

Lee (2013) investigated a public company listed in Taiwan from 2002 till 2010 for testing whether independent directors improve the earnings quality. The study sample consisted of 6,187 observations. The results show that independent directors can improve earnings quality. Other evidence suggests that firms with a higher independent director ratio have higher earnings quality.

Meeampol *et al.* (2013) examined the relationship between the CG and the earnings quality at listed companies on the Stock Exchange of Thailand (SET). The results show that there is a significant relationship between CG and earnings quality. Good earnings quality is one of the radical elements that lead to good corporate governance. This reflects the performance of current operations, a good sign for future operating performance, and is sufficient to support the company's essential value. Furthermore Peasnel *et al.* (2005) examined whether outside directors can improve the abnormal accruals. The results showed that outside directors contribute to the integrity of financial statements, such as agency theory predicted.

Alves (2014) examine whether the independence of the board increase earnings by reducing the earnings quality management in Portuguese, which is a State that is significantly different legal and institutional characteristics of the Anglo-Saxon countries. The samples are all listed companies on the main market, Euronext Lisbon. starting in 2003 until 2010, with a total of 402 observation as Firm-year. The results show that independent board members are positive steps in improving earnings quality. In fact, firms with a higher proportion of independent directors report higher earnings quality compared to firms with fewer independent directors proportions. The results of this study confirm that the earnings quality in companies registered in Portuguese is influenced by the independence of the council.

Unlike the previously mentioned study, the research conducted by Mashayekhi and Esmaili (2006) found no significant relationship between board independence and earnings quality. Similarly, the research Chaharsoughi and Rahman (2013) who found that the independence of the board does not significantly influence the earnings quality at listed companies on the Tehran Stock Exchange (TSE).

Hypothesis

Effect of independence of the commissioners on the earnings quality is based on the agency theory. The independence of the board of commissioners is expected to reduce the information asymmetry, further improve the earnings quality. The arguments put forward in this study is an independent commissioner supervisory board of management, play an important role in monitoring the *CG.* With the independence of the board of commissioners it is expected that management will present a quality earnings.

Some previous studies that examined the effect of the independence of the commissioners on the quality of such earnings, the research results Lee (2013) showed that independent directors can improve the earnings quality. Similarly, the research Meeampol, *el al* (2013) showed that there is a significant relationship between the *CG* and the earnings quality. In line with the research Lee (2013) and Meeampol (2013), the results Alves (2014) showed that the independent board members is a positive step in improving the earnings quality. In fact, firms with a higher proportion of independent directors report higher earnings quality compared to the proportion of firms with fewer independent directors.

Based on the results of research previously described, the hypothesis proposed in this study are as follows:

Hypothesis: The independence of the board of commissioners effect on the earnings quality.

III. Research Methods

The population of this study are all listed companies on the Stock Exchange in 2013. The company which is the sample in this study was the company chosen by *purposive sampling* method of determining the sample on the basis of suitability, characteristics, and specific criteria. Criteria for selection of the sample as follows: (1) The companies included in the category of *high-profile* listed on the IDX; (2) the company has issued the complete financial statements as of December 31, 2012 and 2013; (3) companies consistently using the rupiah currency (Rp.) in presenting the financial statements.

The data of independence of the board of commissioners and the earnings quality used in this study was obtained from IDX website that is www.idx.co.id. To know the effect of independence of board of commissioner to earnings quality used simple linear regression with the help of software SPSS version 21.

Independence of the board of commissioners is the total number of independent commissioners to the total number of members of the board of commissioners. Information on the number of independent commissioners and the total number of the board of commissioners members is obtained from the company's annual report. To calculate the proportion of independence of the board of commissioners, as follows (Bhutta and Shah, 2013; Ifada and Suhendi (2014):

$$\text{The independence of the BOC} = \frac{\text{Number of Independent Commissioners x 100\%}}{\text{Total Number of Board of Commissioners Members}} \quad \text{....... (1)}$$

Earnings quality in this research was measured using earnings persistence. To calculate the earnings persistence, use an estimate of each firm:

$$E_{i,t} = \mu_{0,i} + \mu_{1,i} E_{i,t-1} + v_{i,t} \quad \text{.. (2)}$$

Where $E_{i,t}$ is firm i's net income before extraordinary items in year t divided by the weighted average number of outstanding shares during year t.

Based on the equation (2), then measure the earnings persistence from the estimated regression slope coefficient estimate:

$$PERS_i = \mu_{1,i} \quad \text{.. (3)}$$

IV. Result And Discussion

The population of this study are all listed companies on the IDX in 2013 as many as 492 companies. Companies sampled in this study was the company chosen by purposive sampling method. Based on the sample selection criteria that have been set, the company used as a sample in this study amounted to 125 companies.

In testing the hypothesis in this study using simple linear regression analysis. Simple linear regression analysis is used to determine whether there is influence between independent variables and dependent variables. To know the effect of the independence of the board of commissioners on the earnings quality, used the regression equation as follows:

$Y = a + bX + \mathcal{E}$

Calculation of regression analysis can be seen in table 1.

.

Table 1 Calculation of regression analysis coefficients

Unstandardized Coefficients		Standardized Coefficients	T	Sig.
B	Std. Error	Beta		
,131 ,022	,367 ,090	 ,022	,358 ,240	,721 ,811

a. Dependent Variable: Earnings_Quality

The regression equation as follows:

$Y = a + bX + \mathcal{E}$

$Y = 0.131 + 0.022X + \mathcal{E}$

Based on SPSS output results seen that the significance of the independence of board of commissioners 0.811 with α = 0.05, then the value of sig> α. This means that the independence of the board of commissioners can not be used to measure changes in earnings quality which means rejecting the hypothesis, in this case the independence of the board of commissioners does not significantly affect the earnings quality.

The significance of these findings is that the existence of an independent board of commissioners is not yet effective in improving the earnings quality at listed companies on the IDX. The proportion of independent board of commissioners has not given positive reinforcement to the quality of corporate earnings. The results of this research are not in line with Lee (2013) who found that independent directors can improve the earnings quality. Similarly, the study Alves (2014), which shows that the independent board members is a positive step in improving the earnings quality. But this study are consistent with Mashayekhi and Esmaili (2006) who found no significant relationship between board independence and earnings quality. Similarly, the research Chaharsoughi and Rahman (2013) who found that the independence of the board does not significantly influence the earnings quality at listed companies on the Tehran Stock Exchange (TSE).

V. Concluding Remarks

Based on the results of research and discussion on the influence of the independence of the board of commissioners on the earnings quality, the conclusion as follows: Independence board of commissioners does not affect the earnings quality at listed companies on the IDX. The results of this study indicate that the supervisory function undertaken by independent boards has not been effective in improving the earnings quality at listed companies on the IDX.

This study has the following limitations: (1) limited sample; (2) the mechanism of corporate governance in this study only uses a variable independence of the board of commissioners; (3) earnings quality using only one measurement is earnings persistence.

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