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# Antecedents of Disclosure on Internal Control and Earnings Management

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## Abstract

This study examines the effect of independent commissioners and the Audit Committee on internal control disclosure and its implications for earnings management in the banking industry listed on the Indonesia Stock Exchange for the period 2016–2018. In this study, a purposive sampling technique was used, combined with two multiple regression analysis models. The final sample for this study comprised 30 companies over the three years of observation, such that there were 90 observations in total. This study indicates that independent commissioners, as measured by their composition, do not affect the disclosure of internal control. However, as measured by the number of members, the Audit Committee had a positive effect on internal control disclosures. This study also indicates that the disclosure of internal control as measured by the Internal Control Disclosure index affects reducing the negative practice of earnings management. This study proves that the Audit Committee's role is very dominant in assisting the Board of Commissioners in supervising internal control. This has implications for reducing earnings management practices. However, the Independent Commissioner's role in the Indonesian banking industry has not been optimal in carrying out the supervisory function in this study.

**Keywords:** Earnings Management, Internal Control Disclosure, Independent Commissioner, Audit Committee.

**JEL Classification Code:** G21, G38, H39, M48

## 1. Introduction

Financial reporting provides useful information to its users when making economic decisions, such as assessing investment potential and corporate creditworthiness. Simultaneously, a government may use it to evaluate company compliance with established regulations (Eng et al., 2019).

An essential mechanism for providing complete and reliable information for a company is an optimal internal control system. Ashbaugh-Skaife et al. (2008); Budhathoki et al. (2020) found that markets respond negatively to internal control weaknesses. In Indonesia, internal control disclosure is regulated for the banking industry. The implementation and disclosure of internal control are based on Financial Services Authority Circular Letter Number 35 / SEOJK.03 / 2017, which concerns standard guidelines for commercial banks' internal control systems. Liu and Huang (2020) prove that corporate governance characteristics such as the board of commissioners are associated with internal control weaknesses. The same opinion was expressed by Bedard et al. (2008) that the characteristics of the Board of Commissioners and the audit committee are related to the quality of internal control. One of the management oversight

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roles in implementing internal control is the independent commissioner (Mandzila & Zéghal, 2016).

Several studies related to the role of the Board of Commissioners and the Audit Committee. Lisic et al. (2019); Sterin (2020) proved that the Audit Committee affects increasing internal control disclosure. Meanwhile, Guo and Chen (2020) concluded that the role of the Independent Commissioner can reduce weaknesses in internal control.

In 2018 in Indonesia, Bank Bukopin was found to have modified more than 100,000 credit cards to increase its capital adequacy ratio (CAR). As a result, it revised its 2016 net income to IDR 317.88 billion from the previously reported IDR 106 trillion (www.cnbcindonesia.com/2018). These cases suggest earnings management, which is thought to have arisen due to a weakly implemented internal control system causing several problems. This is supported by several studies, such as that of Koutoupis and Pappa (2018), who concluded that an effective internal control system has a negative effect on earnings management, thus effectively reducing it. Hanwen (2011), however, concluded that the internal governance of a company positively influences discretionary accruals.

According to Alfraih (2016) and Lukviarman (2016), one factor that is thought to affect the disclosure level made by a company is the Board of Commissioners' supervisory role, an internal mechanism within the corporate governance structure. Corporate governance in this study is proxied by independent commissioners and the Audit Committee. Previous research conducted by Agyei-Mensah (2016) proved that independent commissioners affect internal control disclosure. However, the studies of Koutoupis and Pappa (2018); Leng and Ding (2011) yielded different results in that the composition of independent commissioners did not seem to influence internal control disclosure. Research into the role of the Audit Committee remains inconsistent. For example, the study of Lisic et al. (2019) concluded that the Audit Committee's size was related to the disclosure of company information. This finding was further supported by Ashfaq and Rui (2019). Several previous studies have provided inconsistent evidence, and there have been few similar studies for the Indonesian context. This study examines the effect of independent commissioners and the Audit Committee on internal control disclosure and its implications for earnings management in the banking industry listed on the Indonesia Stock Exchange for the period 2016–2018. Banks listed on the Indonesia Stock Exchange were chosen as the object of this research because they incur a high-risk level, so the disclosure of adequate internal controls is regarded as very important. Moreover, Rakhmayani and Faisal (2019) showed that the banking industry experiences more earnings management. Indeed, earnings management tends to be perused more by financial institutions than manufacturing firms.

## 2. Literature Review

This research is based on agency theory by Jensen and Meckling (1976) who stated agency theory is a principle that is used to explain and resolve issues in the relationship between business principals and their agents. Given the assumption that both parties (i.e., managers & investors) are both utility maximizers (i.e., wish to maximize their benefits), a conflict will inevitably arise between them. This study looks at the roles of independent commissioners and Audit Committees in monitoring management behavior. This effect is manifested through the number of independent commissioners and an Audit Committee's size, which assists the Board of Commissioners in its supervisory role (Jahid et al., 2020).

According to Sakaki et al. (2017), Earnings management is the use of accounting techniques to produce financial statements that present an overly positive view of a company's business activities and financial position. Managers choose to pursue earnings management in their accounting policies to achieve specific goals (Scott, 2000). According to these principles, many accounting rules and principles require company management to make judgments. To produce financial reports that inflate or 'smooth' earnings, earnings management benefits from applying accounting rules (Rakhmayani & Faisal, 2019).

Several previous studies about factors affecting earnings management included that of Alzoubi (2018), Campa (2019); Cheng et al. (2016), and concluded that internal governance might play a role in reducing the occurrence of earnings management.

Internal control disclosure is mandatory in the banking industry, reflecting the effectiveness of internal control by the corporate governance mechanisms within a company (Leng & Ding, 2011). Therefore, banks are required to apply internal controls in their operations and disclose these controls (Pham, 2020). Agyei-Mensah (2016) that an ineffective internal control system can result in fraudulent corporate financial reporting, with earnings management being a standard form.

### 2.1. Hypothesis Development

#### 2.1.1. Internal Control Disclosure and Earnings Management

Guo and Chen (2020) found that one of the internal control goals is to strengthen the reliability of financial reporting. Indeed, effective internal control can reduce the risk of accidental procedures and estimation errors in accounting and financial reporting, lower the risks inherent in business operations and strategy, and discourage earnings (Shi, 2017). Research conducted by Guo and Chen (2020);

Liu and Huang (2020) found that adequate internal control has a negative effect on earnings management, concluding that adequate internal control helps reduce earnings management. Based on the above discussion, the following hypothesis is formulated:

***H1:** The disclosure of internal control has a negative effect on earnings management.*

### 2.1.2. Internal Control Disclosure and Independent Commissioners

Independent commissioners on the Board of Commissioners are those members who have no financial, management, or ownership interest in the company and have no family relationship with other board members, company directors, and controlling shareholders or any other relationship that may affect their ability to act independently (Law No. 40/2007 regarding Limited Liability Companies). Therefore, independent commissioners can act as mediators in disputes between internal managers and oversee directors' policies and provide them with advice (El-Chaarani, 2014). One of their goals is to boost transparency, including the disclosure of internal controls. Research by Ahmad et al. (2015); Jianfei and Yiran (2011) concluded that a higher proportion of independent commissioners positively affects internal control and risk management disclosure. A later study by Ashfaq and Rui (2019) showed that independent commissioners' role could increase internal control exposure. Based on the above discussion and the previous research, the following hypothesis is formulated:

***H2:** Independent commissioners have a positive effect on the disclosure of internal control.*

### 2.1.3. Internal Control Disclosure and Audit Committee

According to Myers and Ziegenfuss (2006); Leng and Ding (2011), as an internal supervisory body, the Audit Committee has the right to monitor the board and its management and oversee the formation and implementation of corporate governance and internal control. According to Sterin (2020), a larger Audit Committee is more effective at improving internal control quality.

This view was also expressed by Lisic et al. (2019), who concluded a larger Audit Committee could reduce information asymmetry and increase information disclosure. This is further evidenced in Rakhmayani and Faisal (2019), who showed the Audit Committee's size affects company information disclosure. Likewise, Ashfaq and Rui (2019) proved a positive influence between the Audit Committee's existence and disclosure. Based on the above, the following hypothesis is formulated:

***H3:** The size of the Audit Committee has a positive effect on the disclosure of internal control.*

## 3. Methodology

This research aims to reveal the effect of antecedent variables (i.e., the proportion of independent commissioners and Audit Committee size) to disclose internal control on earnings management. The study population consisted of those banks listed on the Indonesia Stock Exchange during the 2016–2018 period. The purposive sampling method was used to obtain a representative sample according to the specified criteria. The final sample for this study comprised 30 companies over the three years of observation, such that there were 90 observations in total. Table 1 presents the sample selection process used by the author.

This involved two stages and used two multiple regression analysis models. The first stage applied multiple regression analysis for the first model to test the effects of the proportion of independent commissioners and the Audit Committee's size and the control variables Profitability and Company Size, on Internal Control Disclosure. For this first model, the equation used for the multiple regression was as follows:

$$\begin{aligned}\mathrm{DAC}_{i,t} &= \beta_0 + \beta_1\mathrm{DICD}_{i,t} + \beta_2\mathrm{ROA}_{i,t} \\ &+ \beta_3\mathrm{SIZE}_{i,t} + \varepsilon_{1t}\end{aligned} \quad (1)$$

Where,

$\beta_0$: Constant

$\beta_1, \beta_2, \beta_3$: Regression coefficient

$\mathrm{DID}_{i,t}$: Internal Control Disclosure Index Ratio for the company "$i$" in year "$t$"

**Table 1:** Sample

| No | Criteria | Total |
|---|---|---|
| 1. | Bank was listed on the Indonesia Stock Exchange (IDX) during the 2016–2018 period. | 44 |
| 2. | Bank did not report positive profits for the 2016–2018 period. | –12 |
| 3. | Bank provides financial reports other than in the rupiah currency for the 2016–2018 period. | 0 |
| 4. | Bank presents incomplete financial reports for the 2016–2018 period. | –2 |
| Number of sample companies per year | | 30 |

$\text{INDEP}_{i,t}$: Proportion of independent commissioners at the company "*i*" in year "*t*"
ACS, *t*: Size of the Audit Committee for the company "*i*" in year "*t*"
ROA, *t*: Return on Assets for the company "*i*" in year "*t*"
size, *t*: Size of the company "*i*" in year "*t*"
$\varepsilon_{it}$: Error term

The second stage of this research applied multiple regression analysis for the second model to examine the effect of internal control disclosure and the control variables Profitability and Company Size on earnings management. The equation used for the multiple regression analysis at this stage was as follows:

$$\text{DICD}_{i,t} = \beta_0 + \beta_1 \text{INDEP}_{i,t} + \beta_2 \text{ACS}_{i,t} + \beta_3 \text{ROA}_{i,t} + \beta_4 \text{SIZE}_{i,t} + \varepsilon_{it} \quad (2)$$

Where,
$\beta_0$: Constant
$\beta_1$: Regression coefficient
$\text{DAC}_{i,t}$: Discretionary Accruals (earnings management) of the company "*i*" in year "*t*"
$\text{DID}_{i,t}$: Internal control disclosure index ratio for the company "*i*" in year "*t*"
$\text{ROA}_{i,t}$: Return on Assets for the company "*i*" in year "*t*"
$\text{size}_{i,t}$: Size of the company "*i*" in year "*t*"
$\varepsilon_{it}$: Error term

## 4. Results and Discussion

### 4.1. Descriptive Statistics

Table 2 shows that earnings management (DACC) has an average value of –2.354, indicating earnings management in the banking industry. This indicates that banking companies were undervalued. Meanwhile, the standard deviation for the earnings management variable was 1.904. Another dependent variable, namely, Internal Control Disclosure (ICD) has the lowest value of 13.790, showing that this company has a weak internal control system. In contrast, the highest value is 48.280, indicating that this company has a robust internal control system. The Independent Commissioner (IC) variable has an average value of 0.594, which implies that independent commissioners make up 59.4% of a board on average. This demonstrates that Indonesia's banks tend to comply with the required minimum number of independent commissioners on their boards. The standard deviation of 0.115 indicates that this study's data quality is quite good because the mean value is greater than the standard deviation, implying that each variable's standard error is small.

The Audit Committee (AC) variable is 3.922 on average. The minimum size of the Audit Committee variable is 3, and this is shared among 20 companies. This shows that these banks complied with the required minimum size for the Audit Committees in their companies because the IDX requires issuers to have an Audit Committee with at least three members. Meanwhile, the standard deviation for the Audit Committee (AC) variable was 1.114, showing that this study's data quality is quite good. The mean value is greater than the standard deviation, implying that each variable's standard error is small.

The profitability variable (ROA) has an average value of 1.752. The minimum amount is 0.090. This shows that every asset employed could only generate 0.09% returns, indicating that the bank was not effective enough in asset management. Furthermore, this variable's maximum value is 4.000. Meanwhile, the standard deviation for the profitability variable (ROA) is 1.025, indicating that this study's data quality is quite good. The mean value is greater than the standard deviation value, implying that each variable's standard error is small.

The company size variable (SIZE) in this study has an average value of 31.243, showing that companies in

**Table 2:** Descriptive Statistics

| | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| DACC | 90 | –12.761 | –0.562 | –2.354 | 1.904 |
| ICD | 90 | 13.790 | 48.280 | 31.837 | 8.939 |
| IC | 90 | 0.400 | 1.000 | 0.594 | 0.115 |
| AC | 90 | 3.000 | 7.000 | 3.922 | 1.114 |
| ROA | 90 | 0.090 | 4.000 | 1.752 | 1.025 |
| SIZE | 90 | 24.640 | 34.790 | 31.243 | 2.188 |
| Valid N (listwise) | 90 | | | | |

**Table 3:** Regression Analysis

| | B | *t* | Sig |
|---|---|---|---|
| **Model 1:** | | | |
| (Constant) | –59.504 | –3.847 | 0.000 |
| IC | 2.540 | 0.367 | 0.715 |
| AC | 2.385 | 2.831 | 0.006 |
| ROA | –0.374 | –0.433 | 0.666 |
| SIZE | 2.601 | 5.234 | 0.000 |
| *R* Square | 0.340 | | |
| Adjusted *R* Square | 0.401 | | |
| *F* | 14.713 | | |
| Sig | 0.000 | | |
| **Model 2:** | | | |
| (Constant) | 1.417 | 1.129 | 0.262 |
| ICD | –0.020 | –2.155 | 0.034 |
| ROA | 0.364 | 5.008 | 0.000 |
| SIZE | –0.108 | –2.295 | 0.024 |
| *R* Square | 0.312 | | |
| Adjusted *R* Square | 0.286 | | |
| *F* | 11.961 | | |
| Sig | 0.000 | | |

the banking industry tend to be large. Furthermore, the minimum amount of 24.640 is for 2017, which is relatively small compared to other companies but still reasonably large. Meanwhile, the variable's maximum value is 34.790 for 2018 slightly larger than the average, but not in a big way. Meanwhile, the standard deviation is 2.188, indicating that this study's data quality is quite good because the mean value is greater than the standard deviation value, suggesting that each variable's standard error is small.

## 4.2. Hypothesis Testing

Table 3 shows the test with the dependent variable of Internal Control Disclosure (ICD), and the value of the coefficient of determination (adjusted $R$ square) for this research model is 0.401 or 40.1% (model 1). This means that this study's independent variable can explain 40.1% of the dependent variable variance, with the remaining variance being determined by other variables outside this research model. Furthermore, the Internal Control Disclosure (ICD) is known to have the calculated $F$ value of 14.713, which is greater than $F$ Table 2.490, with a significance value of $0.000 < 0.05$. Thus, it can be concluded that the first model used in this study is suitable and feasible for use. The independent commissioner hypothesis test shows that the variable does not affect Internal Control Disclosure, with a $t$-value of 0.367 and a significance value of $0.715 > 0.05$. Thus, it can be concluded that the Independent Commissioner variable does not affect Internal Control Disclosure, so the first hypothesis in this study is rejected. The Audit Committee variable positively influenced Internal Control Disclosure with a $t$-value of 2.831 and a significance value of $0.006 < 0.05$. Therefore, the Audit Committee variable has a positive and significant effect on Internal Control Disclosure, so the second hypothesis of this study is accepted.

The ROA regression coefficient is –0.374, with a significance level of $0.666 > 0.05$. Based on this result, it can be concluded that ROA does not influence Internal Control Disclosure. Therefore, the degree of profitability does not seem to affect the company's internal control disclosure level. When testing the Company Size (SIZE) variable's effect on Internal Control Disclosure, a positive and significant impact was found. This can be seen in the test with all samples revealing a $t$-value of 5.234 for Company Size (SIZE) with a significance level of $0.000 < 0.05$. Based on this result, it can be concluded that Company Size has a positive effect on Internal Control Disclosure.

Testing on model 2 involved testing the dependent variable Earnings Management (DACC). The value of the coefficient of determination (adjusted R square) for this research model is 0.286 or 28.6%, meaning that the independent variable in this study can explain 28.6% of the variance in the dependent variable, with the remainder being determined by other variables not examined in this research model. Furthermore, when testing the dependent variable Earnings Management (DACC), the calculated $F$ value is 11.961, which is greater than $F$ Table 2.720, with a significance value of $0.000 < 0.05$. Therefore, the model used in this study is in the excellent category and feasible for use. The regression results also show that the Internal Control Disclosure variable negatively affects with a $t$-value of –2.155 and a significance value of $0.034 < 0.05$. Therefore, it can be concluded that the disclosure of internal control measures has a negative and significant effect on earnings management, so the third hypothesis of this study is accepted.

When testing the second model's control variables, the $t$-value of ROA is 5.008, with a significance level of $0.000 < 0.05$. Based on this result, it can be concluded that ROA has a positive effect on Earnings Management. Furthermore, the control variable ROA shows a $t$-value of –2.295 for Company Size (SIZE) with a significance level of $0.024 < 0.05$. Based on this result, it can be concluded that firm size has a negative effect on Earnings Management.

### 4.3. Discussion

There is no significant influence between the proportion of Independent Commissioners and Disclosure of Internal Control, presumably due to the less than the Independent Commissioners' optimal role in presenting information related to the company's internal control system. These test results show conformity with the results of research by Leng and Ding (2011). The Audit Committee has a positive effect on Internal Control Disclosure so that the second hypothesis in this study is accepted. These results can also explain that the higher the Audit Committee, the higher a company's Internal Control Disclosure (Mohd Noor et al., 2020). These test results show conformity with the research results by Lisic et al. (2019), who concluded that the Audit Committee could improve the company's Internal Control Disclosure. Disclosure of Internal Control has a negative effect on Earning Management so that the third hypothesis in this study is accepted. These results can also explain that the higher the level of Disclosure of Internal Control measures of the company, the lower the Earnings Management. In terms of financial reporting, managers can perform earnings management to mislead the owners (shareholders) regarding the company's economic performance (Budhathoki et al., 2020; Mohd Noor et al., 2020).

## 5. Conclusions

The number of independent commissioners does not affect internal control disclosure, so this study's first hypothesis was rejected. Meanwhile, the Audit Committee has a positive and significant effect on internal control disclosure, showing that it is a factor affecting such disclosures, with larger Audit Committees leading to increased disclosures. The second hypothesis of this study was, therefore, accepted. The revelation of internal control, meanwhile, has a negative and significant effect on earnings management. This shows that the disclosure of internal control measures is a factor affecting earnings management. Indeed, an increased internal control disclosure level seems to reduce the earnings management level, so the third hypothesis in this study is accepted. It is hoped that this will make the banks more transparent with reliable financial reporting to give investors the confidence to invest in them.

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