The Effect of Investment Opportunity Set, the Presence of Audit Committee, the Composition of Independent Commissioner, and Managerial Ownership on Profit Quality

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Abstract

This study investigates the effect of Investment Opportunity Set (IOS), audit committee, the composition of independent commissioner and managerial ownership on profit quality. Research population is whole public companies listed at Indonesia Stock Exchange in the period 2006-2010. The sampling technique is purposive sampling. The analysis technique used in this study is multiple linear regressions. Results of this study indicate that (1) Investment Opportunity Set influences profit quality, (2) the presence of audit committee does not influence profit quality, (3) the composition of independent commissionrs do not influence profit quality, and (4) managerial ownership influences profit quality.

Keywords: investment opportunity set, the presence of audit committee, and the composition of independent commissioner, managerial ownership, profit quality

Introduction

The main goal of a company is to maximize its stock market value. Manager of the company are responsible for achieving the goal. Agency problems arise within a firm whenever managers prefer to maximize their own personal interests, even at the expense of owners. It naturally follows that some decisions of managers are motivated by self-interest, which reduces the welfare of the principal. If the agent make efforts to maximize their own utility and also have different motivation and desire, there will be a reason to believe that agent (management) not always act accordance with principle's interest (Jensen and Meckling, 1976).

The agency conflict motivates the management to report profit opportunistically to maximize their interests. If this is happen, it will result in lower profit quality. Subramanyam (1996) cited by Siregar and Utama (2005) states that one of corporate performance measurements commonly used for decision making basis is profit generated by company. Profit measured by accrual basis is considered as better measurement than cash basis accounting because accrual basis can reduce time problem and mismatch that commonly occur in short period cash flow utilization (Dechow, 1994).

Accrual basis accounting allows the management to increase or decrease the amount of profit of a company. Managers use flexible accounting principles to manage earnings (Davidson III et al., 2004). Earnings management occurs in corporations where managers attempt to present a more favourable financial picture of the company performance through discretionary accruals (Aini et al., 2006). This may occur because the manager is better informed than the company's owners or shareholders, so management will try to manipulate the company's reported performance for its own self interest. Financial Accounting Standard gives the flexibility in choosing accounting methods used in financial reporting. Companies may choose from several different depreciation methods. The choice of depreciation method can impact profit and loss of a company. The company which uses straight line method will have different profit from the company which uses sum of year digit or declining balance method. These practices could have an impact on the quality of reported profit (Boediono, 2005). Profit is an indicator that can be used for measuring company operational performance. The information on profit can be used to determine the success or the failure of a business in achieving its objectives (Parawiyati, 1996). Both creditors and investors, using the profit information to evaluate the performance of management, estimate profits power, and predict future profits. Because of the reasons, the important thing in profit is its quality. Low quality of profits will result in decision making errors for both investors and creditors.

Several studies found that profit manipulation is often done by management. Profit and loss statement is prepared by management who knows better about the condition of the company. Dechow (1994) states that it would be a problem because management is the one who gives information about the company's performance, and they are evaluated and appreciated based on their own report.

There many variables that influence profit quality, one of them is Investment Opportunity Set (IOS). Investment opportunity set (IOS) is the availability of alternative future investment for the company. The IOS of a firm profoundly influences the way a firm is viewed by managers, owners, investors and creditors. The value of the growth option depends on discretionary expenditure manager. Unobservable managerial act will cause the principal will not be able to monitor whether the manager has already acted in accordance with the principal's interest. Under this condition, there is need of control mechanism in order to balance the various interests that can provide benefits to the company comprehensively. Corporate governance mechanisms will have an impact on the process of improving the financial reporting quality, as well as to prevent earnings manipulation and fraud (Cohen et al., 2004).

Forum for Corporate Governance in Indonesia (FCGI, 2001) formulates good corporate governance objective that is to create additional value for all interested parties (stakeholders). Corporate governance contain four important elements, these are justice, transparency, responsibility, and accountability. The elements are expected to mitigate the agency conflict. The implementation of good corporate governance in a company will encourage management to provide the true information about the company's performance. There are four corporate governance mechanisms which have been used by previous studies to reduce agency conflict: audit committee, independent directors, institutional ownership and managerial ownership.

The audit committee has a very important and strategic role in terms of maintaining the credibility of the financial statements preparation. The committee has an important responsibility on behalf of company shareholders to oversee the financial reporting process and external audit. Studies examining the effect of audit committee on profit quality yield mixed results. Beasley (1996) does not find that audit committee presence is significantly associated with the likelihood of financial statement fraud. In contrast, Abbot et al. (2004) find a significant negative relation between the presence of an audit committee and the occurrence of restatement. Klein (2002) empirically proved that companies that form independent audit committee report profits with the content of discretionary accruals are smaller than firms that do not form an independent audit committee.

Beside IOS and audit committee, the other variables which are also identified to have an impact on profit quality are independent directors, institutional ownership and managerial ownership. The role of the board of commissioners in creating good corporate governance within the company is expected to be enhanced by the existence of an independent commissioner. Through its role in supervision, board composition may influence the management in preparing the financial statements in order to obtain a qualified profit (Boediono, 2005). Chtourou et al. (2001) found that profits management is significantly related to some governance practices by the board of commissioners and the audit committee.

Ownership structure (managerial ownership and institutional ownership) will affect how the company is run by management, which in turn affects the company's performance in achieving corporate goals. There are two competing arguments regarding the effect of managerial ownership on profit quality. First argument states that the higher the managerial ownership the higher the opportunity for manager to manage earnings to maximize their own utility. The second argues that the greater the management ownership the more likely management to act carefully in preparing financial statements. A number of empirical studies support such positive association (Warfield et al, 1995). However, these findings contradict with the results of Gabrielsen et al. (2002) and You et al. (2003) which found inverse relationship between managerial ownership and earning management.

Based on the above explanations, the purpose of this study are (1) to analyze the influence of IOS on profit quality, (2) to analyze the influence of audit committee existence on profit quality, (3) to analyze the influence of presence of independent directors on profit quality, (4) to analyze the effect of managerial ownership on profits quality.

Theories and Hypotheses Development

Effect of Investment Opportunity Set (IOS) on the Profit Quality

Myers (1977) defines the investment opportunity set (IOS) as the extent to which firm value depends on future discretionary expenditures by the firm. IOS of the firm affected how managers, owners, investors and creditors of the company. Based on the research done by Wah (2002), firms with high investment opportunity is more likely to have accrual discretionary (accrual management), but if they have a Big Five auditor discretionary accruals will decrease. The results indicate that managers of companies with high investment opportunity tend to manipulate discretionary accruals, this trend will decline if their company has a better surveillance audit. Based on the description above, the hypothesis of this study can be formulated as follows

H_1 : IOS affect the profit quality.

The Impact of the Audit Committee on Profit Quality

The audit committee is responsible for overseeing financial reporting, the external audit, internal control system and observing (including internal audit). The responsibility can reduce management opportunistic behavior to conduct profit management (earnings management) by supervising the financial reporting and external audit supervision utilization. Klein (2002) empirically proved that companies that make up the independent audit committee report profit with smaller discretionary accruals content than companies that do not form an independent audit committee.

Price Waterhouse (1980) in McMullen (1996) states that investors, analysts and regulators consider the audit committee contributes to the quality of financial reporting. Audit committees improve the integrity and credibility of financial reporting through: (1) supervise the reporting process including the internal control system and the use of generally acceptable accounting principles and (2) supervise the audit process as a whole. Xie et al. (2003) studied the effectiveness of audit committees in decreasing earnings management. The results showed that the audit committee can protect shareholder interests from earnings management done. Based on the explanations above, it can be concluded that the audit committee may reduce profit management activity which affect the quality of financial reporting. These arguments lead to the following hypothesis.

H_2: The existence of audit committee affects profit quality

The Effect of Independent Commissioner in Profit Quality

Board of Commissioners has monitoring role and this may affect the management in preparing the financial statements to obtain a qualified earnings report (Boediono, 2005). A balanced board's composition is important for the board to function effectively. A balanced board means that the composition is not dominated by board members with executive power, and consists of members who are independent from the anagement and shareholders (Shamsul Nahar, 2001). The existence of independent directors is expected to increase the role of the board in order to create good corporate governance within the company. Outside directors act as experts in decision control and signal their expertise to the labor market by acting in shareholders' interests. Vafeas (1998) said in addition to managerial ownership, the role of the commissioners is also expected to improve profit quality by limiting the level of earnings management through monitoring the financial reporting function. Independent board is one of the effective mechanisms in monitoring the accounting process (Klein, 2002).

Beasley (1996) examined the relationship between the proportions of the board of commissioners with fraudulent financial reporting. He found that the companies who commit fraud have external commissioners percentage is significantly lower compared to companies that did not commit fraud. Chtourou et al. (2001) investigate whether the corporate governance has an influence on the quality of the financial information. The result showed that the number of outside directors is negatively related to the level of earnings management. Based on the description above, the hypothesis of this study can be formulated as follows

H_3 : Independent board compositions affect profit quality

The Effect of Managerial Ownership in Profit Quality

With regard to the effects of managerial ownership on managers' reporting behaviors, economics theory identifies two contrasting effects: the incentive alignment effect and the management entrenchment effect. Traditional agency theory argues that considerable agency problems exist between managers and outside shareholders because of a separation between ownership and control. The agency theoey view proposes that shareholdings help manages help align their interests with those of shareholders. In contrast, Morck et al. (1988) argue that greater ownership would provide manager with deeper entrenchment and, therefore, greater scope for opportunistic behavior.

Warfield et al. (1995) investigated the effect of managerial ownership with discretionary accruals on profit information content. The results showed that: (1) managerial ownership is negatively related to discretionary accruals, (2) The higher the managerial ownership the higher profit quality. Gabrielsen et al. (2002) examined the relationship between managerial ownership and the profit information content and discretionary accruals. The findings showed that there is a positive relationship but not significant between managerial ownership and discretionary accruals. The results also found that there is a negative relationship between managerial ownership and profit information content. Smith (1976) found that income smoothing significantly more often done by a company controlled by managers compared to a company controlled by its owner. Based on these descriptions, the hypothesis of this study is as follows.

H_4: Managerial ownership affects profit quality

Based on the arguments developed above, the model proposed in the present study is as follows:

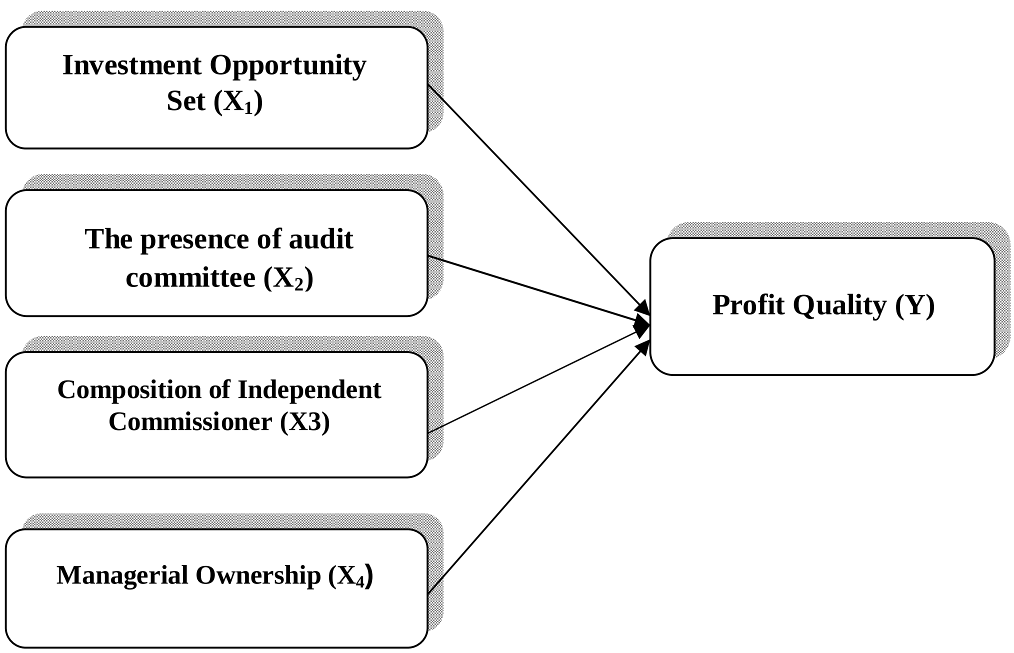

Figure 1. Research Conceptual Framework

Research Methods

Population, Sample and Data Collection Techniques

The population of this study was all public companies listed on the Indonesia Stock Exchange in the period 2006-2010. The sample selections are based on purposive sampling method with the purpose of obtaining a representative sample in accordance with the specified criteria. The sampling criterias of this study are (1) companies are listed on the Indonesia Stock Exchange during the period 2006-2010, (2) companies published financial statements for the period ended December 31, (3) the financial statements are presented in rupiah (IDR) and all data required for this study are available and complete.

Variables and Measurement

Dependent Variables: Profit Quality

Profit quality is measured using discretionary accruals (DACC). In calculating DACC, the Modified Jones model is used because this model is considered better among other models to measure profit management (Dechow et al., 1995). The modified Jones model requires an identification of a set of sample which can be classified as 'clean' from accounting manipulation (Abdul Aziz, 2004).

Independent Variables

1. Investment Opportunity Set (IOS).
   Investment opportunity set is measured using the Book Value to Market Value of Assets Ratio.
2. The presence of audit committee (PAC).
   The existence of an audit committee is a dummy variable, for which the company has an audit committee will receive a value of 1, while the company does not have an audit committee gets the value 0
3. The composition of independent commissioner (CIC).
   Independent commissioner composition calculated using the percentage of independent directors to the total number of commissioners present in the composition of the board of commissioners.
4. Managerial ownership (MO).
   Managerial ownership is calculated using the percentage of shares held by the management.

Data Analysis Techniques and Hypothesis Testing

Multiple Linear Regression Analysis

Analysis techniques used in this study is Multiple Linear Regression Analysis, with the regression equation as follows:

$KL = \beta_0 + \beta_1 IOS + \beta_2 PAC + \beta_3 CIC + \beta_4 MO + \varepsilon$

Where:

β_0 = Intercept
IOS = Invesment opportunity set
PAC = The presence of audit committee
CIC = The composition of independent commissioner
MO = Managerial ownership
PQ = Profit quality
ε = error

Results

Hypothesis Testing

Regression analysis was used to determine the level of influence of the independent variables on the dependent variable. The results of multiple linear regressions can be seen in the following table.

Table 1. Summary Regression Analysis Results

Variabel	Regression Coefficient(beta)	T Count	Probability (p)	Decision
IOS	0.427	3.703	0.000	**Accepted**
PAC	-.067	-0.940	0.349	**Rejected**
CIC	-.044	-0.609	0.544	**Rejected**
MO	0.278	4.385	0.000	**Accepted**
Constanta = 0.215 F count = 5.849 Probability (Sig) = 0,000 Adjusted R square = 0.177 n = 181				

Source : Primary data (processed)

From table 1 above, it can be seen that the adjusted R square value of 0.177 and the calculated F value is equal to 5,849 with a probability rate of 0.000 (p <0.05), so the hypothesis that there is significant influence of IOS (X1), PAC (X2), CIC (X3), MO(X4) simultaneously to PQ (Y) is accepted.

The partial presented in Table 1, can be described in detail as follows:

1. Test of Hypothesis 1 (H_1). It is expected in hypothesis 1 (H_1) that there is a positive and significant effect of IOS (X_1) on profit quality (Y). Findings indicate that IOS (X_1) has a significant influence on profit quality (Y) at the 0.05 level (P <0.05). As shown in table 1, the effect of IOS on profit quality is positive and significant (t =3.703, p = 0,000 < 0.05). This means that the results of the regression model provide strong support for hypothesis 1.
2. Test of Hypothesis 2 (H_2). The second hypothesis of the model requires a test of the expected negatif and significant effect of of the presence of audit committee (X2) on profit quality (Y). The results presented in table 1 reveal that the presence a insignificant effect of the existence of an audit committee on profit quality (t =-0,940, p = 0,349> 0.05). Thus, this result could not provide support for hypothesis 2.
3. Test of hypothesis 3 (H_3). It is expected in hypothesis 3 (H_3) that there is a negative and significant effect of the composition of independent commisioner (X_3) on profit quality (Y). Findings indicate that composition of independent commisioner (X_3) has no significant influence on profit quality (Y) at the 0.05 level (P <0.05), therefore H_3 is rejected. This is evidenced by the amount of regression (b_3) -0.044 and t count -0.609, and probability of 0.544 (p >0.05).
4. Test of Hypothesis 4 (H_4). It is expected in hypothesis 4 (H_4) that there is a positive and significant effect of managerial ownership (X_4) on profit quality (Y). Findings indicate that managerial ownership (X_4) has a positive and significant influence on profit quality (Y) at the 0.05 level (P <0.05). As shown in table 1, the effect of managerial ownership on profit quality is positive and significant (t =4.385, p = 0,000 < 0.05). This means that the results of the regression model provide strong support for hypothesis 4.

Based on the results of multiple regression analysis shown in Table 1, the regression equation can be formulated as follows:

$$PQ = 0.215 + 0.427IOS - 0.067PAC - 0.044CIC + 0.278MO + \varepsilon$$

Discussion

Based on the results of multiple regression analysis (F test) indicated that Investment Opportunity Set (IOS), the presence of an audit committee (PAC), the composition of independent commissioner (CIC), and Managerial ownership (MO) on the profit quality (PQ).

The results of partial analysis using t-test showed that the hypothesis 1 (H1) is accepted which means that the effect of IOS on profit quality is positive and significant. This result indicates that the higher IOS the higher profit quality. When a firm has higher IOS, it is more likely to benefit from having a specialist auditor because the specialist will be better able to audit the particular problems related to high IOS than another auditor would (Cahan et al., 2008). Hence, better quality earnings (lower discretionary accruals) is more likely to occur for firms with high IOS

The hypothesis four (H4) is also accepted, managerial ownership has an influence on profit quality. These result indicates that the greater the managerial ownership the lower discretionary accruals, and the higher the profit quality. This is consistent with the theory that the greater the management ownership the greater alignment of interest between managers and shareholders leading to more faithful of reported profit. This result is consistent with the results of the study done Vafeas (1998) and Jensen and Meckling (1976).

Contrary to expectations, the author did not find significant result on the effect of presence of audit committee and composition of independent directors on profit quality. This maybe because the persons who appointed as a member of audit committee and independent auditors do not have accounting and finance background. This make them do not make any difference in the earning management practices or profit quality.

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