The Role of Internal Corporate Governance Mechanism in Accounting Conservatism

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Abstract

Objective – This study aims to analyze the influence of internal mechanisms (independent commissioner, ownership structure and audit committee) on accounting conservatism in mining companies listed on the Indonesia Stock Exchange for the period of 2015-2017.

Design/methodology – Secondary data in the form of financial statements are collected from the sub-sector companies in mining industry from the Indonesian capital market directory (ICMD). The data is taken from companies listed in Indonesia stock exchange for the period of 2015-2017. Samples are determined by using purposive sampling method and are selected based on certain considerations or criteria. The analysis model used in this study is path analysis.

Results – The results of this study prove that independent commissioners, ownership structures and audit committees have a positive effect on accounting conservatism.

Research limitations/implications – This study is perhaps limited in the number of variables used to test the model. There may be other variables that affect accounting conservatism so that further studies can extend this study by utilizing more variables.

Keywords: Independent Commissioner, Ownership Structure, Audit Committee, Accounting Conservatism.

1. Introduction

Accounting conservatism is one of the accounting principles used in achieving the objectives of financial statements. The principle of conservatism assumes that when managers are faced with choosing between two or more accounting principles that are equally accepted, the manager must choose the option that has the least effect on shareholders’ equity. More specifically, this principle implies that the lowest value of assets and income and the highest value of obligations and expenses should be chosen for reporting (Belkaoui, 2011: 288).

Conservatism is a controversial accounting principle. Among researchers, there are two conflicting opinions regarding the principles of accounting conservatism. Opinions that support say that the use of conservatism can be considered beneficial, namely to anticipate uncertainties that can be experienced by the company in the future, but on the other hand the use of conservatism is considered not to reflect the actual financial condition of the company so that it can affect the quality of corporate financial statements. Accounting conservatism is used to reduce risk and the excessive use of optimism carried out by managers and business owners (Sulastri and Anna, 2018).

Conservatism can be explained from the perspective of agency theory. In agency theory there is a separation between the agent and the principal. This can result in potential conflicts that can affect the quality of reported earnings. Management that has certain objectives such as getting bonuses tends to compile financial statements with large profit figures. Therefore, companies can prevent this by applying accounting conservatism in the preparation of financial reports.
The principle of conservatism can prevent fraudulent financial statements carried out by managers, because this principle can prevent overstatement of earnings reporting. However, there are still many fraudulent actions carried out by internal companies in showing the low application of accounting conservatism principles in the company to compile their financial statements. As is the case with Japanese technology company Toshiba Corp. The research team found that Toshiba's accounting and bookkeeping had been falsified so that the company's income seemed to increase. The company manipulated its profit report with a value of US $1.2 billion over the past few years. Reports by independent accountants and lawyers say Toshiba's operating profit has been overstated by ¥151.8 billion or around US $1.22 billion. Tanaka and Sasaki (Deputy Directors) were pressured by the business division to meet difficult targets, and they overstated and delayed loss reports, a corporate culture where employees could not oppose orders from superiors. Employees are forced to obey orders from executives to delay the loss of the next accounting period (Sari, 2017).

Conservative accounting applications in the company's financial statements can be influenced by the implementation of the Good Corporate Governance mechanism in the company, which consists of independent commissioners, ownership structures and audit committees. The independent commissioner functions to carry out independent supervision of the performance of the company's management. The existence of independent commissioners will increase supervision of management in managing the company, so that the supervisors of the independent board of commissioners want the financial statements to be accurate, reliable and reliable. The application of conservatism can avoid opportunistic behavior of managers so that independent board of commissioners tend to want the application of conservative accounting principles (Limantauw, 2012).

In addition to the independent board of commissioners who influence the application of accounting conservatism. The application of accounting conservatism is also influenced by the ownership structure or shareholders can influence management to be more careful in accounting records of the company due to the strict supervision of the shareholders on the sustainability of the company, so that eventually more ownership structures make a level of caution in the company increases (Agustina et al, 2015).

Another aspect of good corporate governance is the existence of an audit committee within the company. The audit committee is the final party that monitors the company's financial reporting process and the audit committee will influence the management policies taken by the company relating to the principles used in financial reporting including the principle of conservatism (Siregar and Haryati, 2017). The audit committee will examine and review the financial statements prepared by management, encouraging management to follow generally accepted accounting standards. This condition triggers managers to be more careful in making policies on accounting records. In other words the audit committee encourages managers to carry out conservative financial reports (Almilia et al, 2018).

2. Literature Review, Theoretical Framework and Hypothesis Development

The Influence of Independent Commissioners on Accounting Conservatism

In line with agency theory, the existence of independent commissioners can help reduce agency conflicts arising from the separation between shareholders and managers through effective monitoring of managerial behavior (Jensen and Meckling, 1976). Therefore, the existence of independent commissioners in a company is very important. Independent commissioners are considered useful because they can be objective and have a small risk of conflict of interest. The independent commissioner as a member of the board of commissioners is not affiliated with the controlling shareholders, members of the board of directors, other board of commissioners, and the company itself both in the form of business relations and family (KNKG, 2006). If the number of independent commissioners is less, the supervision carried out will be weak so that company managers have the opportunity to use accounting principles that are more aggressive and less conservative (Limantauw, 2012). Research conducted by Yunos et al (2014), Elshandidy and Hassanein (2014) and Nasr and Ntim (2018) showed that independent commissioners had an effect on accounting conservatism. Therefore it is hypothesized that:

H1: Independent commissioners have an effect on accounting conservatism.

The Influence of Ownership Structure on Accounting Conservatism

Basically the ownership structure in accounting conservatism can be explained by agency theory. Jansen and Meckling 1976) form a theory which states that share ownership by management will reduce agency problems because the more shares owned by management, the stronger the motivation of management to work in increasing the value of the company's shares. The ownership structure of the company which is more dominated by external parties will also encourage management to be more conservative in the presentation of financial statements, due to the presence of better supervision of the company's survival (Agustina et al, 2015). Research conducted by Agustina et al (2015), Lafond and Roychowdury (2007) and Limantauw (2012) found that ownership structures seen from managerial ownership influence accounting conservatism. Therefore it is hypothesized that:

H2: Ownership structure influences accounting conservatism.

The Influence of the Audit Committee on Accounting Conservatism

The audit committee is a committee that works in a professional and independent manner formed by the board of commissioners and thus the task is to assist and strengthen the function of the board of commissioners or supervisory board in overseeing the financial reporting process, risk management, auditing and implementation of corporate governance (Indonesian Audit Committee Association, 2006). The existence of an audit committee is very important as one of the main tools in the application of good corporate governance where transparency, accountability, independence, and responsibility, as well as fairness are the principles and foundations of corporate organization. The audit committee will also be responsible for reviewing the company's compliance with applicable laws and regulations so that it will encourage the application of accounting conservatism principles. In the research of Mamesah et al (2016), it shows that the audit committee has a positive effect on the application of accounting conservatism. This is due to the existence of an audit committee in a company, so the company's financial reporting process will be monitored well. The existence of this audit committee will encourage the use of higher conservatism in the company's financial reporting process. Therefore it is hypothesized that:

H3: Audit committee influences accounting conservatism.
3. **Research Method**
This data in this study are secondary data in the form of financial statements of sub-sectors companies in mining. Secondary data from this study are quantitative data obtained from the sites of www.idx.co.id and Indonesia capital market directory (ICMD). The data collection process is carried out through documentation by downloading the annual report the company on sub-sectors of mining that are listed in Indonesia stock exchange in 2015-2017 which is obtained from the official website at www.idx.co.id.

The population of this study are the companies in mining category that are listed in Indonesia stock exchange during 2015-2017. Samples are determined by using purposive sampling method which is a non-random sampling method and the samples are selected based on certain considerations or criteria. Data analysis was performed using path analysis which is then processed by using SPSS (Statistical package for social science). Path analysis is a statistical technique used to determine the direct relationship between variables or indirect relationships between variables in the model (Latan and Ghozali, 2012: 314).

![Equation](image)

Where:
- KA : Accounting Conservatism
- KI : Independent Commissioners
- SK : Ownership Structure
- KAU : Audit Committees.

4. **Result and Discussion**
Processing data with path analysis requires two stages of assessment to assess the fit of the model from a research model. These stages are the outer model and inner model.

**Measurement Model (Outer Model)**
The measurement model or outer model shows the validity and reliability of the model. Outer models with reflexive indicators are assessed through Convergent Validity and Discriminant Validity from indicators forming latent constructs and Composite Reliability for indicator blocks (Chin, 1998 in Latan and Ghozali, 2012: 77).

1) **Convergent validity**
Convergent validity is assessed based on the value of loading factors. For studies that are confirmatory in nature the value of the loading factor must be more than 0.7. While for exploratory studies the value of loading factors between 0.6-0.7 is still acceptable. However, for the initial phase of the development of the measurement scale, the value of the loading factor of 0.5-0.6 is still considered sufficient (Chin, 1998; in Latan and Ghozali, 2012: 78).

2) **Discriminant validity**
To test the Discriminant Validity with a reflexive indicator, that is by comparing the AVE square of the contract for each construct with the correlation value between constructs in the model. Good discriminant validity is shown from the square root AVE for each construct greater than the correlation between constructs in the model (Fornell and Larcker, 1981 in Latan and Ghozali, 2012: 79). The recommended AVE value must be greater than 0.5 which means that 50% or more variance of the indicator can be explained. The results of discriminant validity tests are done by comparing the values of square roots AVE and the correlation between constructs are:
In table 1 can be seen that the square root value of AVE is greater than the correlation value between latent constructs in the same column. This explains that all constructs in this research model meet the requirements of discriminant validity.

3) Composite Reliability
Latan and Ghozali, (2012: 79-80), the Role of Thumb commonly used to assess construct reliability, that is, the value of Composite Reliability must be greater than 0.7 for a confirmatory assessment and a value of 0.6-0.7 is acceptable for exploratory research.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Composite Reliability</th>
</tr>
</thead>
<tbody>
<tr>
<td>KI</td>
<td>0.766</td>
</tr>
<tr>
<td>KAU</td>
<td>0.845</td>
</tr>
<tr>
<td>KA</td>
<td>0.897</td>
</tr>
<tr>
<td>SK</td>
<td>0.732</td>
</tr>
</tbody>
</table>

The Structural Model (Inner Model)
The structural model is assessed by looking at the R-Squares value for each endogenous latent variable as the predictive power of the structural model. The R-Squares results can be seen in the table 3 below:

<table>
<thead>
<tr>
<th>Variables</th>
<th>R Square</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting conservatism</td>
<td>0.252</td>
</tr>
<tr>
<td>Independent Commissioner</td>
<td></td>
</tr>
<tr>
<td>Ownership Structure</td>
<td></td>
</tr>
<tr>
<td>Audit Committee</td>
<td></td>
</tr>
</tbody>
</table>

Hypothesis Testing
Based on the tests that are carried out by using the path analysis, the influence of each variable in detail can be seen in table 4.

<table>
<thead>
<tr>
<th>Original Sample</th>
<th>t Statistic</th>
<th>t Table</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>KI -&gt; KA</td>
<td>2.155</td>
<td>1.99</td>
<td>Be accepted</td>
</tr>
<tr>
<td>SK -&gt; KA</td>
<td>3.112</td>
<td>1.99</td>
<td>Be accepted</td>
</tr>
<tr>
<td>KAU -&gt; KA</td>
<td>3.883</td>
<td>1.99</td>
<td>Be accepted</td>
</tr>
</tbody>
</table>

The Effect of Independent Commissioners on Accounting Conservatism
Independent commissioners influence accounting conservatism and path coefficient values are positively coefficient. The results of this study are consistent with the research conducted by Nasr and Ntim (2018) stating that independent commissioners proxied by the number of independent commissioners are positively related to accounting conservatism. Independent commissioners tend to use accounting conservatism as a tool to reduce agency conflict and facilitate the process of monitoring managers. Therefore, the greater the number of independent commissioners it generates a conservative profit because it is obliged to protect minority shareholders.

The results of this study are in line with the research conducted by Prena (2012) who found that independent commissioners positively influence the level of accounting conservatism by using accrual measures. This shows that with the presence of independent commissioners in a company, the company’s financial reporting process will
be well monitored. This independent commissioner will ensure that the company applies accounting principles that will produce accurate and quality corporate financial information through the use of higher principles of conservatism in the company's financial reporting process.

The independent commissioner has been regulated in the Financial Services Authority Regulation No. 33 / POJK.04 / 2014 concerning directors and commissioners of issuers of public companies. In this regulation it was stated that companies listed on the Indonesia Stock Exchange must have at least 30% (thirty percent) of the total number of commissioners.

The Effect of Ownership Structure on Accounting Conservatism

Ownership structure has a positive effect on accounting conservatism. The results of this study are consistent with the research conducted by Agustina et al (2015) dan Putra et al (2019) which shows that the ownership structure that is proxied by institutional has a positive effect on the application of accounting conservatism. The ownership structure owned by the institutional influences the management to be more careful in the accounting records of the company due to the strict supervision of the institution on the sustainability of the company, so that in the end more and more institutional ownership structures increase the level of caution in the company. The high institutional ownership structure also encourages management to be more conservative because institutional parties are involved in making decisions that can threaten management with poor performance, because institutional parties expect dividends from investments they have invested in a company. When the institutional ownership structure decreases, the level of conservatism in the company will decrease, due to the reduced supervision carried out on management.

The Effects of the Audit Committee on Accounting Conservatism

Audit committee has a positive effect on accounting conservatism. Yunos et al. (2014) stated that audit committees proxied by the number of audit committee meetings had a positive effect on accounting conservatism. The frequency of audit committee meetings is an indication that shows the perseverance of members of the audit committee, because usually in the audit committee meeting will solve the problem with the auditor in a formal meeting. By holding meetings periodically, the audit committee can prevent and reduce the possibility of errors in decision making by management because control activities are carried out continuously and structured so that any problems that arise are detected quickly. Adhikary and Mitra, (2016) stated that as an audit committee formed by the board of commissioners, the audit committee can reduce agency problems by reducing information asymmetry between internal parties and external parties, as well as other parties with an interest in making corporate financial decisions. Thus the audit committee can play a role in equalizing the interests of the principal and agent by encouraging the application of conservatism in the company's financial statements.

5. Conclusions

Based on the description of the results of this study it is thus can be concluded that: 1) the results of testing the first hypothesis indicate that independent commissioners have a positive effect on accounting conservatism. That is, the existence of independent commissioners in a company will protect minority shareholders and supervise management to implement accounting conservatism; 2) the results of testing the second hypothesis can prove the positive influence of ownership structure with accounting conservatism. The ownership structure in the company tends to choose accounting that is conservative, especially if the shares are high; 3) the results of testing the third hypothesis can also prove the audit committee has a positive effect on accounting conservatism. The influence of the audit committee on accounting conservatism is because the
audit committee has a role to oversee and provide input to the board of commissioners in terms of the creation of a monitoring mechanism. A competent audit committee will be able to make corrections to the company’s financial condition that can be used as a reference by management to make improvements to the end of the annual financial period.

The variables tested in this study were limited to independent commissioners, ownership structures and audit committees. Though there are still many other variables that are thought to have an effect on accounting conservatism. Therefore, for further research, it can add and expand variables that are thought to influence the application of accounting conservatism, either as independent variables, moderation or mediating variables. And to reduce the subjectivity in interpreting the extent of the level of accounting conservatism, should collaborate with experienced parties to help interpret the extent of the level of application of accounting conservatism.

References


Komite Nasional Kebijakan Corporate Governance, Pedoman Corporate Governance Tahun 2006.


Peraturan Otoritas Jasa Keuangan Nomor 33/POJK.04/2014.