Board Structure in the Control of Real Earnings Management: Does Profitability Play a Role? Evidence from Indonesia's LQ45

Sarah Widyana Putri[1], Riyan Harbi Valdiansyah[2], Amrie Firmansyah[3]

Jurusan Akuntansi
UPN " Veteran" Jakarta
Universitas Budi Luhur
Jakarta, Indonesia

e-mail: sarah.widyana@upnvj.ac.id; rvaldiansyah@budiluhur.ac.id; amriefirmansyah@upnvj.ac.id

Abstrak

Penelitian ini bertujuan untuk menganalisis peran profitabilitas sebagai variabel moderasi dalam hubungan antara struktur dewan dan manajemen laba rii. Penelitian ini menggunakan metode analisis kuantitatif pada sampel perusahaan yang terdaftar di LQ 45 periode tahun 2021 - 2023. Hasil penelitian menunjukkan bahwa ukuran dewan yang lebih besar memperkuat pengawasan manajerial melalui beragam keahlian sehingga mengurangi manipulasi laba. Independensi dewan juga meningkatkan transparansi dan akuntabilitas sesuai dengan regulasi OJK di Indonesia. Sebagai variabel moderasi, profitabilitas menunjukkan bahwa ukuran dan independensi dewan berpengaruh signifikan terhadap manajemen laba riil; khususnya, dewan yang lebih besar membatasi manipulasi laba pada perusahaan yang lebih menguntungkan, sementara profitabilitas yang lebih tinggi memperkuat peran pengawasan direktur independen sehingga menekan praktik manipulatif. Penelitian ini berkontribusi pada literatur tata kelola perusahaan dengan menunjukkan bahwa kombinasi karakteristik dewan dan profitabilitas mendukung tata kelola etis sesuai teori keagenan. Disarankan untuk penelitian selanjutnya agar menyertakan variabel moderasi tambahan, seperti kepemimpinan manajerial atau kebijakan dividen untuk memahami lebih dalam peran dewan dalam mengurangi manajemen laba riil.

Kata kunci: Real Earnings Management, Board Size, Board Independence, ROA

Abstract

This study analyzes the role of profitability as a moderating variable in the relationship between board structure and real earnings management. Using quantitative analysis on companies listed in the LQ 45 index from 2021 to 2023, the findings show that a larger board size strengthens managerial oversight through diverse expertise, reducing earnings manipulation. Board independence enhances transparency and accountability in line with Indonesian Financial Services Authority (OJK) regulations. Profitability, as a moderating variable, reveals that board size and independence significantly impact real earnings management. Specifically, larger boards limit earnings manipulation in more profitable companies, while higher profitability strengthens the oversight role of independent directors, curbing manipulative practices. This study contributes to corporate governance literature by showing that board characteristics combined with profitability support ethical governance in line with agency theory. Future research should include variables such as managerial leadership or dividend policy to further explore the board's role in reducing real earnings management.

Keywords : Real Earnings Management, Board Size, Board Independence, ROA

INTRODUCTION

The information presented in a company's financial reports often does not reflect the actual value of the company. The link between financial reports and external parties of the company allows the company management to be motivated to achieve profit expectations, which may lead to earnings management activities (Lo, 2008). The shift in behavior from accrued earnings management to real earnings management in Indonesia has now become widespread since the adoption of IFRS in Indonesia. Real earnings management allows for a direct impact on changes in annual income because there is a close relationship between the costs and income presented in the income statement. When earnings management is carried out to hide the true condition of the company, this will certainly have a negative impact which can be detrimental to shareholders or other external stakeholders (Ipino & Parbonetti, 2017).

The debate on the fairness of real earnings management occurs between practitioners; some consider it a deviation while others consider it an opportunistic behavior to achieve profits. This gives companies the freedom to choose the basis for a method or policy in recording and preparing financial reports. Even though this is not considered fraud as long as the financial reports are still guided by accounting standards and principles. Therefore, earnings management is not an act of fraud and is still permitted. Even though this does not violate accounting standards, real earnings management can mislead outside parties who use financial report information (Lo, 2008).

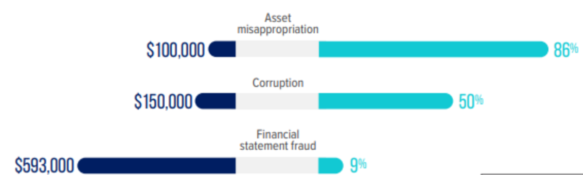
In Report to The Nations in 2022, an investigation carried out by the ACFE (Association of Certified Fraud Examiners) indicated that the losses experienced by companies resulted more from cases of fraud in financial reports.

Figure 1 Investigation of Fraud Cases in Various Countries

Source : The 2022 Report to The Nations (ACFE)

Measuring the true extent of fraud is challenging due to the inherent nature of concealment and deception in most schemes. ACFE also estimates that companies experience more than $4.7 trillion lost to fraud globally in every industry in all parts of the world.

Figure 2 Number of Cases and Losses Due to Fraud Worldwide



Source : The 2022 Report to The Nations (ACFE)

The above investigation is supported by the Financial Statement Fraud case scheme, which contributes to more losses than corruption and asset misappropriation. This has become an interesting issue to address because of the losses incurred by this small percentage (ACFE, 2022). The practice of earnings management, which is still a part of financial statement fraud, is a classic issue that is still ongoing today. Scandals regarding earnings management activities occur not only in developing countries but also in developed countries, such as the United States. Enron, Lucent, WorldCom, Tyco, and Xerox are companies that commit fraudulent financial reporting with the aim of controlling the market in order to get an increase in market prices which are indexed to the growth of the

company's performance between periods (Bergstesser & Philippon, 2006).

Earnings management cases in Indonesia have also occurred in one of the companies listed on LQ45, such as PT Lippo Karawaci Tbk, where there were indications of earnings management and deconsolidation of profits from prestigious projects. Another corruption was committed by PT Waskita Beton and PT Waskita Karya the state making the state suffer losses of up to IDR 2.5 trillion.

The cases revealed by researchers are but a few examples occurring in Indonesia. The case may start as the management sees it as an opportunity to maximize profit disclosure. Then it continues with an unethical attitude that violates various accounting principles and guidelines. So based on this point of view, earnings management activities are carried out systematically driven by certain motivations and interests (Riduwan, 2020).

In terms of impacts, board structure strongly influences earnings management activities carried out in real terms. The large size of a company's board can make it difficult for it to work effectively and efficiently. Therefore, a larger board size is considered less efficient because it leads to worse financial reporting and does not create good entity value (Buertey et al., 2020). When a board is too small, it lacks the capacity to effectively address the company’s daily operational needs, which can hinder the company’s ability to reach its profit targets (Gerged *et al*, 2021). Board independence is essential for monitoring and ensuring that all decisions made prioritize the interests of all parties in the company. This is done to achieve common interests and avoid opportunistic behavior to improve company performance (Abdullah et al., 2021).

In Indonesia, earnings management cases often stem from weaknesses in board structure, such as small board size, lack of competence, and absence of independent commissioners. Notably, in 2001, PT Kimia Farma Tbk inflated its revenue by Rp32.7 billion due to inadequate oversight from the board, lacking independent commissioners to ensure transparency. Studies, like those by Midiastuty and Machfoedz (2003), show that ineffective board structures increase earnings manipulation risks, highlighting the need for competent, appropriately sized boards with independent commissioners to support sound corporate governance and prevent financial misreporting. In conclusion, it is crucial to assess board structure and effectiveness to anticipate and mitigate earnings management, as a well-governed board plays a vital role in ensuring financial transparency and protecting shareholder interests.

A notable phenomenon in Indonesia regarding profitability that can strengthen the relationship between board structure and real earnings management is the pressure on publicly listed companies, especially those on indices like LQ45, to maintain high profitability amid intense market competition. When profitability increases, companies are seen as effectively managing their assets to generate profit, which sends a positive signal to investors and stakeholders.

A strong board structure, characterized by size and independence, is crucial to prevent harmful earnings management in high- profitability conditions. Boards with independent members uphold financial integrity, reducing manipulation as solid performance is already achieved. High profitability allows larger boards to focus on oversight rather than aggressive profit target, where effective boards in profitable firms can mitigate conflicts of interest and enforce strong governance.

Research on the relationship between board structure and real earnings management is essential, especially considering current phenomena and inconsistencies in previous studies. The novelty of this study lies in its integration of a previous research model, specifically the study conducted by Dakhlallh et al. (2021) in Jordan, by using different measurement proxies for Board Structure in accordance with Indonesian regulations and adding profitability as a moderating variable (Karina et al., 2023). This study highlights the importance of an optimized board structure in effective earnings

management, emphasizing that appropriate board size and independence enhance accountability and reduce earnings manipulation risks. It addresses prior research inconsistencies, showing how a well-structured board supports ethical governance and sustainable profitability in line with agency theory. This study contributes to corporate governance literature by demonstrating that the combination of board characteristics and profitability supports ethical governance in line with agency theory.

HYPOTHESIS DEVELOPMENT

Agency theory highlights the role of board structures in addressing agency problems. Board size significantly influences decision-making efficiency in earnings management. Accounting literature contrasts the effectiveness of large versus small board sizes, noting that large boards can increase agency problems, potentially supporting fraud and reducing top management control due to communication and collaboration issues (Sáenz-González & García-Meca, 2014). This can lead to increased earnings management activities. Research by Githaiga et al. (2022) shows that larger boards negatively impact performance, while studies by Cho & Chung (2022), Dakhlallh et al. (2021), and Rajeevan & Ajward (2019) suggest that smaller boards are more effective in reducing earnings management.
H1: Board Size has a significant effect on real earnings management

Board independence is an essential component of a company’s structure. Fama and Jensen (1983) suggest that independent board members enhance the board's control efficiency. Board independence reflects the company's alignment with shareholder interests, as external directors can safeguard shareholder rights and reduce agency problems. Rajeevan and Ajward (2019) argue that a board with more external directors brings diverse knowledge and stronger control mechanisms, ensuring shareholder and stakeholder interests are protected. Supporting agency theory, Rajeevan and Ajward (2019) found that board independence reduces real earnings management. Similarly, research by Gerged et al. (2021) and Kapoor and Goel (2019) confirms the significant role of board independence in limiting earnings management, reinforcing agency theory’s principles.
H2: Board Independence has a significant effect on real earnings management.

This hypothesis posits that a larger board size is associated with reduced real earnings management, as the presence of additional directors enhances monitoring and reduces the likelihood of opportunistic behaviors. Return on Assets (ROA), as a measure of profitability, serves as a moderating variable that strengthens this relationship. Higher profitability indicates better financial performance, which can reduce the incentive for management to manipulate earnings through real activities (Widyaniandhita & Solihin, 2020). Thus, when profitability is high, the negative effect of board size on real earnings management is expected to be stronger, as both a larger board and higher profitability align management actions with shareholder interests, promoting transparency and reducing the need for earnings manipulation (Karina et al., 2023). Here is a hypothesis that incorporates profitability as a moderating variable in the relationship between board size and real earnings management.
H3 : Profitability strengthens the relationship between Board Size and Real Earnings Management

This hypothesis suggests that a higher proportion of independent board members is associated with reduced real earnings management, as independent directors are more likely to prioritize shareholder interests and provide objective oversight. profitability representing the company's profitability, strengthens this relationship by reducing management's motivation for earnings manipulation (Widyaniandhita & Solihin, 2020). When profitability is high, it is expected that the influence of board independence on curbing real earnings

management will be stronger, as both independent oversight and high profitability align with transparent financial reporting, thus lowering the likelihood of manipulative practices (Karina et al., 2023). Here is a hypothesis that incorporates profitability as a moderating variable in the relationship between board independence and real earnings management.
H4: Profitability strengthens the relationship between Board Independence and Real Earnings Management

RESEARCH METHODS

In this research, real earnings management is used as the dependent variable, and corporate sustainability reports and board structure with board size and board independence variables are the independent variables while the profitability is a moderating variable and profitability is a control variable. The research objects are all companies listed on the Indonesian Stock Exchange (BEI) which are included in the LQ45 category in the period 2021 to 2023. This is the basis for the researcher to take the LQ45 company as an object because the companies included in it have the highest capitalization and liquidity values and other requirements that have been classified by the IDX. Total sample measurements resulting in 63 samples of 21 LQ45 companies listed on the Indonesia Stock Exchange with an observation period of 2021 - 2023. Data processing techniques are assisted using EVIEWS by carrying out screening stages of the data to be processed (Ghazali, 2018 p. 27).

Table 1. Operational Definition of Variables

Num.	Variable	Measurements
1	Real Earnings Management (REM)	Abnormal Production cost, Abnormal Discretionary Expenses, & Addition Procy (Zang, 2012)
2	Board Size	The number of a company's board of directors during an accounting period (Dakhlallh et al, 2021)
3	Board Independence	Proportion of non-executive Directors in the company during one accounting period (Saleem, 2019)
4	Profitability	$ROA = \frac{Earnings\ After\ Tax}{Total\ Assets}$ (Karina et al., 2023)

Source : Data Processed by Authors

RESULTS AND DISCUSSION

Descriptive statistical testing is used to obtain clarity and a complete picture of the variables to be studied. The following is the output produced with the help of EVIEWS-14 software.

Table 2. Descriptive Statistical Test Results

	REM	BOARD_SIZE	BOARD_INDEPENDENCE	PROFITABILITY
Mean	-0,0340	7,1746	0,4281	0,1171
Median	0,0100	6,0000	0,4000	0,0745
Maximum	0,5000	14,0000	2,3300	0,7152
Minimum	-0,5900	4,0000	0,1700	-0,0348
Std. Dev.	0,1879	2,4596	0,2667	0,1328
Observations	63,0000	63,0000	63,0000	63,0000

Source : Data Processed by Authors

After the regression model is free from classical assumption tests, the next stage is hypothesis testing. In this research, the tests carried out include the Coefficient of Determination, Simultaneous Test (F), and Partial Test (T) as well as multiple linear regression analysis. Based on the R2 results, the results obtained are 0.8183 or 81.83%. This means that 81.83% of the dependent (dependent) variable can be explained by the independent variable being tested, then the remaining percentage is (100% - 81.83%) explained outside the variables tested.

Table 3. Individual Parameter Test Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
(constant)	0,3711	0,1004	3,6974	0,0007
BOARD_SIZE	-0,0237	0,0129	-1,8350	0,0407
BOARD_INDEPENDENCE	-0,5491	0,2255	-2,4349	0,0122
ROA	-3,2441	0,8613	-3,7666	0,0006
BOARD_SIZE* PROFITABILITY	0,1304	0,0393	3,3154	0,0018
BOARD_INDEPENDENCE * PROFITABILITY	5,0823	1,7904	2,8385	0,0051
R-squared		0,8745		
Adjusted R-squared		0,7897		
F-statistic		10,3117		
Prob(F-statistic)		0,0000		

Source : Data Processed by Authors

The results indicate that board independence and profitability significantly reduce real earnings management, while board size alone does not have a direct effect. profitability moderates the influence of both board size and independence on reducing earnings manipulation, especially in profitable firms. The model explains 87.45% of the variance in real earnings management and is statistically significant. These findings underscore the roles of board independence and profitability in mitigating earnings manipulation.

The Influence of Board Size on Real Earnings Management

The first hypothesis in this research explores the effect of Board Size on Real Earnings Management. Board Size is defined as the total number of directors on the board, and Real Earnings Management refers to managerial actions that deviate from normal operational practices to influence reported earnings, measured using the Zang (2012) model to capture its impact numerically. With a t-value of -1.53, compared to the critical t-value of 1.66342, and a probability of 0.126 (greater than the 0.05 alpha level),

the analysis indicates that Board Size does not significantly affect Real Earnings Management, leading to the rejection of H1.

According to Agency Theory, a larger board should theoretically enhance the board's monitoring capabilities, which can help mitigate earnings management. Agency theory posits that larger boards provide more diverse competencies and oversight, which theoretically improves control over management's decisions (Sáenz-González & García-Meca, 2014). However, in practice, larger boards may face communication and coordination challenges, which can reduce their effectiveness, potentially increasing the risk of earnings management.

In this study, data were collected from LQ45 companies in Indonesia, chosen for their representation of large-cap, actively traded stocks, making them ideal subjects for examining corporate governance and financial performance. These companies

generally comply with Financial Services Authority Regulation No 33/POJK.04/2014, which mandates a minimum of two directors. The typical board size in this sample includes at least seven directors, with a minimum of five directors in the structure. However, simply meeting the regulatory requirement for board size does not appear to mitigate real earnings management. For instance, ANTM in 2018 had a board size of five directors but still recorded a Real Earnings Management value of 0.0541, illustrating that board size alone is insufficient to curb earnings manipulation.

Accounting literature has debated the efficacy of larger boards in reducing earnings management. Some studies, like Xie et al. (2003), suggest that boards with a diverse set of competencies, especially with independent directors knowledgeable in corporate governance and financial management, could be more effective in monitoring. This research aligns with findings by Garven (2015) and Al-Haddad & Whittington (2019), who observed no significant relationship between board size and earnings management, supporting the premise of agency theory, particularly Fama and Jensen (1983), that a larger board may enhance oversight due to its diverse expertise. However, this result contradicts Githaiga et al. (2022), who identified a link between board size and real earnings management, suggesting that further research is needed to explore these dynamics across different settings.

The Influence of Board Independence on Real Earnings Management

The hypothesis in this study examines the influence of Board Independence on Real Earnings Management. Board Independence is defined as the proportion of independent directors on the board, which represents directors not involved in the day-to-day operations of the company and are therefore expected to enhance oversight quality. According to Fama & Jensen (1983), the presence of independent directors is essential as it can increase the board’s efficiency in carrying out control mechanisms. This aligns with Agency Theory, which posits that the inclusion of independent board members helps align the company’s activities with shareholder interests, reducing agency problems by offering unbiased oversight and protecting shareholders' rights.

The importance of Board Independence is also underscored in Indonesia's regulatory framework, specifically Law No. 40 of 2007, which mandates the board of commissioners to supervise corporate activities, including the provision of accurate financial reporting for stakeholders. This requirement ensures that a non-executive board, composed mainly of independent members, provides an effective monitoring function that minimizes conflicts of interest. Compliance with POJK Regulation No. 33/POJK.04/2014 further enforces that independent commissioners should constitute at least 30% of the board of commissioners to ensure adequate independence.

In terms of data characteristics, the Board Independence variable in this study averages 0.4281, exceeding the standard deviation of 0.2667, indicating that most LQ45 companies meet or exceed the regulatory threshold, with at least 30% of their board comprising independent commissioners. This data reflects the commitment of LQ45 companies to regulatory standards on board independence.

Empirical evidence from Rajeevan & Ajward (2019) supports the view that a board with a higher proportion of independent directors has a broader range of expertise and can more effectively represent shareholders' interests. Their research aligns with agency theory, suggesting that board independence reduces real earnings management. Similarly, Gerged et al. (2021) and Kapoor & Goel (2019) found significant effects of board independence in limiting earnings management, further reinforcing agency theory’s perspective on the importance of board structure in maintaining financial integrity.

Based on these arguments and supporting literature, this study hypothesizes that Board Independence negatively influences Real Earnings Management, aligning with agency theory and regulatory frameworks aimed at enhancing governance quality in publicly traded companies.

The Influence of Board Size to Real Earnings Management with Profitability as moderation

Sáenz-González and García-Meca (2014) suggest that larger boards may face communication and collaboration challenges, reducing top management's control and potentially leading to more earnings management. From an agency theory perspective, coordination issues in large boards can weaken monitoring, allowing management greater flexibility to engage in earnings manipulation. Thus, merely increasing board size might not reduce real earnings management if oversight quality declines.

When profitability acts as a moderating factor, however, this relationship changes. profitability, representing profitability, indicates effective asset use and aligns board and management interests with those of shareholders. High profitability decreases management's need for earnings manipulation, as positive financial performance already signals success to investors. This suggests that in profitable firms, board size can significantly impact real earnings management by strengthening oversight. Research by Githaiga et al. (2022) supports this view, finding that larger boards negatively affect performance without a profitability context, highlighting the importance of ROA as a moderator.

Studies also indicate that smaller boards are generally more effective in maintaining oversight and reducing earnings manipulation. Research by Cho and Chung (2022), Dakhlallh et al. (2021), and Rajeevan and Ajward (2019) supports the idea that smaller boards, with fewer coordination issues, may enforce stronger monitoring practices. Yet, in profitable firms with high profitability, larger boards can overcome inefficiencies, as profitability strengthens alignment between board actions and shareholder interests.

In conclusion, while larger boards may face coordination issues, high profitability (ROA) enhances board effectiveness, reducing these risks. This demonstrates that board size significantly impacts real earnings management when supported by strong profitability. In such contexts, profitability aligns management actions with shareholder interests, allowing larger boards to uphold ethical practices, decrease agency costs, and improve oversight effectiveness.

The Influence of Board Independence to Real Earnings Management with Profitability as moderation

Board independence plays a key role in curbing real earnings management by enhancing objective oversight and monitoring management's actions. According to agency theory, independent board members, being uninvolved in daily operations, are less prone to conflicts of interest, enabling them to act in shareholders' best interests and prevent earnings manipulation. Rajeevan and Ajward (2019) affirm that board independence significantly reduces real earnings management by promoting transparency in financial reporting and aligning management actions with shareholder goals.

The moderating effect of profitability further strengthens this relationship. High profitability reflects strong financial performance, reducing management's motivation for earnings manipulation since performance expectations are already met. This profitability boosts the board's oversight power, making independent board members more effective in discouraging manipulative practices. Gerged et al. (2021) also show that board independence, particularly in profitable firms, enhances monitoring capacity and deters earnings manipulation.

Kapoor and Goel (2019) provide additional support for agency theory, demonstrating that independent directors effectively monitor management without internal bias, further limiting earnings management. The combination of board independence and high profitability creates a strong governance framework, dissuading management from altering financial reports.

In conclusion, board independence and high profitability together limit real earnings management by aligning board and shareholder interests, improving financial transparency, and reinforcing ethical practices, as shown in studies by Rajeevan and Ajward (2019), Gerged et al. (2021), and Kapoor and Goel (2019). This integration of agency theory and evidence underscores the importance of independent boards in safeguarding shareholder value and ethical financial practices.

CONCLUSION & RECOMMENDATIONS

This study examines the profitability's moderating effect on the relationship between board structure and real earnings management, with profitability as a control variable. A larger board improves oversight and expertise diversity, while board independence enhances control, aligning with Indonesia's Financial Services Authority regulations (POJK No. 33/POJK.04/2014) to protect stakeholders. The findings show that board size and independence significantly affect real earnings management when moderated by ROA. In profitable firms, larger boards reduce earnings manipulation, as ROA aligns management with shareholder interests. Similarly, board independence curbs earnings management, with high ROA reinforcing independent directors' oversight. This combination creates a governance framework that supports transparency and ethical practices, aligning with agency theory in protecting shareholder value. Future research should consider additional governance moderating variables, such as managerial leadership, or incorporate board diversity and gender diversity to better understand board influence on real earnings management.

The study's limitations include its focus on Indonesian companies, which may limit the generalizability of findings to regions with different regulatory frameworks. Additionally, restricting the sample to LQ45 index companies may reduce applicability to firms outside this index or with weaker governance standards. The use of secondary data also may not fully capture qualitative board dynamics that influence earnings management practices.

The researcher suggests using moderating variables that reflect good governance, like managerial leadership and dividend policy, or a corporate governance index to evaluate governance effectiveness in preventing real earnings management. Additionally, future studies could include new board structure proxies, such as board and gender diversity, to better capture the board's impact on real earnings management in companies.

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