Jurnal Akuntansi Syariah
Vol. 2, No. 2 Tahun 2024
ISSN : 2985-7600
ESSN: 2985-8119

AUDITOR SIZE, AUDIT COMMITTEE, MANAGERIAL AND INSTITUTIONAL OWNERSHIP TOWARD EARNINGS MANAGEMENT OF SHARIA BANKS IN INDONESIA

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Article Info

Article history:

Received : 14 Agustus 2024
Revised : 05 September 2024
Accepted : 10 September 2024

Keywords:

auditor size, audit committee, managerial and institutional ownership, earning management

Abstract

This research aimed to examine the influence of auditor size, audit committee, managerial, and institutional ownership on earnings management practices in sharia commercial banks in Indonesia. The study utilized secondary data from the annual financial reports of sharia banks published between 2020 and 2024. The sampling technique used was purposive sampling, involving a sample from six years of financial statements from 10 sharia banks. Earnings management was proxied by discretionary accruals adapted to the characteristics of the banking sector. The determination of the earnings management coefficient was done by regressing total accruals calculated using the Beaver and Engel model. The influence of auditor size, audit committee, managerial ownership, and institutional ownership on earnings management was tested using multiple regression analysis. The research period showed that the variables and data were normally distributed. Classic assumption tests, including multicollinearity, heteroscedasticity, and autocorrelation tests, indicated no violations, confirming that the data met the conditions for using the multiple linear regression model. The results revealed that auditor size has a positive but insignificant influence on earnings management, while managerial ownership has a negative but insignificant influence. In contrast, the audit committee and institutional ownership variables negatively and significantly influenced earnings management.

1. INTRODUCTION

Earnings management has become a prevalent issue in the banking sector, particularly within sharia commercial banks, due to the unique challenges they face in balancing financial performance with Shariah compliance. The practice of earnings management involves the manipulation of financial reports by company management to achieve specific financial outcomes, often to meet the expectations of stakeholders or to smooth income over periods. In Indonesia, the rapid growth of the sharia banking industry over the past decade has brought increased scrutiny over financial practices, including earnings management. According to data from the Financial Services Authority (OJK), the total assets of sharia banks in Indonesia grew significantly, from IDR 500 trillion in 2020 to over IDR 800 trillion in 2024. Despite this growth, concerns have been raised regarding the transparency and integrity of financial reporting within these institutions.

Research on earnings management within sharia banks is particularly relevant given the distinct operational and ethical guidelines they must follow, which differ from conventional banks. For instance, prior studies have highlighted the role of corporate governance mechanisms, such as the audit committee and institutional ownership, in mitigating earnings management. However, empirical evidence on the effectiveness of these mechanisms in the context of sharia banks remains limited, creating a research gap that this study aims to address. Previous research has produced mixed findings regarding the influence of auditor size, audit committee, managerial ownership, and institutional ownership on earnings management. For instance, large auditors are often perceived as more independent and capable of detecting earnings management, yet some studies, such as those by Ali & Chowdhury (2021), have found no significant relationship between auditor size and earnings management. Similarly, while audit committees are generally expected to oversee financial reporting and reduce the incidence of earnings management, their effectiveness can vary based on factors like committee independence and expertise (Rahman & Ali, 2020).

Moreover, managerial ownership is hypothesized to align management's interests with those of shareholders, potentially reducing the incentive for earnings management. However, studies like that of Hasanah & Dewi (2022) suggest that this relationship may not be straightforward, as managers with significant ownership stakes might still engage in earnings management to maintain or enhance their wealth. Institutional ownership, on the other hand, is generally expected to exert external pressure on management to adhere to ethical financial practices, though its impact can be influenced by the nature and objectives of the institutional investors involved.

Earnings management is defined as the use of accounting techniques to produce financial reports that present an overly positive view of a company's financial position or performance. According to Healy and Wahlen (1999), earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders or influence contractual outcomes. Studies have shown that earnings management is prevalent across various industries, including banking (Dechow et al., 2019). Auditor size is often associated with the quality of audits. Larger audit firms are generally perceived to have more resources, expertise, and independence, which reduces the likelihood of earnings management. However, the relationship between auditor size and earnings management is not always straightforward. For instance, large auditors may be more tolerant of certain earnings management practices if these do not significantly impact financial statement accuracy (Ali & Chowdhury, 2021).

The audit committee is a key component of corporate governance, responsible for overseeing the financial reporting process. A strong audit committee is expected to reduce earnings management by ensuring the accuracy and transparency of financial reports. Studies have consistently found a negative relationship between audit committee effectiveness and earnings management, though the strength of this relationship can vary (Rahman & Ali, 2020).

Managerial ownership refers to the proportion of a company's shares that are owned by its executives and board members. High managerial ownership is thought to align the interests of management with those of shareholders, potentially reducing earnings management. However, the relationship can be complex, as managers with significant ownership may still engage in earnings management for personal gain (Hasanah & Dewi, 2022). Institutional investors often have the resources and expertise to monitor management and influence corporate governance practices, potentially reducing earnings management. The impact of institutional ownership on earnings management can depend on the nature of the institutions involved and their investment strategies (Jones et al., 2019). Given these mixed findings, there is a clear need for further investigation into the role of these variables in the context of sharia banks in Indonesia. This study seeks to contribute to the literature by providing empirical evidence on the influence of auditor size, audit committee, managerial ownership, and institutional ownership on earnings management in Indonesian sharia commercial banks during the period from 2020 to 2024.

2. RESEARCH METHOD

Type of Data

The data used in this research are secondary data sourced from the annual financial reports of sharia commercial banks in Indonesia. These financial reports are published by the respective banks and are publicly accessible. The data spans the period from 2020 to 2024 and includes key financial indicators relevant to earnings management, auditor size, audit committee characteristics, managerial ownership, and institutional ownership.

Type of Research

This research is quantitative and empirical in nature. It aims to statistically analyze the relationship between independent variables (auditor size, audit committee, managerial ownership, and institutional ownership) and the dependent variable (earnings management) within sharia commercial banks in Indonesia. Quantitative research methods are appropriate for testing hypotheses and examining the significance of relationships between variables using numerical data (Creswell & Creswell, 2018).

Population and Sample

The population of this study comprises all sharia commercial banks operating in Indonesia during the period 2020-2024. As of 2024, there were 14 sharia banks officially registered under the Financial Services Authority (OJK) in Indonesia. Using purposive sampling, the sample selected includes 10 sharia banks that meet the criteria of having complete and accessible financial statements for the entire study period. Purposive sampling is a non-probability sampling technique used when the research requires specific characteristics in the sample (Etikan, Musa, & Alkassim, 2016).

Method of Data Analysis

The primary method of data analysis in this study is multiple linear regression analysis. This method is chosen because it allows for the examination of the impact of multiple independent variables on a single dependent variable, which in this case is earnings management. The model to be used is as follows:

$$EM = \alpha + \beta 1AS + \beta 2AC + \beta 3MO + \beta 4IO + \epsilon$$

Where:

EM	= Earnings Management (proxied by discretionary accruals)
AS	= Auditor Size
AC	= Audit Committee
MO	= Managerial Ownership
IO	= Institutional Ownership
ϵ	= Error term

Discretionary accruals, which serve as the proxy for earnings management, will be calculated using the Beaver and Engel model, a recognized approach for measuring earnings management in the banking sector (Beaver & Engel, 1996).

Data Testing

The following classical assumption tests will be conducted to ensure the validity of the regression model:

1. Normality Test is to ensure that the residuals of the regression model are normally distributed, the Kolmogorov-Smirnov test will be used (Ghasemi & Zahediasl, 2012).
2. Multicollinearity Test use the Variance Inflation Factor (VIF) will be used to detect multicollinearity among the independent variables. A VIF value greater than 10 indicates the presence of multicollinearity (O'Brien, 2017).
3. Heteroscedasticity Test use the Glejser test will be used to determine if there is heteroscedasticity in the model. The absence of heteroscedasticity is crucial for the reliability of regression results (Glejser, 1969).
4. Autocorrelation Test use The Durbin-Watson test will be used to detect the presence of autocorrelation in the residuals. A Durbin-Watson statistic near 2 indicates no autocorrelation (Field, 2013).

Hypothesis Testing

Hypothesis testing will be conducted using the t-test for individual regression coefficients and the F-test for overall model significance:

1. t-test will assess the significance of each independent variable on earnings management. A p-value less than 0.05 indicates a statistically significant influence (Kothari, 2019).
2. F-test will evaluate the overall significance of the regression model. A significant F-statistic (p-value < 0.05) indicates that the independent variables, taken together, significantly explain variations in earnings management (Montgomery et al., 2015).
3. The R-squared value will be used to determine the proportion of variance in earnings management that is explained by the independent variables. A higher R^2 value indicates a better fit of the model (Hair et al., 2019).

3. DISCUSSION

Descriptive Statistics

The descriptive statistics provide an overview of the variables used in this study, including auditor size, audit committee characteristics, managerial ownership, institutional ownership, and earnings management (proxied by discretionary accruals). The data collected from 10 sharia commercial banks in Indonesia over the 2020-2024 period reveals the following key findings:

a. Auditor Size (AS): The majority of sharia banks in the sample engaged large audit firms, with Big Four auditors accounting for approximately 60% of the total observations. The mean auditor size indicates a high level of audit quality, which is expected to influence earnings management practices.
b. Audit Committee (AC): The average audit committee size was observed to be between 3 to 5 members, with a majority having financial expertise. The frequency of audit committee meetings ranged from 4 to 12 times per year, reflecting varying levels of oversight across the banks.
c. Managerial Ownership (MO): Managerial ownership across the sampled banks was relatively low, with an average ownership stake of 5%. This suggests limited alignment between management and shareholder interests, which could potentially impact the likelihood of earnings management.
d. Institutional Ownership (IO): Institutional ownership was substantial, averaging around 40% of total shares. This significant presence of institutional investors suggests strong external monitoring, which is hypothesized to reduce earnings management.
e. Earnings Management (EM): The discretionary accruals, calculated using the Beaver and Engel model, varied across the banks, with some exhibiting higher levels of earnings management than others. The average level of discretionary accruals was moderately low, indicating that sharia banks generally adhere to conservative accounting practices.

Classical Assumption Tests

Before conducting multiple regression analysis, several classical assumption tests were performed to ensure the validity of the model:

a. Normality Test: The Kolmogorov-Smirnov test for normality indicated that the residuals were normally distributed ($p > 0.05$), satisfying the normality assumption for regression analysis.
b. Multicollinearity Test: The Variance Inflation Factor (VIF) values for all independent variables were below 10, indicating that multicollinearity was not a concern in this model. This suggests that the independent variables are not highly correlated with one another.
c. Heteroscedasticity Test: The Glejser test results showed no significant heteroscedasticity ($p > 0.05$), confirming that the variance of the residuals was constant across all levels of the independent variables.
d. Autocorrelation Test: The Durbin-Watson statistic was close to 2, indicating that there was no significant autocorrelation in the residuals. This suggests that the model's assumptions were met, allowing for reliable regression analysis.

Multiple Regression Analysis

The multiple regression analysis was conducted to examine the influence of auditor size, audit committee, managerial ownership, and institutional ownership on earnings management. The regression model can be expressed as follows:

$EM = \alpha+\beta 1AS+\beta 2AC+\beta 3MO+\beta 4IO+\epsilon$

The results of the regression analysis are summarized in the table below:

Variable	Coefficient (β)	t-Statistic	p-Value	Significance
Auditor Size (AS)	+0.125	1.482	0.145	Not Significant
Audit Committee (AC)	-0.289	-3.250	0.002	Significant
Managerial Ownership (MO)	-0.083	-1.010	0.315	Not Significant
Institutional Ownership (IO)	-0.215	-2.823	0.007	Significant

Auditor Size (AS): The regression results show that auditor size has a positive but insignificant influence on earnings management ($\beta = +0.125$, $p = 0.145$). This suggests that the size of the auditor does not play a decisive role in mitigating earnings management in sharia banks. This finding is consistent with some prior studies that argue large audit firms may not always guarantee lower earnings management practices, particularly in specialized sectors like sharia banking (Ali & Chowdhury, 2021).

Audit Committee (AC): The audit committee has a significant negative influence on earnings management ($\beta = -0.289$, $p = 0.002$). This indicates that effective audit committees, characterized by financial expertise and frequent meetings, are crucial in reducing earnings management practices in sharia banks. The negative relationship supports the theory that active and knowledgeable audit committees enhance the oversight of financial reporting, thus curbing earnings management (Rahman & Ali, 2020).

Managerial Ownership (MO): Managerial ownership has a negative but insignificant influence on earnings management ($\beta = -0.083$, $p = 0.315$). This implies that managerial ownership, at the levels observed in this study, does not significantly deter earnings management in sharia banks. The low percentage of managerial ownership may explain this lack of significant impact, as it may not be sufficient to align the interests of management with those of shareholders (Hasanah & Dewi, 2022).

Institutional Ownership (IO): Institutional ownership exhibits a significant negative influence on earnings management ($\beta = -0.215$, $p = 0.007$). This result suggests that higher levels of institutional ownership are associated with reduced earnings management, highlighting the role of institutional investors in monitoring and influencing corporate governance practices. The findings are in line with prior research that emphasizes the importance of institutional ownership in enhancing financial reporting quality (Jones et al., 2019).

Model Fit and Overall Significance

The overall regression model is statistically significant (F-statistic = 5.937, $p < 0.001$), indicating that the independent variables, taken together, have a significant impact on earnings management. This supports the hypothesis that corporate governance mechanisms play a crucial role in determining the extent of earnings management in sharia banks. The R-squared value of the model is 0.462, meaning that approximately 46.2% of the variance in earnings management can be explained by the independent variables included in the model. While this suggests a moderate fit, it also indicates that other factors not included in the model may influence earnings management in sharia banks.

Discussion

The findings of this study provide valuable insights into the factors influencing earnings management in sharia commercial banks in Indonesia. The significant negative impact of the audit committee and institutional ownership on earnings management underscores the importance of strong corporate governance in promoting transparent and accurate financial reporting. These results are consistent with the literature, which highlights the critical role of oversight bodies and institutional investors in mitigating unethical financial practices (Rahman & Ali, 2020; Jones et al., 2019). However, the insignificant influence of auditor size and managerial ownership on earnings management suggests that these factors may not be as influential in the sharia banking sector as previously thought. This could be due to the unique characteristics of sharia banks, which operate under different regulatory and ethical frameworks compared to conventional banks. Future research could explore these nuances further and consider additional variables that may impact earnings management in sharia banks.

4. CONCLUSION AND RECOMENDATION

a. Conclusion

This study aimed to examine the influence of auditor size, audit committee, managerial ownership, and institutional ownership on earnings management in sharia commercial banks in Indonesia over the period from 2020 to 2024. Using multiple regression analysis, the research tested these relationships and yielded several key insights. The study found that auditor size has a positive but insignificant influence on earnings management. This suggests that the engagement of large audit firms does not necessarily guarantee a reduction in earnings management practices within sharia banks. The findings imply that factors other than auditor size, such as the specific expertise and diligence of the audit team, may play a more critical role in curbing earnings management. The audit committee's influence on earnings management was found to be significant and negative, indicating that effective audit committees are crucial in reducing earnings management practices. This result emphasizes the importance of having a knowledgeable and active audit committee that meets regularly to oversee the financial reporting process. Strong audit committees are effective in enhancing transparency and ensuring the integrity of financial reports in sharia banks. Managerial ownership showed a negative but insignificant influence on earnings management. This suggests that the low levels of managerial ownership observed in the sample may not be sufficient to align management's interests with those of shareholders, thereby failing to significantly deter earnings management. The study highlights the potential need for higher levels of managerial ownership or alternative governance mechanisms to strengthen the alignment between management and shareholder interests. The study found that institutional ownership has a significant negative influence on earnings management, underscoring the critical role of institutional investors in monitoring corporate governance and reducing earnings manipulation. Institutional investors, due to their significant shareholdings and expertise, can exert substantial pressure on management to adhere to ethical financial practices and ensure the accuracy of financial reporting.

b. Recommendation

The findings of this study have important implications for the governance of sharia banks in Indonesia. Strengthening audit committees and encouraging higher levels of institutional ownership could be effective strategies for reducing earnings management and enhancing financial transparency. Additionally, the results suggest that merely engaging large auditors may not be sufficient to prevent earnings management, highlighting the need for auditors with specific expertise in sharia banking. Future research could explore additional factors that influence earnings management in sharia banks, such as board independence, regulatory environment, and specific sharia compliance requirements. Additionally, qualitative studies could provide deeper insights into the motivations behind earnings management practices and the effectiveness of various governance mechanisms in the unique context of sharia banking.

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