EARNING MANAGEMENT AND DETERMINANT FACTORS OF SOCIAL DISCLOSURE IN INDONESIAN COMPANIES

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Abstract: *The objective of this study is to investigate relationship between earning management and factors, which determine social disclosure in Indonesia companies. Sample of this study are public companies that report social disclosure in annual report on period 2003–2006. Earning management measurement used Jones's Model. Whereas, regression analysis is used to explain relationship social disclosure index as dependent variables and independent variables, that consist of earning management, managerial ownership, leverage, size, board of commisioners and profitabilty. The results of this study show that public companies in Indonesia, that have disclosed social activities in annual report, conduct earning management. Beside this, the result of this study find significant relationship between size with social diclosure. In the other hand, there is no realtionship between profitability, managerial ownership, leverage, board of commissioners and earning management with social disclosure.*

Keywords: *earning management, social disclosure, agency theory, stakeholder theory, legitimacy theory*

Research in environmental and social disclosure themes increase in Indonesian. Research about environmental disclosure conducted by Suratno, *et al.* (2006), explained that environmental disclosure had significant relationship with economic performance. However, Susi (2005) found that environmental disclosure and economic performance has no relationship. There are other studies of environmental disclosure in Indonesia conducted by Rusmana (2003) and Shodiq, *et al.* (2006). Both of the studies related to management behavioral in environmental agenda. Whereas social disclosure research is employed by Zuchroch, *et al.* (2003), they found relationship between social disclosure and trading volume. Other research conducted by Anggraini (2006), who found that managerial ownership and type of industry have relationship with social disclosure. Other findings of her research were no relationship among size, financial leverage and profitability with social disclosure. However, Sembiring (2005) found that size, profile, board of commissioner have significant relationship with social disclosure.

Social disclosure often is related with agency problem. Disclosure will reduce agency problem (Healy & Palepu, 2001). Veronica & Bachtiar (2003); Halim, *et al.* (2005) found that disclosure had negative relationship with earning management in Indonesian companies. Motivation of this study is to investigate social disclosure that can reduce agency problem, in this case is earning management. It is difference with Veronica & Bachtiar (2003) and Halim, *et al.* (2005), they did not use social disclosure variable to explain earning management. Besides that, this study follow up Anggarini's research (2006) and Sembiring's research (2005), they recommended to add time of observation. Both of prior studies were not consistent yet in determinant factors that influence social disclosure.

Literature Review and Hypotheses Development

Earning Management and Social Disclosure

Beaudoin & Agoglia (2009) explored that one potential mitigating earning management is corporate social responsibility. According their study, the tendency of managers to manage earnings through discretionary accruals is influenced by their firm's commitment to social responsibility. Thus, corporate boards may be able to mitigate self-interested behavior by fostering a socially responsible climate. There were negative relationship between earning management and disclosure (Halim, *et al.*, 2005; Veronica & Bachtiar, 2003) This findings are consistent with opportunistic earning management perspective. This result of this study indicated that disclosure can reduce earning management practices.

Earning management can be explained by bonus plan hypothesis. The bonus plan hypothesis predict that manager with their bonus plan will choose accounting policy to seek for maximize utility. When they want to avoid political cost, they will choose accounting policy that can reduce earning reporting. Conversely, if they want to receive more bonus, they will choose accounting policy, that can increase earning. In other words, lower disclosure rate, higher chance manager to manage earning to opportunistic objective. It is consistent with the role of disclosure in capital market. Healy & Palepu (2001) stated that the role of disclosure is to reduce asymmetry information in agency problem and information problem. Based on prior studies, this study formulated hypothesis:

H 1 : Earning management has negative relationship with social disclosure.

Managerial Ownership and Social Disclosure

Conflict of interest between agent and principal is greater when managerial ownership in companies smaller (Jensen & Meckling, 1976). Conversely, the greater ownership in the company's managers, the more productive actions managers in maximizing corporate value. In other words, the cost of contracts and supervision are low. Managerial ownership can reduce agency costs. Manager of the company will disclose social information in order to enhance corporate image, even though he had to sacrifice resources for the activity (Gray, *et al.*, 1988). Results of research in Indonesia by Anggraini (2006) found a positive influence between the percentage ownership of management and social information disclosure. Based on prior study, this research formulates hypothesis:

H2 : Managerial ownership has positive relationship with social disclosures.

Board of Commissioners and Social Disclosure

Existence of Corporate Governance does not separate with agency theory. Watts & Zimmerman (1986) explained that agency costs included monitoring costs and bonding costs. Corporate governance can reduce monitoring costs because of increasing of controlling and transparency, or reducing information asymmetry. Many studies explain affect from ownership composition and board of director composition with corporate performance. Booz-Allen & Hamilton (1998) and McKinsey & Company (2001) in Kusumawati & Riyanto (2005) indicated bad market assessment on corporate governance in Indonesian. Corporate governance mechanism also is a determinant factor of corporate to conduct social disclosure. Coller and Gregory (1999) stated larger board of commissioner size, easier to controlling and monitoring CEO. Beasley (2000), Arifin (2002) and Ujiyhanto & Pramuka (2007) found that board of commissioners existence can reduce agency problem with reveal social disclosure. Beasley (2000); Arifin (2002); Sembiring (2005) found positive relationship between size of board commissioners and social disclosure. According prior study, this research formulates hypothesis:

H 3 : Board of commissioners has positive relationship with social disclosure.

Political Cost and Social Disclosure

The other theory, which are used by researchers to explain social disclosure, is a political cost hypothesis, that is based on positive accounting theory. Grey, *et al.* (2001) found that larger companies avoid political cost by reducing earning reporting and more reveal social disclosure than smaller companies. According to political cost hypothesis, large companies tend to have greater political costs than small firms. Large companies tend to provide information on earnings is lower than small firms, so that large companies tend to spend more money on social disclosure than small firms. Based on agency theory size of companies has positive relationship with social disclosure. The studies successfully demonstrated the positive relationship between size and social disclosure of companies were conducted by Karpik & Belkaoui (1989), Adam, *et al.* (1998), Hackston and Milne. (1996), Kokubu, *et al.* (2001), Hasibuan (2001), Gray, *et al.* (2001) and Anggarini (2006). Based on prior studies, this study formulates the hypothesis:

H4 : Size have positive relationship with social disclosure.

Profitability and Social Disclosure

There are many different results about empirical social disclosure studies. Those were caused by different theory basic. Some research rooted on legitimacy theory and the other based on stakeholder theory. Guthri & Parker (1990) explained that CSR disclosure in annual report was one of way's corporation to sustain and to legitimate contribution on economic and politics. O'Donovan & Gibson (2000) explained that profitability and social disclosure have negative relationship based on legitimacy theory. One of the arguments in the relationship between profitability and the level of disclosures of social responsibility is when a company has a high rate of profit, management considered no necessary to report the things that can disturb information about the company's financial success. Conversely, when low levels of profitability, they hope users will read the report "good news" the company's performance. For example in the social sphere, and thus investors will still invest in the company. Thus it can be said that profitability has a negative relationship to the level of corporate social responsibility disclosure.

Social disclosure will be different perspective if seen from lens stakeholder theory. According to this theory, manager tries to satisfy all stakeholders by disclosing their social activities and then maintain all stakeholder expectations. Involvement of corporate in activities social is important, because society is one of their stakeholders. Mitchel, et al. (1997) and Belkaoui & Karpik (1989) found positive relationship between corporate social performance (CSP) and Corporate Financial Performance (CFP). Satisfaction of each stakeholder group is support instrument for companies financial performance (Jones, 1995). Anggraini (2006) found positive significant relationship between profitability and social disclosure in Indonesian Companies. Based prior study this research formulates hypothesis:

H5 : Profitability has positive relationship with social disclosure.

Leverage and Social Disclosure

Debt contract showed in financial leverage rate. Financial leverage used to limit managerial capacity to transfer of assets between stockholder and bondholder (Jensen & Meckling, 1976). The debt contract filled about rules, which corporate must maintain leverage rate (Watt & Zimmerman, 1990). Higher leverage has more chance for manager to break rule of debt contract, so that corporate will report higher earning (Belkaoui & Karpik, 1989). In order to increase earning reporting, manager has to reduce costs, included cost to disclose social information. Belkaoui & Karpik (1989) illuminate that decision to reveal social information will follow expenditure of disclosure that can reduce revenue. Agency theory predicts that companies with higher financial leverage will reveal more information, because agency cost of company with such capital structure is higher. Additional information is needed to eliminate doubts bondholders against the fulfillment of their rights as creditors. Therefore, firms with high leverage ratios have obligation to conduct a broader expression than firms with low leverage ratios. In the agency theory perspective, companies which have high financial leverage ratio will reduce social disclosure to avoid the spotlight from the debt holders. Belkaoui & Karpik (1989); Cormier & Magnan (1999) and Anggraini (2006) found negative relationship between financial leverage and social disclosure. Based on prior study, this study formulates hypothesis:

H6 : Leverage has negative relationship with social disclosure.

Method

Data and Sample Selection

Out of 354 companies listed on The Jakarta Stock Exchange in the period 2003 to 2006. There are 91 companies revealed social disclosure of 354 companies. 46 companies were selected as sample out of the 91companies. The selection of sample had to meet the following criteria: (1) They have been registered on the Jakarta Stock Exchange for at lest four years (2003–2006). (2) They have published financial statements completely, included social disclosure. (3) Information of board of commissi-o-ner and managerial ownership are available.

Information or data of this research collected from Indonesian Capital Market Directory. Information of corporate social disclosure collected uses criteria from Sayekti &Wodanbio (2008). There are 78 items covered environmental, energy, health and safety of workers, other about employee, product, other and community involvement.

Variables Measurement

Variables measurement of this study can see below.

Analytical Model

Analytical model used to test the hypotheses. The regression model is as follows:

Table 1. ***Variables Measurement***

Variables	Measurements
Social Disclosure Index	Social disclosure measurement based on Corporate Social Responsibility Index developed by Hanifa & Cooke (2005). This method used dichotomy approach in each item on social disclosure, it will be given score 1 if item disclose present and score 0 if no present. Then, score of each item is added to get total score for each company.
Earning management	Discretionary accrual based on Jones's model (Setyawati, 2002).
Managerial ownership	Percentage of stock ownership by managers (Sembiring, 2005)
Board of Commissioners	Number of board of commissioners in each company, based on Beasley (2000) in Sembiring (2005)
Size	size measurement used total assets, based on Waddock & Graves (1997) in Fauzi et al. (2007)
Profitability	This study used Return On Assets (ROA) based on Mahoney and Roberts (2007)
Leverage	Debt to equity ratio based on Kokubu et al.(2000), in Sembiring (2005)

$$Y= \beta 0 + \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 + \beta_5 X_5 + \beta_6 X_6 + e$$

Where:
Y : *Social Disclosure Index*
X1 : *earning management*
X2 : *managerial ownership*
X3 : *board of commisioners*
X4 : *size*
X5 : *profitability*
X6 : *leverage*

Results and Discussion

Descriptive Statistics

Table 2 shows the mean and standard deviation for each variable. The mean was 0.0318 with standard deviation of 0.02175 for social disclosure index. The mean of each independent variables can see in table 2.

Table 3 shows the result of the regressions mode that used in this research. This model uses social disclosure with social disclosure index model

Table 2. ***Descriptive Statistic***

Variables	N	Mean	SD
Social Disclosure Index	46	.0318	.02175
Earning Management	46	.0208	.06065
Managerial Ownership	46	3.1485	4.87893
Leverage	46	2.8972	6.59669
Size	46	2275150.7	7294161.0347
Board of Commissioners	46	4.1957	2.05069
Profitability	46	84.3511	212.54735

Table 3. ***Regression Analysis Social Disclosure Index as Dependent Variable***

Earning Management	**-.185**	**.053**	**-1.251**	**.219**
Managerial Ownership	.115	.001	.744	.461
Leverage	.248	.000	1.634	.110
Size	.510	.000	1.810	.078
Board of Commissioner	-.324	.002	-1.418	.164
Profitability	-.050	.000	-.201	.841
Model Summary				
Adjusted R Square	.057			
F statistics	1.456			
Prob.	.219			

according to Hanifa & Cooke (2005) as dependent variable. Whereas, each of independent variable includes earning management, managerial ownership, leverage, size, board of commissioner and profitability. Based on table 3, only size variable has positive significant relationship with social disclosure at $p<0.078$. However earning management, managerial ownership, leverage, board of commissioners and profitability does not have relationship with social disclosure. The results of regression analysis of social disclosure's influence factors indicates and gives evidence to reject hypothesis 1, 2, 3, 4, 6, and supports hypothesis 5.

Using to model summary table, indicating Adjusted R Square is 0.057 or 5.7%. This result presents only 5,7 % of all dependent variables affect dependent variable. In other word, earning management, managerial ownership, board of commissioners, profitability, size and leverage are little factors that determine social disclosure in sample companies. There are 94,3% other factors that affect social disclosure. Future research can explore more other variables that affect social disclosure.

Earning management does not have relationship with social disclosure. This results reject hypothesis1, that state earning management has negative relationship with social disclosure. Finding of this study is inconsistent with Halim, *et al.* (2005); Veronica & Bachtiar (2003); Lobo & Zou (2001). All studies, based on agency theory, found that disclosure have negative relationship with earning management and disclosure. This study also is not supported by Healy & Palepu (2001), who stated disclosure can reduce agency problem, and Baudoin & Agoglia (2009) who found potential mitigating earning management is corporate social responsibility. Although the result is fail to support the hypothesis, but this result indicates negative relationship direction of two variables. The finding can be explored wider in the future research.

Table 2 shows mean and standard deviation of earning management are 2,08% and 6,065%. In addition, the minimum and maximum score of earning management are -0.0966 and 0.160749. Minus sign indicates that manager increase earning. However, plus sign indicates manager decreasing earning. Mean of earning management is 2,08% that indicates manager increase earning. This result indicates earning management practice was conducted by Indonesian companies that reveal social disclosure.

Managerial ownership did not have relationship with social disclosure. The finding is different with Anggraini (2006). According to Anggraini (2006) managerial ownership, one of the factors affects social disclosure. This study can not support agency theory that explains managerial ownership can reduce agency cost. Based on agency theory, manager of the company will disclose social information in order to enhance corporate image, even though he had to sacrifice resources for the activity (Gray, *et al.*, 1988). Based on this study, managerial ownership in companies that conducted earning management is not one of factors which determined social disclosure.

Based on table 3, board of commissioner variable did not have significant relationship with social disclosure. The results reject hypothesis 3 that predict board of commissioners have positive relationship with social disclosure. The finding of this study is different with Coller & Gregory (1999); Sembiring (2005); Anggraini (2006) who found significant positive relationship in both variables. Although this results does not have significant relationship, there is negative direction between board of commissioner with social disclosure. Negative relationship of both variables were found by Yermack (1996); Beaslley (1996); Jensen (1993) in Ujiyhanto & Pramuka (2007).

According to prior study, it can be said that smaller size of board commissioners more effective make controlling than larger one. Larger size of board commissioners considered less effective in conducting their functions because of difficulty in communication, coordination and decision making (Ujiyhanto & Pramuka, 2007). This study lead to a fact that smaller size board of commissioners has high social disclosures. In other word, relationship of both variables is negative. Briefly, Indonesian companies better use small size of board commissioners. Findings of this study does not support agency theory. Agency theory perspective considers that good corporate mechanism on corporate that has larger board of commissioners have higher social disclosure rate. Board commissioners are expected can reduce agency cost with disclose more social information. Sembiring (2005) and Anggraini (2006) supported this theory. They found positive relationship board of commissioners with social disclosures in Indonesian companies.

Hypothesis 4, size has positive significant relationship with social disclosure, support political cost hypothesis. This findings is consistent with Belkaoui & Karpik (1989), Adam, *et al*. (1995, 1998), Hackston dan Milne (1996), Kokubu, *et al*. (2001), Hasibuan (2001); Gray, *et al*. (2001), Sembiring (2005); Fauzi, *et al*. (2007). This result explains companies which have larger total assets tend to disclose more social information than smaller. Size is used proxy to political cost hypothesis. In this case, size of Indonesian Companies supports to political cost hypothesis related social disclosure.

Table 3 indicates profitability does not relation with social disclosure. This result fail to support hypothesis 5 that state profitability have positive relation with social disclosure. This result is different to Anggrani (2006); Belkaoui & Karpik (1989); Mitchel, *et al*. (1997) who used stakeholder theory. In this theory, social disclosure can increase image companies, and then it will affect financial performance. Briefly, stakeholder predict positive relation between social disclosure and financial performance.

Although have no significant relation between profitability and social disclosure, this research indicated negative direction in both of variables relationship. Negative relationship in both variables based on legitimacy theory, but social disclosure prefer based on legitimacy strategy (Gray, Owen, and Adams, 1996). O'Donovan and Gibson (2000) found profitability have negative relation with social disclosure. Based on this study, higher profitability of Indonesian companies considered as good news. Shortly, social disclosures are not necessary to attract public interest. However, when rate of profitability is low, social disclosure is important to attract public interest.

Leverage does not relationship with social disclosure. This result rejects hypothesis 6. Relation direction between leverage and social disclosure, based on this study, indicates positive relationship, although it is not significant. This finding opposites with Belkoui & Karpik (1989), Cormier & Magnaan (1999); Anggraini (2006) that faund negative significant for both variables relationship. Skipper (1999) in Marwata (2001); Meek (1995) in Fitriany (2001) found positive relationship between leverage and disclosure. Because of additional information in the form of social disclosure is necessary to remove doubts bondholders against the fulfillment of their rights as creditors. Therefore companies with high leverage ratios have the obligation to conduct a broader expression than firms with low leverage ratios.

Conclusion, Implication, Limitation

Overall, result of this study concluded that only variable size have positive relation with social disclosure. This results support the hypothesis of study, which state size has positive relationship with social disclosure based on agency theory. However, result of this study fails to confirm agency theory about earning management, board of commissioners, managerial ownership and leverage. Besides that, this study fails to support legitimacy theory. According to this theory, profitability has negative relationship with social disclosure.

Policy implication of this study is social disclosure can reduce opportunistic earning management perspective. Despites of, results of this study have not presented negative significant relationship between social disclosure and earning management, but the results indicated negative relation direction. According this finding, regulator can considering social disclosure as mandatory disclosure to avoid management opportunistic behavior.

Small number of sample is limitation in this research. If it is compared with Anggraini (2006) and Sembiring (2005) the sample size of study smaller than both research. Sample of this study only considered companies that conduct earning management. Future research can add number of observation. Besides that, future research can used other variables which predict affect social disclosure, for instance motivation of manager, cost of capital and innovation expenditure.

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