Corporate Diversification, Institutional Ownership, and Chief Executive Officer Replacement to Earning Management

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Abstract

This study aims to determine the effect of corporate diversification, institutional ownership, and the change of chief executive officer (CEO) to earnings management. The population in this study is the consumer goods industry sector companies listed on the Indonesia Stock Exchange. Sampling used in this study is the census of the entire population being the study sample, and the number of samples of this study was 35 companies. The research data is secondary data obtained from the Indonesia Stock Exchange website from 2013 to 2018. The research hypothesis testing uses multiple linear regression analysis techniques, with SPSS application tools. The results showed that: (1) Corporate diversification has a positive effect on earnings management. (2) Institutional ownership has a positive and significant effect on earnings management. (3) CEO replacement has a negative and significant effect on earnings management. (4) Corporate diversification, CEO replacement, and institutional leadership simultaneously have a significant effect on earnings management.

Keywords: CEO replacement; corporate diversification; earnings management; industry; institutional ownership;

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1 Introduction

Financial statements are the main tool for managers to show the results of performance and achievements carried out in carrying out the company's operational activities. Financial statements relating to the provision and delivery of information. In general, the income statement takes more attention from the users of the financial statements compared to other reports, because the income statement can help the owner or other parties in estimating the company's earning power in the future. The tendency of external parties to pay more attention to earnings information in measuring company performance will encourage management to manipulate earnings information. This is what then led to the emergence of earnings management.

Earnings management is an activity of manipulating financial statements by choosing appropriate accounting methods and is appropriate to achieve the expected level of profit (Belkaoui & Riahi, 2006). Earnings management is deliberately carried out by management to trick stakeholders who want to know the performance and condition of the company. Earnings management also causes the resulting financial statements to be biased and reduce the credibility of financial statements because the reported numbers do not reflect the actual conditions (Healy & Wahlen, 1999). Seeing the development of the economy in Indonesia, where an increasing number of companies are expanding, one of them is by diversifying. Earnings management is often carried out by diversified companies. Earnings information is one of the benchmarks used to assess company performance by users of financial statements. The main concern for estimating management performance or responsibility is focused on the earnings information presented. Profit is a measure often used to assess an entity for a period (Chen & Ho, 2000; Singh et al., 2003; Lichtenthaler, 2005).

Earnings information helps stakeholders in making decisions and predict the company's earnings power in the future. Masud et al. (2017) states that locally diversified companies and a combination of industry and geographically diversified companies mitigate earnings management, and this research is in line with Vasilescu & Millo (2016), Alhadab (2015), Haroon et al. (2015) research. Ajay & Madhumati (2015), Nugroho &Darsono (2015), Rodríguez-Pérez & Van Hemmen (2010), Lim et al. (2008), which states that corporate diversification has a positive effect on earnings management. According to Jensen & Meckling (1976) states that institutional ownership can reduce conflicts of interest between management and company owners. Institutional ownership does not easily believe in earnings management behavior carried out by management. Institutional ownership is ownership of company shares by insurance companies, banks, and investment companies. Research conducted at companies in Taiwan shows that institutional investor ownership plays an important role in shaping real earnings management (Lan et al., 2015).

The results of Riwayati (2016) existence of an independent commissioner have the effect of reducing asymmetric information to earnings management actions, whereby companies that carry out accrual practices or aggressive earnings management tend to implement corporate governance using institutional decisions. This is in line with research by Bukit & Nasution (2015), Iraya et al. (2015), Man & Wong (2013), Waweru & Riro (2013), Liu (2007), and Cornett (2001), who stated that institutional ownership has a positive effect on earnings management. Following the theory put forward by Scott (1997) which states at the time of CEO replacement will lead to earnings management practices with taking a bath pattern. Companies that make CEO replacements, tend to take action taking a bath to get the maximum profit in the desired period. Taking a bath is an earning management activity by shifting the estimated cost of the coming period to the present so that the performance of the new CEO can be considered successful and the new CEO has a greater chance of earning profits in the future (Wandeca & Liza Alvia, 2012).

Hazari (2012), proves there are earnings management actions taken by the new CEO. Earnings management in this research was found in the form of income decreasing by the new CEO to maximize high profit in the next period. The implications of these studies show that earnings management practices always overshadow CEO replacement events wherever the company operates. This is in line with the research of Yasa & Novialy (2012), Sadia (2014), and Martin (2011), which states that CEO replacement has a negative effect on earnings management.

Literature Review and Hypothesis Development

Diversified companies have a more complex organizational structure, less transparency so that investors have difficulty in analyzing the company. Diversification not only motivates managers to carry out accounting manipulations but also makes conditions supportive of making earnings management difficult to detect. This study is in line with research by Masud et al. (2017), Vasilescu & Millo (2016), Alhadab (2015), Haroon et al. (2015), Ajay & Ajay & Madhumati (2015), Nugroho &Darsono (2015), Rodríguez-Pérez & Van Hemmen (2010), Lim et al. (2008) which states that corporate diversification has a positive effect on earnings management.

**H1: corporate diversification has a positive effect on earnings management**

Institutional ownership can reduce conflicts of interest between management and company owners. Institutional ownership does not easily believe in earnings management behavior carried out by management. Institutional ownership is ownership of company shares by insurance companies, banks, and investment companies. Research conducted on companies in Taiwan shows that institutional investor ownership plays an important role in shaping earnings management (Lan et al., 2015; Martin & Sayrak, 2003; Comment & Jarrell, 1995). Another result obtained from research conducted in Nigeria which shows the result that there is a positive relationship between institutional investor ownership and earnings management (Isenmila & Elijah, 2012). This is in line with research by Riwayati (2016), Bukit & Nasution (2015), Iraya et al. (2015), Man & Wong (2013), Waweru & Riro (2013), Liu (2007), and Cornett (2001), who stated that institutional ownership has a positive effect on earnings management.

**H2: institutional ownership has a positive effect on earnings management**

The new CEO replacement encourages management to practice earnings management in the form of taking a bath. According to Handoko (2006) the company's financial statements reduce income to make a loss the following year in increasing future profits. Scott (1997), states that the new CEO has the potential to take a bath in order to maximize high profit in the next period. The reason for the new CEO is taking a bath because he does not want to be responsible for the poor performance of the previous CEO. Hazarika (2012), proves there are earnings management actions taken by the new CEO. Earnings management in this research was found in the form of income decreasing by the new CEO in order to maximize high profit in the next period. The implications of these studies show that earnings management practices always overshadow CEO replacement events wherever the company operates. This is in line with research by Yasa & Novialy (2012), Sadia (2014), and Martin (2011), which states that CEO replacement has a negative effect on earnings management.

**H3: CEO replacement has a negative effect on earnings management**

2 Methods

This research was conducted using an associative approach. Associative research is research that aims to explain the effect or also the relationship between two or more variables. The method of collection in this study uses the non-participant observation method, namely the selection of sample companies in the consumer goods industry sector listed on the Indonesia Stock Exchange during the study period based on certain criteria. The purpose of this method is to get samples that are in accordance with predetermined criteria. The criteria used to determine earnings management companies whose companies have diversified the company, institutional ownership, and CEO replacement for at least two consecutive years, namely in 2013 to 2018.

3 Results and Discussions

This study connects the effect of corporate diversification, institutional ownership, CEO replacement on earnings management. This study was conducted on companies in the consumer goods industry sector which are listed on the Indonesia Stock Exchange. The analysis technique used is linear regression analysis, to predict the relationship between independent variables, the dependent variable.

3.1 Multiple Linear Regression Analysis

Multiple linear regression analysis is a linear relationship between two or more independent variables (X1, X2, X3, and X4) with the dependent variable (Y). The data used is usually interval or ratio scale.
Table 1
Multiple Linear Regression Analysis

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>(Constant)</td>
<td>40.11</td>
<td>17.33</td>
<td>2.31</td>
<td>0.02</td>
</tr>
<tr>
<td>1</td>
<td>corporate diversification</td>
<td>-12.28</td>
<td>-0.04</td>
<td>0.52</td>
</tr>
<tr>
<td></td>
<td>institutional ownership</td>
<td>-0.43</td>
<td>-0.16</td>
<td>-2.32</td>
</tr>
<tr>
<td></td>
<td>CEO Replacement</td>
<td>-3.60</td>
<td>-0.01</td>
<td>-0.19</td>
</tr>
<tr>
<td>R</td>
<td></td>
<td></td>
<td>0.17</td>
<td></td>
</tr>
<tr>
<td>R Square</td>
<td></td>
<td></td>
<td>0.28</td>
<td></td>
</tr>
<tr>
<td>Adjusted R Square</td>
<td></td>
<td></td>
<td>0.14</td>
<td></td>
</tr>
<tr>
<td>F value</td>
<td></td>
<td></td>
<td>1.99</td>
<td></td>
</tr>
<tr>
<td>Sig.</td>
<td></td>
<td></td>
<td>0.12</td>
<td></td>
</tr>
</tbody>
</table>

Secondary data, 2019

Based on the results of the regression analysis as presented in Table 1, the structural equation can be made as follows:

\[ Y = 40.11 - (12.28) X_1 + (0.43) X_2 + (3.60) X_3 \]

3.2 Effect of Corporate Diversification on Earnings Management

Based on Table 1 results of the company's diversification t-test, the earnings management obtained a significance value of 0.00 with a beta coefficient value of 1.03 positive value. A significance value of 0.00 < 0.05 indicates that H1 was accepted. This result means that the company's diversification has a positive and significant effect on earnings management. This result means that Corporate Diversification has a positive and significant effect on earnings management. In other words, the increasing diversification of the company will further improve earnings management, on the contrary, if the diversification of the company decreases the earnings management will decrease.

Earnings management is often carried out by diversified companies. The phenomenon of the relationship between Corporate Diversification and earnings management is increasingly in the spotlight. Diversified companies are on average more likely to do earnings management than companies of similar size that are focused on one area of their business. This can happen because the higher the level of diversification of a company, the level of transparency will tend to decrease. Account translation and consolidation are some of the factors that can reduce a company's transparency to external parties, and it is this decrease in transparency that results in increasing the implementation of earnings management in a company. The implementation of diversification will cause the organizational structure contained in the company to become more complex and lower levels of transparency and complexity of information for investors and financial analysis will be higher. The existence of information asymmetry between management and company owners can lead to earnings management practices and the higher the level of information asymmetry, the less information owned by owners and financial analysts to see the possibility of profit manipulation.

Corporate diversification has a more complex organizational structure, less transparency so that investors have difficulty in analyzing the company. Diversification not only motivates managers to carry out accounting manipulations but also makes conditions supportive of making earnings management difficult to detect. This study is in line with research by Masud et al. (2017), Vasilescu & Millo (2016), Alhadab (2015), Haroon et al. (2015), Ajay & Madhumati (2015), Nugroho & Darsono (2015), Rodriguez-Pérez & Van Hemmen (2010), Lim et al. (2008) which states that Corporate Diversification has a positive effect on earnings management.

3.3 Effects of Institutional Ownership on Earnings Management

Based on Table 1, the results of the t-test for institutional ownership on earnings management obtained a significance value of 0.00 with a beta coefficient of 0.07 positive. A significance value of 0.00 < 0.05 indicates that H2 was received. This result means that institutional ownership has a positive and significant effect on earnings management. This result
means that institutional ownership has a positive and significant effect on earnings management. In other words, increasing institutional ownership will increasingly improve earnings management, conversely, if institutional ownership decreases, earnings management will decrease.

Institutional ownership can reduce conflicts of interest between management and company owners. Institutional ownership does not easily believe in earnings management behavior carried out by management. Institutional ownership is ownership of company shares by insurance companies, banks, and investment companies. Research conducted on companies in Taiwan shows that institutional investor ownership plays an important role in shaping earnings management (Lan et al., 2015). Another result obtained from research conducted in Nigeria which shows the result that there is a positive relationship between institutional investor ownership and earnings management (Isenmila & Elijah, 2012). This is in line with research by Riwayati (2016), Bukit & Nasution (2015), Iraya et al. (2015), Man & Wong (2013), Waweru & Riro (2013), Liu (2007), and Cornett (2001), who stated that institutional ownership has a positive effect on earnings management.

3.4 Effect of CEO Replacement on Earnings Management

Based on Table 1 the results of the CEO replacement test on earnings management obtained a significance value of 0.00 with a coefficient value of beta -0.49 negative value. A significance value of 0.00 <0.05 indicates that H3 is accepted. This result means that CEO replacement has a negative and significant effect on earnings management. This result means that CEO replacement has a negative and significant effect on earnings management. In other words, the increasing CEO replacement will further reduce earnings management, conversely, if CEO replacement decreases the earnings management will increase.

Substitution of chief executive officer, hereinafter referred to as CEO, can motivate earnings management to be carried out, this condition is caused by the CEO as a trusted agent in the preparation of strategies and corporate decision making to achieve certain objectives within the company. Yasa & Novialy (2012) state that CEOs have an increased risk of job loss. The risk arises if the results obtained or company profits in one period are not following the objectives of the principal and the CEO must be responsible for the results obtained. This situation will encourage the principal to replace the company’s CEO because he thinks the current CEO has failed to carry out his duties, while on the CEO’s situation this will force him to manage earnings so that his position is not replaced in the company. Before the CEO replacement is done earning management actions carried out by the old CEO tend to aim to get a bonus before he was fired by increasing profits (income increasing). Income increasing is done by the CEO at the time before the turnover with the motivation to get a large bonus before being replaced.

The new CEO replacement encourages management to practice earnings management in the form of taking a bath. According to Handoko (2006) the company’s financial statements reduce income to make a loss the following year in increasing future profits. Scott (1997), states that the new CEO has the potential to take a bath to maximize high profit in the next period. The reason the new CEO took a bath was that he did not want to be responsible for the poor performance of the previous CEO. Hazarika (2012), proves there are earnings management actions taken by the new CEO. Earnings management in this research was found in the form of income decreasing by the new CEO to maximize high profit in the next period. The implications of these studies show that earnings management practices always overshadow CEO replacement events wherever the company operates. This is in line with research by Yasa & Novialy (2012), Sadia (2014), and Martin (2011), which states that CEO replacement has a negative effect on earnings management.

3.5 Effect of Corporate Diversification, CEO replacement, and Institutional Ownership on Earnings Management

Based on Table 1 the results of the simultaneous significance test (F-Test) obtained a significance value of F of 0.00. The significance value of 0.00 <0.05 indicates that Corporate Diversification, CEO replacement, and institutional leadership simultaneously have a significant effect on earnings management. These results mean that Corporate Diversification, institutional leadership, and CEO replacement simultaneously have a significant effect on earnings management. In other words, corporate diversification, institutional leadership, and CEO replacement simultaneously have a significant effect on earnings management, affecting the decline and increase of management together.
3.6 Analysis of the Coefficient of Determination

The magnitude of the influence of independent variables on the dependent variable shown by the total determination value (R Square Adjusted) of 0.20 means that 20% of earnings management variation is influenced by variations incorporates diversification, institutional leadership, and CEO replacement while the remaining 80% is explained by factors others are not included in the model.

4 Conclusion

Corporate diversification has a positive and significant effect on earnings management. In other words, the increasing diversification of the company will further improve earnings management, on the contrary, if the diversification of the company decreases the earnings management will decrease. Institutional ownership has a positive and significant effect on earnings management. In other words, increasing institutional ownership will increasingly improve earnings management, conversely, if institutional ownership decreases, earnings management will decrease. CEO replacement has a negative and significant effect on earnings management. In other words, the increasing CEO replacement will further reduce earnings management, conversely, if CEO replacement decreases the earnings management will increase. Based on the analysis results obtained by corporate diversification, institutional leadership, and CEO replacement simultaneously have a significant effect on earnings management. In other words, corporate diversification, institutional leadership, and CEO replacement simultaneously have a significant effect on earnings management, affecting the decline and increase of management together.

Conflict of interest statement
The authors declared that they have no competing interests.

Statement of authorship
The authors have a responsibility for the conception and design of the study. The authors have approved the final article.

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