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DIRECTOR CHARACTERISTICS AND EARNINGS QUALITY OF INDONESIAN FIRMS: AN EMPIRICAL STUDY

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ABSTRACT

This study examines the relationship between director characteristics where earnings persistence is used as a proxy for earnings quality. The characteristics of directors include director age, busyness, gender diversity of directors, and nationality. Upper echelon theory with the premise that a person's actions are not entirely rational but influenced by personal characteristics (limited rationality) has been applied to develop hypotheses. The financial data were hand-collected from annual reports of Indonesian public companies from 2015-2022. As many as 3.119 firm-year observations were used for the test of hypotheses. Results show that the percentage of female directors has a positive correlation with earnings quality and firms with foreign director exhibit lower earnings quality. However, director busyness and age have no correlation with earnings quality.

KEYWORDS: Characteristics of CEO, earnings quality, upper echelon theory, earnings persistence

INTRODUCTION

Financial reports provide relevant and reliable information on the prospects of companies that is useful to make informed decisions. As primary users of financial reports, investors and creditors need reliable financial information to help them navigate their portfolios and allocate them efficiently. The importance of financial information for investors and creditors should encourage companies to publish transparent financial reports that reflect economic reality. Schipper (2005) stated that quality earnings reduce information risk. However, several financial report manipulation cases discussed in Jain and Rezaee (2006) suggested that some companies have less commitment to report financial achievements transparently.

Empirical research on earnings quality can be divided into two groups (Francis et al., 2005). The first group focuses on the causes of earnings quality and the second focuses on the response of financial report users to the earnings quality. Earnings quality is the earnings that reflect the company's economic performance that are relevant for making specific decisions by specific decision makers

(Dechow et al., 2010). Prior studies have reported several earnings attributes that are closely related to earnings quality (Sloan, 1996; Dechow and Dichev, 2002; Barth et al., 2008). Subramanyam (2014) argues that quality earnings are persistent earnings with attributes of predictability, stability, variability and earnings management (discretionary accruals). Francis et al. (2005) argues that quality earnings are those with higher accrual quality. Penman and Zhang (2002) state that earnings that are able to predict future earnings are quality earnings.

Earnings management studies generally partition accruals into normal accruals and discretionary (abnormal) accruals using various models derived from the Jones model. Normal accruals stem from normal transactions that are difficult for managers to influence. Meanwhile, discretionary accruals come from credit transactions or other accrual items that are vulnerable to manager intervention. Higher discretionary accruals suggest covert effort to influence earnings which lead to reduced earnings quality. An extensive review of earnings management studies discussed in Healy and Wahlen (1999) reveals various motivations that encourage managers to engage in earnings management. These include capital market motivation (Teoh et al., 1998; Burgstahler and Eames, 1998), contracting motivation (Healy and Palepu, 1990; Dechow and Sloan, 1991), and regulatory motivation (Beatty et al., 1995).

Earnings persistence generally refers to the extent to which current earnings persist over a long period. This earnings attribute is quite intuitive because it gives an indication of sustainable profit (Canina and Potter, 2018). Early studies of earnings persistence as a proxy for earnings quality include Kormendi and Lipe (1987) and Sloan (1996). Sloan (1996) examines the extent to which current earnings will persist in the future by correlating accrual and cash components with future earnings. The results show that the ability of current earnings to persist depends on the size of the accrual and cash components. In particular, the greater the cash component contained in current earnings, the higher the earnings persistence.

While some studies focused on corporate characteristics and governance practices, other studies looked into the relation between managerial characteristics and financial reporting quality. Francis et al. (2008) argue that the innate nature of a manager can shape financial reporting decisions. They find the reputation of CEOs which is measured by the media coverage of managerial activities has a positive correlation with earnings management. Although the findings are not intuitive, but it is consistent with the rent extraction hypothesis and matching hypothesis. Subsequent research has identified several other CEO characteristics that are associated with financial reporting quality (Hazarika et al., 2012; Huang et al., 2012; Huang, 2013; Jiang et al., 2013; Ali and Zhang, 2015; Zouari et al., 2015; Faccio et al., 2016; Choi et al., 2014; Gull et al., 2018).

In this study, we propose director nationality and busyness as the potential determinants of earnings quality. Note that earning persistence is used as a measure of earnings quality. We also reexamine the role of age and gender as determinants of earnings quality. This research contributes to the literature of earnings quality by providing additional evidence of determining factors of earnings quality. In addition, this research also makes an important contribution to capital market players especially in Indonesia when making investment decisions based on director characteristics.

LITERATURE REVIEW

The upper echelon theory introduced by Hambric and Mason in 1984 describes the development of an organization through the characteristics of executives who run the organization. The basic tenet of this theory is that the executive behavior is influenced by his personal interpretation of the strategic challenges surrounding the organization. Furthermore, personal interpretation is influenced by experience, values, and personality of the individual. Thus, upper echelon theory is based on the premise that a person's actions are not completely rational but are influenced by personal characteristics (bounded rationality). To understand the dynamics of an organization, one must consider the biases and tendencies of the individuals who hold power.

According to the upper echelon theory framework, CEOs' characteristics contribute to the strategic choices and the direction of the companies (Hambrick, 2007). Several studies on corporate financial reporting have documented evidence of the association between CEOs' characteristics and the quality of corporate financial reporting. Francis et al. (2008) show that CEO reputation is positively related to earnings management which is consistent with the rent extraction hypothesis and matching hypothesis. Huang et al. (2012) provide evidence of a positive correlation between CFO's age and the quality of financial reporting as measured by financial restatements and meeting or beating analyst forecasts. Ali and Zhang (2015) report that CEO tenure has a positive effect on earnings management. Saleh et al. (2020) provide evidence of a negative correlation between CEO duality and financial performance. Zouari et al. (2015) report that CEO reputation is positively associated with earnings management. Jiang et al. (2013) report that CEOs with financial experience are less likely to carry out earnings management. Faccio et al. (2016) report that companies managed by female CEOs have lower risk reflected in lower debt levels, lower earnings volatility and higher going concerns. Wells (2002) and Hazarika et al. (2012) provide evidence that CEO turnover tends to increase financial restatement. Anaso (2020) and Jalbert et al. (2007) showed that a CEO's nationality is significantly related to capital structure and compensation. Huang (2013) provides evidence that a company's CSR performance is significantly related to educational background.

Director Age and Earnings Quality

As upper echelon theory suggests the demographic factors play significant role in shaping the direction

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of a company through various strategic choices by executives. Age of executives is expected to influences the level of risk that the company is willing to bear that ultimately affect the quality of financial information (Belot and Serve, 2017). Accounting and psychology studies suggest a positive relationship between age and ethical behavior (Huang et al., 2012). Older individuals tend to behave more ethically because they have lives that are more exposed to the culture and customs that exist in society. Deshpande (1997) reports that older managers are more likely to perceive certain business practices as immoral than younger managers. Hess et al. (2005) found that older individuals were more likely to draw conclusions that conform to norms of ethical behavior. Twenge and Campbell (2008) concluded that the younger generation tends to be narcissistic and has a higher self-esteem that leads to unethical behavior. Meanwhile, Wimalasiri (2001) reports that moral reasoning increases with age.

Prendergast and Stole (1996) argue that young managers tend to invest in riskier projects because they want to give a positive signal about their abilities. Previous studies support this argument (Li et al., 2017; Serfling, 2014; and Yim, 2013). The higher a manager's age, the less likely to take risky decisions. Sundaram and Yermack (2007) report that older CEOs manage companies more conservatively.

Unethical and excessive risk-taking behavior are also expected in the process of financial reporting decisions. Younger managers are more likely to adopt income-increasing accruals policies to build a good reputation in the labor market. On the other hand, older managers have less incentives to choose certain accrual policies to increase reported earnings but instead are more driven by providing the true economic reality. As a result, the accrual component of current earnings contains value-relevance information which is useful to predict future earnings.

H1: Director age is positively related to earnings quality

Director Busyness and Earnings Quality

Managerial busyness is defined as multiple directorships in more than one company. The multiple jobs in different companies causes managers to have limited time and less energy to control and manage the company (Core, 1999). Absence from important board of directors' meetings reduce the quality of strategic decision making (Jiraporn et al., 2009) and disrupt company activities (Ferris et al., 2003) which ultimately lower the firm performance (Fich and Shivdasani, 2006).

The CEO's busyness can also impact the financial reporting decision in terms of accrual components in earnings. Inaccuracy of making accounting choices to report transactions and economic events result in lower quality of accruals component which in turn reduces the predictive power of earnings. Sharma and Iselin (2012) report a positive relationship between financial restatement and multiple directorships. Falato et al. (2013) detected a negative market reaction to directors who are too busy.

Fich and Shivdasani (2006) found a negative relationship between director busyness and firm value.
H2: Director busyness is negatively related to earnings quality

Gender of Director and Earnings Quality
Individuals show different behavioral tendencies based on his/her gender. Croson and Gneezy (2009) found that a person's behavior in bearing risks, and making ethical considerations are associated with gender. Psychology and management literature have documented a bulk of evidence that gender plays a significant role in conservative behavior, risk-tolerance, and styles of leadership (Peni and Vahaman, 2010). Francis et al. (2015) find that women have a tendency to be indecisive, have lower self-confidence, obey rules and behave more ethically.

The preceding evidence suggests that a CEO’s gender may have an effect on financial reporting policies. In terms of accounting choices, women have a tendency to avoid information risks by implementing reporting policies based on accepted accounting standards resulting in higher earnings quality. The tendency to be risk-averse and adhere to accounting standards prevents female CEOs from choosing accounting policies that deviate with the economic realities. As a result, reported earnings are more informative and useful in predicting future earnings and cash flows. Francis et al. (2015) compared earnings quality prior and after the CFO position was held by women. The research findings show that the presence of a female CFO has a positive influence on earnings quality.
H3: Gender diversity of director is positively associated with earnings quality

Director Nationality and Earnings Quality
Several studies have linked a manager's nationality to international experience, management style and CEO salary (Sebbas, 2017; Jalbert et al., 2007). Jalbert et al. (2007) provide evidence that a CEO’s nationality has significant correlation with CEO's managerial style. The culture and experience in home countries subjectively influence leadership style and strategic decisions of a manager. A higher salary offered to foreign directors is indicative of higher firm growth expectations that leads to increased firm value. The involvement of foreign directors in various business projects in different countries and cultures is expected to increase managerial abilities and thus enhance the quality of decision making, including financial reporting policies. However, foreign directors may have an opportunistic behavior to intervene financial reporting process.
H4: The nationality of directors is associated with earnings quality

RESEARCH METHODS
Data was hand-collected from annual reports of Indonesian public firms in the 2015-2022 period, excluding financial and insurance institutions. Annual reports of Indonesian public firms were downloaded from the official website of Indonesian Capital Market and the firm’s official website.

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The number of firm-year observations available during the research period is 3365 but 246 were eliminated due to missing data and data extremes, leaving 3119 usable data for further analysis. Following regression is employed to test the hypotheses. To control differences in company characteristics, leverage (Lev), firm size (Size), and profitability (ROA) were added to the regression model.

$$Qual_{it} = \beta_0 + \beta_1 Age_{it} + \beta_2 Busy_{it} + \beta_3 Gen_{it} + \beta_4 Nat_{it} + \beta_5 Lev_{it} + \beta_6 Size_{it} + \beta_7 ROA_{it} + \beta_8 Year + \varepsilon_{it}$$

Where Qual = Earnings quality, Age = Director age, Busy = Director busyness, Gen = Gender diversity, Nat = Nationality, Lev = Leverage, Size = Firm size, ROA= Profitability, Year = Research period.

Variable Measurement

The term director varies from country to country. As a common practice in Indonesia, directors refer to the President Director, Vice President Director and Director. The three are known in Indonesia as the board of directors. Control variables comprise of leverage, firm size, profitability and year. These variables are inserted to account for the confounding effect that might reduce the research validity.

This study uses earnings persistence as a proxy for earnings quality. By definition, earnings persistence is the predictive ability of current earnings on one-year ahead earnings. The age of director is the average age of directors which comprises president director, deputy president director and director. Director busyness is the percentage of CEOs who also serve as commissioners in other companies. By serving as a Board of Commissioners in another company, the workload that must be carried out increases. Following Gull et al. (2017), gender diversity is measured by the percentage of female directors. Nationality is measured with a dummy variable that takes 1 if a firm has foreign director and 0 otherwise (Anaso et al., 2020).

RESULTS AND DISCUSSION

Descriptive Statistics

As described earlier, the final sample available for the test of hypotheses is 3119 firm-years observations. Table 1. presents descriptive statistics for all variables.

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Table 1. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Age	3119	28	74	52.04	5.780
Busy	3119	0	1	0.327	0.321
Gend	3119	0	1	0.138	0.189
Qual	3119	-2.712	2.674	0.203	0.613
Nat	3119	0	1	0.313	0.464
Lev	3119	0.003	2.997	0.741	0.597
Size	3119	15.567	39.497	28.424	1.861
ROA	3119	-2.452	2.072	0.031	0.145

Table 1. shows that the mean for earnings quality (Qual) is 0.203 with a standard deviation of 0.613. These statistics suggest that the average accuracy of current earnings to predict one-year ahead earnings is 20.3%. Considering the value of the standard deviation, we can say the variation in predictive power of current earnings is quite large among firm-samples. The mean for directors' age (Age) of 52.04 suggests that firm-samples are generally run by mature managers with little variations as reflected in the standard deviation of 5.780. In other words, firm-samples are managed by people who are conservative and risk averse. The mean for director's busyness (Busy) of 0.327 suggests that 37.9% of directors also serve as commissioners in other companies but the majority of directors only have a single job. The mean for gender diversity and nationality are 0.138 and 0.313 respectively. These statistics suggest that 13.8% of directors are women and 31.3% are foreigners. The means for the control variables suggest that the sample came from medium-sized companies with lower debt and profitability.

Correlation Coefficient

Table 2. presents the Spearman's correlation among variables. While director busyness and nationality (Nat) are significantly related to earnings quality, age and gender are not significantly related to earnings quality. However, the correlation coefficients of director busyness and nationality are not consistent with the predicted direction which should be negative and positive respectively. The correlation among other variables gives some insight into director characteristics of the firm-samples. The following are important inferences: 1) Older directors tend to have multiple jobs and work for big companies. 2) Female directors tend to be younger, work for little companies, and are Indonesia origin. 3) Foreign directors tend to work for big companies. For control variables, firm size and profitability are significantly correlated with earnings quality. The significant correlation suggests that firms with higher earnings quality exhibit higher profitability and big in size. Meanwhile, leverage does not have a significant correlation with earnings quality.

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Table 2. Correlation Coefficient

	Qual	Age	Busy	Gend	Nat	Lev	Size	ROA
Qual	1	0.022	0.035*	0.030	-0.048**	-0.010	0.074**	0.094**
Age	0.022	1	0.068**	-0.217**	0.030	-0.027	0.146**	0.015
Busy	0.035*	0.068**	1	-0.027	-0.066**	0.039*	0.247**	0.054**
Gend	0.030	-0.217**	-0.027	1	-0.095**	-0.072**	-0.066**	0.013
Nat	-0.048**	0.030	-0.066**	-0.095**	1	0.019	0.081**	0.093**
Lev	-0.010	-0.027	0.039*	-0.072**	0.019	1	0.170**	-0.115**
Size	0.074**	0.146**	0.247**	-0.066**	0.081**	0.170**	1	0.161**
ROA	0.094**	0.015	0.054**	0.013	0.093**	-0.115**	0.161**	1

*Significant at the 5% level, **Significant at the 1% level

Test of Hypotheses

As described earlier, 3119 observations are available to test the hypotheses. The results are reported on Table 3. Director's gender diversity and nationality are significantly associated with earnings quality at the 10% and 1% respectively. Meanwhile, director busyness and age are not significantly associated with earnings quality. In addition, profitability and size have significant correlation with earnings quality.

Table 3. Regression Results

(DV= *earnings quality)*

	Expected	Coefficients	T-stat	P-Value	VIF
AGE	(+)	0.002	1.208	0.227	1.091
BUSY	(-)	0.017	0.484	0.629	1.083
GEN	(+)	0.105	1.763	0.078	1.068
NAT	(+/-)	-0.078	-3.255	0.001	1.031
LEV	(+/-)	-0.016	-0.814	0.416	1.191
SIZE	(+)	0.020	3.165	0.002	1.164
ROA	(+)	0.356	4.570	0.000	1.078
YEAR	(+/-)	-0.007	-1.368	0.172	1.186

Hypothesis One

Hypothesis one (H1) predicts that an older director is associated with higher earnings quality. The test result does not support the prediction, indicating that age does not play an important role in increasing the integrity and transparency of financial reporting. Less variation in director age may explain these inconsistent results. Descriptive statistics show that the average age of directors is 52 years old, while the 75th percentile age is 55 years old. This means that most of the sample companies have old directors. Given the lack of variation in director age, it is difficult to detect its influence on earnings quality.

The finding is contradictory with previous studies. Previous studies indicate that older managers adhere more to established and generally accepted accounting rules and thus choose accounting policies that reflect the economic realities experienced by the company. Older managers are more consistent in implementing good accounting practices and maintaining the integrity of financial reporting. Studies in psychology show a positive relationship between age and ethical behavior (Huang et al., 2012). Older individuals have a strong traditional culture because they have lived long and are accustomed to existing customs so they behave more ethically than younger individuals. In a study involving 252 managers of nonprofit organizations, Deshpande (1997) found that older managers were more likely than younger managers to perceive certain business practices as immoral. Meanwhile, Twenge and Campbell (2008), conducting a review of research conducted between 1930 and 2008, reported that the younger generation tends to be more narcissistic and has excessive self-confidence, which leads to unethical behavior. Wimalasiri (2001) concluded that moral reasoning increases with age.

Hypothesis Two

Hypothesis two (H2) predicts that busier directors are associated with lower earnings quality. The test result rejects the prediction, indicating that being busy working elsewhere does not make directors neglect their responsibilities in the financial reporting process. The findings are not consistent with previous studies that directors who hold multiple directorships tend to ignore financial reporting processes. Corporate governance studies propose two conflicting theories regarding the advantages and disadvantages of directors who hold multiple directorships.

A reputation hypothesis proposed by Fama and Jensen (1983) states that managers need to build a reputation to increase their value in the labor market by holding various key positions in different companies so that they have a lot of experience related to different managerial styles and business strategies (Perry and Peyer, 2005). Numerous managerial experiences help managers develop expertise in corporate governance as compared with managers who only have one position (Jiraporn et al., 2009). Meanwhile, Ferris et al. (2003) argue that busy managers can help companies expand faster for they have a wider business network. They would provide a wide array of opportunities for companies to develop profitable relationships with customers, suppliers and other stakeholders. However, the arguments for a busy director have limited empirical support and largely show inconsistent results (Ferris et al., 2003; Jiraporn et al., 2009; Byrd et al., 2010).

On the other hand, the director busyness hypothesis posits that multiple directorships will result in directors neglecting their responsibilities to monitor and enforce good corporate governance which leads to a negative consequences performance (Ferris et al., 2003; Conyon and Read, 2006). Empirical support for the director business hypothesis includes Fich and Shivdasani (2006), Jiraporn et al. (2009).

Hypothesis Three

Hypothesis three (H3) predicts that the presence of female managers in a company increases the credibility of financial reporting and higher earnings quality. The argument is that women tend to obey the rules, are risk averse, behave ethically and have a strong motivation to adopt sound financial reporting practices. The test result lends support to the prediction. Specifically, the test results show more female directors are associated with higher earnings quality. However, Gull et al. (2017) argue that the decision to appoint women as directors should be based on personal qualities and not simply on meeting women's quotas.

Previous studies on the role of female directors in improving the quality of financial reporting show inconsistent results. Krishnan and Parson (2008) report that companies with more female directors have higher earnings quality. Gavious et al. (2012), Srinidhi et al. (2011), and Arun et al. (2015) also report consistent findings that the presence of female directors reduces earnings management. On the other hand, several authors found the opposite results. Sun et al. (2011) and Peni and Vahama (2010) fail to provide evidence of a negative relationship between the proportion of female directors and earnings management. These conflicting results suggest that the presence of female directors does not necessarily improve earnings quality. Gull et al. (2017) conducted further tests on the role of female directors in improving the quality of financial reports. They find the presence of female directors reduces earnings management. Further testing by including demographic and statutory attributes such as leadership, experience, business expertise and membership on the Audit Committee show similar results.

Hypothesis Four

Hypothesis four (H4) predicts that the nationality of directors is significantly associated with earnings quality. Firms who have foreign directors will have a lot of international experience to improve corporate governance so that the quality of decision making becomes better. Although there is no research that directly links director nationality with the credibility of financial reports, foreign directors can be expected to work more carefully and seriously than local directors in order to maintain their international reputation. They will continue to strive and maintain integrity by adopting business practices and financial reporting that comply with accounting rules and standards applicable in the country. However, the results show the opposite results. Companies with foreign directors have lower earnings quality relative to local directors. This finding is certainly very confusing.

At this time, the author cannot provide any scientific explanation regarding the findings. Further research needs to isolate differences in personal attributes possessed by foreign directors. It is possible that the insignificant results are due to other variables that reflect differences in individual attributes. Empirical studies on directors' citizenship are mostly related to managerial behavior, compensation and capital structure.

CONCLUSION

Directors are the most influential people in the company and are fully responsible for every important decision taken by the company. The future success of the company depends largely on the director's skill in allocating limited resources to investment projects and increasing firm’s value. According to the upper echelon theory, manager characteristics are associated with a company's strategic choices that ultimately affects performance. More specifically, this theory explains that the personality, experience, and values believed by CEOs determine how they respond to changes that occur in the business environment and in turn influence them in making strategic choices (Hambrick, 2007).

This research tries to provide additional empirical evidence regarding the relationship between director demographic attributes such as age, gender, busyness and nationality on the quality of financial reporting. These demographic attributes are predicted to influence the cognitive values and basic values that directors believe in, thereby influencing strategic decision making and the company's financial reporting policies. Different demographic attributes are also believed to influence management design and control so that they can predict the behavior and contribution of directors in determining company success (Hiebl, 2014).

Multiple regression analysis gives the following results: 1) Director age is not significantly associated with earnings quality. 2) Director busyness is not significantly related to earnings quality. 3) Gender diversity is significantly related to earnings quality. 4) Director nationality is inversely related to earnings quality. 5) Size and profitability are not significantly related to earnings quality.

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