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ASSOCIATION OF OVERCONFIDENCE MANAGEMENT WITH EARNINGS MANAGEMENT: MODERATION OF AUDIT COMMITTEE EFFECTIVENESS

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ABSTRACT

This study aims to obtain information and empirical evidence about the association of managerial overconfidence on earnings management and the effect of moderating the effectiveness of the audit committee. This study uses 1938 observations of companies listed on the Indonesian stock exchange for six periods from 2013 to 2018. The analysis technique used in this study is a moderated regression analysis using SPSS 25 software. This study finds that managerial overconfidence has a significant positive association. on earnings management, this is due to managerial overconfidence who feels he is better than other parties so that they ignore the realistic evaluation, when an investment project is not as estimated, they will perform earnings management to cover their miscalculations. Furthermore, the audit committee was unable to reduce the positive association of managerial overconfidence on earnings management, from the research data it was found that the company only met a few criteria for the effectiveness of the audit committee.

Keywords: Managerial, Overconfidence, Earnings Management, Good Corporate Governance, Audit Committee

INTRODUCTION

Earnings management can be interpreted as an intervention in external financial data reports carried out by parties who want personal interests (Schipper, 1989). In previous studies, there were 2 types of earnings manipulation, namely accrual earnings management and real earnings management (Cohen et al., 2008a; Roychowdhury, 2006). Accrual type earnings management is carried out by tweaking the accounting method or estimation of a transaction in the financial statements (Zang, 2012). Meanwhile, real earnings management is the timing of transactions, investment selection, operational agendas, which are executed by management which has the goal behind it, namely changing reported earnings (Zang, 2012).

Overconfidence was researched and studied for the first time in the field of Psychology, previous research defined Overconfidence as an individual tendency where he feels he is better than the other party, that trait will lead to a tendency to have excessive expectations of the results

to be obtained, and will ignore what is suggested by a realistic evaluation (Bhandari & Richard, 2010). Roll's research (1986) initiated research examining the effect of overconfidence on managerial action. The study by Malmendier and Tate (2005) shows that management who is overconfident tends to exaggerate the expected returns on their decisions, thereby making managers pay less attention to any adverse effects that may occur. Based on studies, Overconfidence can result in miscalculations (Alicke, 1985).

Previous literature indicates that managers with Overconfidence have unrealistically high expectations of the future performance of their firms (Hackbarth, 2003; Wong, 2008) and the belief that they can ensure that high performance is achieved (Malmendier and Tate, 2005). Consistent with this belief, Hribar and Yang (2013) show that companies with overconfidence in management tend to issue more optimistic earnings forecasts. Furthermore, Schrand and Zechman (2012) found that if there is managerial overconfidence in the company, the financial statements may experience financial misstatement.

Several studies have discussed the relationship between managerial overconfidence and earnings management, but the results show inconsistency. In research (Chae & Ryu, 2016; Salehi et al., 2020), the results show that management overconfidence has a negative association with earnings management, a negative relationship between managerial overconfidence and earnings management is due to the fact that, on the other hand, managerial overconfidence also has high managerial abilities, so they have good skills in analyzing investments and making decisions, according to managers, profits generated from earnings management do not increase the value of the company in the long term, and instead give the company losses in the long term. In Li and Hung's research (2013), managerial overconfidence has a positive relationship to accrual-based earnings management and real earnings management. This positive relationship is based on managerial behavior that feels better than other parties, so they ignore realistic evaluations and behave irrationally in investment selection. The author assumes that there is a positive relationship between managerial overconfidence and earnings management.

To mitigate the relationship between management's overconfidence and earnings management, the authors argue that the audit committee is able to mitigate this relationship. Audit committees represent a governance mechanism that functions effectively to limit potential agency conflict problems arising from the separation of ownership and control of a company (Abbott & Parker, 2000; Jensen & Meckling, 1979). In view of good corporate governance the oversight role

of the board, committee and independent auditors is central. Such a monitoring role is a means of ensuring proper accountability, fairness and transparency in the conduct of a company's business (Australian Stock Exchange (ASX), 2010a).

In the study Duellman et al. (2015) made the audit committee a moderating variable between managerial overconfidence in audit fees, the results show that strong audit committees will tend to have higher audit fees, because they ask for complex and high-quality audit services. The audit committee is involved as a bridge in negotiations between management and external audit in realizing good financial reports (Herdman, 2002), so that the justification for including the audit committee effectiveness variable as a moderating variable in this study will be appropriate, because the audit committee is a body involved between management and external audit in the process of making financial reports to the public to create good external financial reports.

The motivation for this research is that there is a research gap from research that examines the relationship between management's overconfidence and earnings management. This study seeks to increase literacy by integrating previous studies by including the audit committee effectiveness variable in the relationship between managerial overconfidence and earnings management. So we get a model that describes the relationship between managerial overconfidence, audit committee effectiveness, and earnings management.

The difference in this study is that the authors moderate the relationship of managerial overconfidence to earnings management using the audit committee effectiveness variable. To find out whether the Overconfidence factor in managers can lead to earnings management behavior, as well as whether the audit committee as a company supervisor, especially in the process of external financial reporting is able to mitigate managerial overconfidence associations with earnings management. This research uses managerial overconfidence measurement based on capital expenditure. On earnings management, this study uses discretionary accruals and real earnings management index as additional analysis. This study selects the population of all companies listed on the Indonesia Stock Exchange from 2013-2018 by excluding companies from the financial industry.

LITERATURE REVIEW

Overconfidence Management and Earnings Management

Agency theory views the firm as a contractual relationship with conflicting parties' interests when brought to equilibrium (Jensen & Meckling, 1979). Through this contractual relationship, the owner (principal) delegates decision-making authority to the manager (agent), in turn, placing the manager in front of many decisions related to the design of company policies, including the role of assessing future unknowns (demand, cash flow, competition) and use these projections as inputs for designing company policies (Ben-David et al., 2007). When assessing the unknowns of the future, managers are subject to biases, e.g. excessive trust bias (Zaher, 2019).

Management that is overconfident can give managers the illusion that the company's value is below its estimate, unintentional earnings misstatement can occur (Schrand & Zechman, 2012). Overconfidence managers are more likely to engage in earnings management, trying to signal better future performance to further improve investor expectations (Bhattacharya et al., 2007). However, if the future performance of the firm does not improve as expected, meaning that overly optimistic forecasts of earnings are in fact impossible to achieve, this will lead to the possibility of incorrect earnings estimates (Jaggi et al., 2006). Considering the potential costs resulting from overestimating earnings forecasts, overconfidence managers may deliberately manipulate profits to cover up any errors, to convey the impression that they have been able to meet earnings forecasts or hide their own poor performance (Hilary and Hsu, 2011; Hribar and Yang, 2006). Managerial overconfidence feels that he is better than other parties, which with that factor in him makes him ignore the realistic calculations of other parties. They still use their personal abilities in analyzing economic realities when they are about to make strategic moves. Consistent with managers who are overconfident can make wrong estimates of income, thus, management who are overconfident can manipulate earnings to cover up their estimation errors. Researchers have a hypothesis that:

H1. Overconfidence management has a positive relationship with earnings management.

Overconfidence Management, Earnings Management, And Audit Committee Effectiveness

The application Agency Theory Jensen and Meckling (1979), states that in agent and principal relations there is monitoring expenditure to reduce information asymmetry of both parties, so that the audit committee is a manifestation of the costs incurred to monitor the work of agents and reduce the information asymmetry of both parties. Many studies that develop mostly

from agency theory have examined corporate governance mechanisms (audit committees) as an effective tool in reducing agency problems between managers and shareholders and have aligned management interests with investors' interests (Inaam & Khamoussi, 2016). Therefore, the audit committee is expected to improve the quality of company reporting and, especially, limit earnings management (Inaam & Khamoussi, 2016).

In the case of a positive relationship between excessive managerial confidence and earnings management, a strong audit committee will function as a monitor according to its function as supervisor of financial reports that will be published to the public. based on the interaction between the three parties involved in the financial reporting process, namely management, external auditors, and the audit committee itself, it is hoped that in the interaction the audit committee will communicate well supported by the relevant competence and experience of its members as well as the independence gained from the requirements of being a non-member having affiliations with directors, company owners and other interests, so that they become reliable supervisors who are not controlled by any party, therefore the authors assume the effectiveness of audit committees will demand quality financial reports and reduce earnings management carried out by managerial overconfidence as a result of miscalculations in determining steps corporate strategy. Based on the description above, the researcher has a hypothesis that:

H2: Audit committee effectiveness reduces the positive association between overconfidence in management and earnings management.

Moderated Regression Analysis (MRA)

In Testing hypothesis 1 and hypothesis 2 in this study was carried out using moderated regression analysis (MRA). Moderated regression analysis (MRA) is a test of interaction between more than two variables, one of the variables tests whether there are differences in the direction of influence and coefficient values when in the interaction of two independent and dependent variables, the moderating variable also interacts with the independent variable (Liana, 2009). The moderated regression analysis model is formulated as follows:

Model: Moderated Regression Analysis

EM = β0 + β1Overcon + β2 LTAit + β3RECINVit + β4LEVERAGEit + β5ROAit + β6LOSSit+β7BIG4it+ β8DUMMYYEARit + β9DUMMYINDUSTRYit + e…………(12)

EM = β0 + β1Overcon + β2ACEffectiveness + β3 LTAit + β4RECINVit + β5LEVERAGEit +

β6ROAit + β7LOSSit + β8BIG4it + β9DUMMYYEARit + β10DUMMYINDUSTRYit+e…………………………………………………….... (13)

EM = β0 + β1Overcon + β2ACEffectiveness+ β3 Overcon*ACEffectiveness + β4 LTAit + β5RECINVit + β6LEVERAGEit + β7ROAit + β8LOSSit + β9BIG4it + β10DUMMYYEARit+β11DUMMYINDUSTRYit+e………………….…………..(14)

The MRA regression equation or model describes whether the variable the effectiveness of the audit committee is a moderating variable, . Moderating variables are variables that systematically change the shape and/or strength of the relationship between predictor variables and criterion variables (S. Sharma et al., 1981). The multiplication variable between overconfidence management and audit committee effectiveness is also called a moderating variable because it illustrates the moderating effect of committee effectiveness variables. audit of overconfidence management and earnings management. The model or equation that has been formed is first tested by using the F statistic test and the coefficient of determination and then tested by the hypothesis.

The audit committee effectiveness variable is said to be a moderator variable if the β3 coefficient in equation number 12 is significant at the specified significance level. In this study, the limit value of Sig. used is 1%, 5% and 10%. If the value of Sig. shows a value that is greater than the Sig value limit. then the moderating variable does not have a significant effect on the relationship between the independent variables and the dependent variable. If the value of Sig. shows a value that is smaller than the Sig value limit. then the moderating variable has a significant influence on the relationship between the independent and dependent variables

RESEARCH METHODS

This In this analysis, the results obtained from the multiple linear regression test model, where the model in this study included several types of variables, namely independent variables, dependent variables, moderating variables, and control variables, namely management overconfidence, audit committee effectiveness moderating variables and control variables. namely BIG4, Loss, ROA, leverage, RECINV, size of the dependent variable of earnings management as measured by discretionary accruals and real earnings management index.

Tabel 4.8

Dual Regressions Analysis

	Discreationery Accrual						**Real Earnings Management Index**					
	Model 1	t	Model 2	t	Model 3	t	Model 1	t	Model 2	t	Model 3	t
Constant	0.273*	3.297	0.254*	3.027	0.259*	3.050	-0.003	-0.033	-0.037	-0.429	-0.039	-0.446
Overcon	0.054*	6.252	0.054*	4.726	0.048*	2.722	0.028*	3.155	0.028*	3.161	0.031***	1.687
ACE			0.007	-1.247	-0.009	-1.163			-0.014*	-2.450	-0.103*	-1.633
OverconfxACEffectiveness					0.004	0.396					-0.002	-0.160
BIG4	-0.004	-0,0415	-0.003**	0.757	-0.003	-0.316	0.003	0.313	0.005	0.612	0.005	0.610
LOSS	0.012	1.210	0.012*	1.169	0.012	1.151	0.003	0.249	0.001	0.141	0.002	0.148
ROA	-0.076*	-4.235	-0.076*	-4.225	-0.076*	-4.226	-0.018	0.948	-0.018	-0.932	-0.017	0.352
LEV	0.036*	4.552	0.036*	4.574	0.036*	4.559	0.008	1.020	0.009	1.078	0.009	1.082
RECINV	0.031	1.247	0.032***	1.193	0.032	1.302	0.361*	0.186*	0.189*	7.352	0.188*	7.347
SIZE	-0.016**	-2.310	-0.013***	-1.199	-0.013***	-1.932	0.009	1.281	0.013***	1.835	0.013**	1.840
Year Dummies	Included											
Industry Dummies	Included											

F- Value	12.434*		11.894*		11.330*		30.144*		29.750*		28.395*	
Adjusted R-Square	0.101		0.101		0.101		0.650		0.651		0.650	

The following is an interpretation of the regression coefficient values:

1. A constant value of 0.273 means that when there are no other variables included in the model, the earnings management value is 0.273, while the constant value is -0.003 on the real earnings management index variable, meaning that if there are no other variables, then the earnings management value which is proxied using the real earnings management index is -0.003.
2. The managerial overconfidence variable has a regression coefficient of 0.054 in relation to earnings management from the discretionary accrual proxy. This result illustrates that when managerial overconfidence increases by one point, the dependent variable, namely discretionary accruals, will also increase by 0.054. in other models constant. In the relationship between managerial overconfidence and earnings management proxy from the real earnings managements index has a regression coefficient of 0.028 in relation to earnings management from the real earnings managements index proxy, these results illustrate that when managerial overconfidence increases by one point, the dependent variable is real earnings managements index. will also increase by 0.028 , the same thing happens the other way around if the variables in the other models are constant.
3. The ACEffectiveness variable gets a coefficient of 0.007 in the regression test, the data says that when the ACEffectiveness variable increases in magnitude by one point, the dependent variable, namely earnings management which is proxied using discretionary accruals, will also decrease by 0.007. The same thing will happen otherwise, provided that the other variables in the model are constant . This will apply when the significance is met, in this variable the significance limit is not met.
4. The variable Overconfident*ACEffectiveness has a regression coefficient value of 0.004, which means that when the ACEffectiveness variable increases by one point, the impact of the dependent variable on earnings management that is proxied using discretionary accruals

will decrease by 0.004. This is the opposite with the other variables in the constant model. This will apply when the significance is met, in this variable the significance limit is not met.

The next step of this test is to see whether this research is accepted or not, by testing the t value so that from the results it can be seen that each variable relationship exists in the model.

1. The coefficient point of the overconfidence management variable is 0.054 with a significance level of 0.000. from these results it can be seen that the direction of the relationship is positive, the significance value is also below 0.01 so that it can be said that the relationship is positive and significant, in accordance with hypothesis 1 if managerial overconfidence has a positive and significant association with earnings management, thus it can be interpreted that hypothesis 1 is accepted and H0 rejected.
2. The coefficient value of the Overconf*ACE variable has a coefficient value of 0.004, which means that the effectiveness of the audit committee weakens the relationship of overconfidence and earnings management, but the significance level of 0.692 is greater than the significance level of 0.10. From the above results it can be concluded that the Overconf*ACE variable is not able to moderate the relationship between independent and dependent variables, not in accordance with the hypothesis proposed so that the second hypothesis in this study was rejected.

RESULTS AND DISCUSSION

Effect of Managerial Overconfidence on Earnings Management

Based on the results of this study it is known that the variable managerial overconfidence has a significant positive effect on the earnings management variable which is proxied using discretionary accruals. This shows that managerial overconfidence has an effect on earnings management proxied using discretionary accruals, this is consistent with research conducted by Li and Hung (2013), found that managerial overconfidence has a positive effect on earnings management proxied using discretionary accruals, these results increase our understanding is that managerial overconfidence has incentives to carry out earnings management. The author also includes the real earnings management index as an additional analysis, and finds that managerial overconfidence has a significant positive effect on earnings management which is proxied by the

real earnings management index, in accordance with the research of Cohen et al. (2008a) which shows that when doing earnings management it tends to lead to low cash flow from operations, low discretionary costs, and high operating costs. Managerial tends to manage profits through real activities, namely: accelerating sales time, reporting lower cost of goods sold and reducing discretionary expenses, managerial takes advantage of this manipulation because using real earnings management modalities is not easy to detect (Kouaib & Jarboui, 2016). Overconfidence management is an executive party that has decision-making authority that is too exposed to company risks (Hribar & Yang, 2016).

Managerial overconfidence can give managers the illusion that the company's value is below their estimate, so that unintentional earnings misstatements can occur (Schrand & Zechman, 2012). Managerial overconfidence is more likely to engage in earnings management, trying to signal better future performance to further improve investor expectations (Bhattacharya et al., 2007). However, if the future performance of the firm does not improve as expected, meaning that overly optimistic forecasts of earnings are in fact impossible to achieve, this will lead to the possibility of incorrect earnings estimates (Jaggi et al., 2006). Considering the potential costs resulting from overestimated earnings forecasts, managerial overconfidence can deliberately manipulate profits to cover up any mistakes, to convey the impression that they have been able to meet earnings estimates or hide their own poor performance (Hilary and Hsu, 2011; Hribar and Yang, 2006).

Effects of Managerial Overconfidence, EARNINGS MANAGEMENT and Audit Committee Effectiveness

Based on the results of this study it is known that the effect of managerial overconfidence on earnings management is not significant when moderated by the effectiveness of the audit committee. The results showed that the variable audit committee effectiveness was not able to moderate the relationship between managerial overconfidence and earnings management, in other words it was unable to reduce managerial motivation to carry out earnings management when the effectiveness of the audit committee in the company was high. The results of the study indicate that the effectiveness of the audit committee is not able to moderate the relationship between management's overconfidence and earnings management. In the research by Chandrasegaram et al. (2013) which shows that the characteristics of the audit committee, namely the frequency of audit committee meetings, the size of the audit committee and the independence of the audit

committee are not negatively related to the amount of earnings management. Therefore, these characteristics are not sufficient to preclude the practice of earnings management in Malaysia.

In research from Palestine (2009) and Sanjaya (2008) which found that the audit committee is not able to influence earnings management. Research by Azhari et al. (2020) found that the audit committee's expertise and independence were not significant in deterring accounting misstatements. Research from Haniffa et al. (2006) and (Peasnell et al., 2005) also found no relationship between audit committee and earnings management.

The results of the research do not support the results of the research which do not match the research by Duellman et al. (2015), that a strong audit committee moderating variable will monitor the financial reporting process properly. Also inconsistent with the research of V. D. Sharma et al. (2011) that the audit committee moderating variable can reduce the tendency of the company to carry out earnings management. This is discussed based on descriptive statistics on the variable effectiveness of the audit committee, 90.5% of the sample only fulfills 2 criteria for the effectiveness of the audit committee, so it is possible that the audit committee in the sample does not have sufficient resources within the audit committee. So that the reality in the field is that the supervisory function in this research sample is not yet effective because it only meets a few criteria for audit committee effectiveness, which has an impact on the audit committee's inability to moderate the positive association between managerial overconfidence and earnings management.

CONCLUSION

1. Overconfidence management has a significant positive effect on earnings management, thus the hypothesis in this study is accepted, because H1 is accepted and Ho is rejected. The results of this study indicate that there is a tendency for managerial overconfidence to manage earnings. Managerial overconfidence will ignore realistic evaluations from other parties when making investment decisions, when managerial overconfidence realizes that they miscalculated they will do earnings management.

2. The variable moderating the effectiveness of the audit committee when it becomes a moderating variable between overconfidence management and earnings management is not significant, thus hypothesis 2 in this study is rejected. The results of the study show that the implementation of the audit committee function has not been effective in preventing

managerial overconfidence in earnings management. Research data shows that many companies do not fully comply with the regulations of the financial services authority POJK/No. 55/POJK.04/2015, which has an impact on the ineffectiveness of the audit committee in supervising the company's financial reporting process.

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