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Procedia - Social and Behavioral Sciences 219 (2016) 632 – 638

Procedia
Social and Behavioral Sciences

3rd Global Conference on Business and Social Science-2015, GCBSS-2015, 16-17 December 2015, Kuala Lumpur, Malaysia

Implementation of Corporate Governance Influence to Earnings Management

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Abstract

The purpose of this paper is to test the influences of corporate governance implementation to earnings management practical. This research used two stages data analysis. Firstly, this research used asymmetrical information variable as intervening variable. Secondly it would have increased significant rate in Structural Equation Modeling those variable used without intervening variable. This research used primary data, collected by 70 respondents. The respondent are all experts, manager, decision maker and the owner. They are performers in the corporate governance. The research has the previous model and method which explain implementation of corporate governance reduced the bad impact of earnings management.

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Peer-review under responsibility of the Organizing Committee of the 3rd GCBSS-2015

Keywords: Corporate Governance; Asymmetrical Information; Earnings Management.

1. Introduction

Implementing corporate governance is considered suitable to repair bad images on banks, to protect the interests of stakeholders and to improve compliance toward legislation and general ethics of banking industry to portray a healthy banking system. Moreover, implementing good corporate governance is expected to affect banks performance, for applying corporate governance can improve financial performance, reduce risks of parties who are only zeroed in their own interests (Sari, 2010).

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Peer-review under responsibility of the Organizing Committee of the 3rd GCBSS-2015
doi:10.1016/j.sbspro.2016.05.044

The issue of corporate governance is motivated by agency theory which states that the agency problems arise when managing a company apart from its holdings. The owner as a supplier of capital companies delegates authority to manage the company to professional managers. As a result, the authority to use company resources is in the hands of the executive. It raises possibility of moral hazard where management does not act in the best interests of the owner (conflict of interest). Managers with information, they may act only to benefit themselves at the expense of the owner for the manager has information about the company that is not owned by the owner (information asymmetry). This will affect the company's performance and eliminate investors' confidence in return on investments that they have planted in the company. To achieve good corporate governance, it requires a systematic mechanism to monitor all policies (Sari, 2010).

Research on the effect of corporate governance toward company's financial performance has been done by previous researchers. Wati (2012) conducted a study that aims to determine the effect of corporate governance implementation of financial performance in companies listed on the Indonesia Stock Exchange. Research results provide conclusion that the practice of Corporate Governance Perception Index (CGPI) significantly influence the company's financial performance as measured by return on equity and net profit margin. In contrast, Meythi and Devita (2011), the research results show that the variable corporate governance implementation does not affect the return on equity.

Referring to the results of empirical research that has been done, it appears that the empirical evidence shows the importance of implementing corporate governance to achieve corporate goals. This research was conducted to determine the effect of applying good corporate governance towards earnings management.

2. Theoritical review

2.1 Corporate Governance

The perspective of agency theory is used to understand the basic corporate governance. Agency theory is a concept that describes the contractual relationship between the principal (owner) and the agent (manager). The agency relationship manager is the party who has information about the company more than the owner, so that the resulting asymmetry of information is a state where there are parties that have more information than outsiders that benefit them (Deegan 2004 in Arifani, 2013).

According to Bukhori (2012), corporate governance has some principles that can be applied to every aspect of the business and the entire company. Principles of corporate governance according (Bukhori, 2012; Dharma, Christina, and Paskah, 2013) include the following: 1) transparency, companies should take the initiative to reveal not only the problems signaled by the legislation, but also important matters for decision-making by shareholders, creditors, and interests of the other parties; 2) accountability, is a necessary precondition to achieve continuous performance; 3) responsibility, the company has a responsibility towards society and the environment and must abide by the laws and regulations applicable to its business continuity so it can be maintained in the long term; 4) independence; and 5) equality and fairness, the company must always consider the interests of all stakehonders based on the principle of equal treatment and the principle of reasonable benefits.

2.2 Earnings Management

Earnings management assigned as the use of managerial judgment in structuring transactions to alter financial reports either to misinform stakeholders with respect to the firm's performance or to reap the benefit of a contractual outcome that is dependent on accounting numbers (Healy & Wahlen, 1999; Latif & Abdullah, 2015). Thus, managers can estimate future economic events at their discretion and these are reflected in firms' financial reports. Those events can include salvage value and the expected life of long-term assets, deferred taxes, asset impairment, losses from bad debts, and post-employment benefits (Healy & Wahlen, 1999; Latif & Abdullah, 2015).

Managerial discretion also have impact the choice of acceptable accounting methods for inventory costing, such as last-in-first-out (LIFO), first-in-first-out (FIFO), and average cost. These can have a significant impact on accounting outcomes in different economic conditions (Zhang, Shi, Gao, & Wang, 2014; Omar, Rashidah, Bello, & Saliza, 2014) and on recording transactions LIFO-FIFO is accelerated depreciation or the straight-line method. Waweru and Riro

(2013) argue that managers also use their discretion in working capital management such as in receivables policies, the timing of inventory purchases, and inventory levels. All these affect net revenues and cost allocations.

By using earnings management, accounting choices are made to reflect either increased or decreased income. For example, in certain instances, stockholders and managers may agree that earnings management is desirable and choose to apply income-decreasing accounting choices to avoid incurring regulatory or political costs (Ujiyanto & Bambang, 2007). On the other hand, when the interests of shareholders and managers diverge, this gives rise to moral hazard. Almilia, 2009; Waweru & Riro, 2013; Latif & Abdullah, 2015; notes that agency theory is an important construct in understanding financial reporting incentives. Agency theory holds that, in the presence of information asymmetries, managers will choose to make a set of decisions that maximize their usefulness.

2.3 Previous research study

(Latif & Abdullah, 2015; Katmon & Omar, 2015) found that audit committee independence is negatively related to the use of discretionary accruals, allowing us to accept the sixth hypothesis. The presence of outside members on the committee strengthens its effective oversight, thus reducing the likelihood of corporate failure and financial fraud. The effectiveness of corporate governance mechanisms differs for high-growth and low-growth firms. These results have important implications for constraining earnings management practices. CEO duality, for instance, is positively related to earnings management only in the case of high-growth firms (Gumati, Ari, Elok, and Ester, 2015). This implies that CEOs that also chair a firm's board may become heavily involved in earnings management to ensure that the firm remains attractive; this is not the case for low-growth firms. Institutional shareholding is positively related to earnings management only for low-growth firms and is irrelevant in the case of high-growth firms (Jerry & Mark, 2010). The independence of the audit committee is negatively related with the practice of earnings management for both high-growth and low-growth firms. Thus, an independent audit committee is likely to prove an effective corporate governance mechanism and ensure that financial reports remain neutral.

Gonzalez & Meca (2014), researching about analyze the relationship between the effectiveness of the government and the earnings management behavior. His research find the document how when a country implements controls aimed at reducing corruption, strengthening the rule of law or improving the effectiveness of government, this leads to a reduction in firm earnings management.

Research conducted by Ujiyanto & Bambang (2007) used a sample of 30 companies in a manufacturing sector from 2001-2004. Results from this study show that: (1) institutional ownership does not significantly affect earnings management, (2) managerial possession gives significant negative effect on earnings management, (3) Proportion of independent board does have significant positive effect on earnings management (4) the amount of commissioners does not have significant effect on earnings management.

Research on corporate governance and earnings management is also done by Rahmawati (2007). The research was conducted on the banks which are listed on the IDX from 2000-2004. Results of this study are: (1) the composition of independent board has significant negative influence on earnings management, (2) the size of board of commissioners has positive and significant effect on earnings management practices, (3) the existence of an audit committee significantly affect earnings management, and (4) the size of the company does not affect the earnings management practices.

Hypothesis: Corporate governance in a company can eliminate a number of asymmetrical information, so that the spread of information can be done where perceptions of investors and the company are aligned.

3. Research Methodology

The sample in this study is a manufacturing company that has gone public in the Indonesian stock market. This study uses primary data obtained from questionnaires. The object of this research is investors and financial managers of selected companies. For the category of investors, the questionnaires are directed to the shareholders who have assets over 2-5 billion rupiah. And for financial managers, the questionnaires are directed to investment managers who have experienced for 5-10 years. This research have collected 80 respondents in between 70 respondents as the normal data. The respondent are all experts, manager, decision maker and the owner. They are performers in the corporate

governance. According with the objectives of this research and the availability data in this research, analysis data were processed using Partial Least Square (PLS).

4. Analysis and Results Discussion

4.1 First Stage Testing

In the first modeling, it can be seen that the modeling does not meet all requirements of significant Structural Equation Modelling (SEM) models. The first modeling is based on determining the relationship of asymmetrical information on corporate governance and earnings management, so that each effect of the amount of asymmetrical information can be seen. By placing asymmetrical information as moderating variable between earnings management and corporate governance, it is expected that contribution of modeling meets its initial purpose of corporate governance (Tangjitprom, 2013).

By entering a number of critical indicators, the preparation of a table can be done as follows:

Table 1. The Minimum Criteria SEM

Criteria	Result of this Research	The Critical Value	Interpreting
Chi-Square	74,96	Smaller	Bad
Probability	0,00	≥0,05	Good
RMSEA	0.336	≤0,08	Bad
GFI	0.865	≥0,90	Good
AGFI	0.171	≥0,90	Good
CMIN/DF	24.898	≤2,00	Bad
TLI	0.67	≥0,95	Good
CFI	0.901	≥0,95	Bad

Source: output PLS (2015)

Looking at the table above, it can be said that the study did not meet all the indicators of significant SEM models. This can be seen from; 1) Chi Square value is too high, so the next test is carried out to reduce the value of Chi Square; 2) RMSEA is considered to be too high, so that the requirements of significant SEM models failed; 3) CMIN/DF is assessed to be too high that it also failed to meet the requirements of valid and significant SEM models; 4) CFI Indicators is also experiencing the same thing, failed to meet the requirements of SEM models.

4.2 Second Stage Testing

Having seen the failure to meet the requirements of SEM models, the study aims directly at the relationship between corporate governance and earnings management. Assuming asymmetrical information is part corporate governance, thus the absence of this variable. For the next step, the model developed between corporate governance and earnings management are linked directly. This eliminates asymmetrical information modelling variable, leaving the following assumptions: 1) the purpose of corporate governance aims to eliminate or reduce asymmetrical information; 2) asymmetrical information is the effect of corporate governance policies, indirectly associating it with corporate governance.

Reduction of research object changes the relationship between corporate governance and earnings management (Katmon & Omar, 2015). After re-evaluating the second testing, the framing of a number of critical indicators of minimum criteria Structural Equation Modelling into the table below.

Table 2. The Minimum Criteria SEM

Criteria	Result of this Research	The Critical Value	Interpreting
Chi-Square	40.952	Smaller	Good
Probability	0	≥0,05	Good
RMSEA	0	≤0,08	Good
GFI	0.966	≥0,90	Good
AGFI	0.91	≥0,90	Good
CMIN/DF	0.982	≤2,00	Good
TLI	1.002	≥0,95	Good
CFI	1	≥0,95	Good

Source: output PLS (2015)

Noting that a number of indicators of minimum table SEM has all been fulfilled, it can be said that the model has a fairly good level and significance, valid and representative on interactional level. Thus it can be said that corporate governance has good relationships with earnings management. Corporate governance has considerable influence on earnings management. With the two-stage test, the obtained findings are as follow: First, corporate governance aims to eliminate the asymmetry of information from interested parties, so that the asymmetry can be part of the corporate governance. Thus the removal of asymmetric variables can increase the level of validity of this study. Second, with regard of reciprocal relationship between corporate governance and earnings management, it can be said that the company uses earnings management as an effect of the corporate governance, or corporate governance is used to cover earnings management policies. By running corporate governance, the company can cover earnings management in removing policies or reducing asymmetrical information process.

4.3 Corporate Governance and Earnings Management Relations

Earnings information helps the owner/others in estimating the strength of earnings to assess the risk on investment and credit (Rahmawati, Sri, & Erna, 2015). The importance of information such profits has to be realized by the management as financial statements compilers as well as parties whose performance is measured upon (Rahmawati, Sri, & Erna, 2015). Statement of Financial Accounting Concepts (SFAC) stated that earnings information is a key element in financial statements and is very important for those who use it for it has predictive value.

Earnings management can be applied in preparing financial statements through creative accounting practices, the choice of accounting methods, the classification of accounting systems and the timing of the transaction (Rahmawati et al., 2007). Timing of transactions and the accounting systems of classification affect earnings management in the preparation of financial statements (Indriastuti, 2012). Earnings management practices can also be done through the selection of inventory accounting method, depreciation of fixed assets, and capitalization of pensions, inflation, and amortization.

Managers' drive to apply earnings management are: the bonus program, violation of debt, turnover of top managers, taxation, political cost, and companies that conduct IPO. Asymmetry of information gives a chance that the manager can perform earnings management. Quality auditor by proxy auditor industry is the limit in earnings management. Deferred taxes resulting from the difference between deferred tax assets and deferred tax liabilities can be used to detect earnings management.

Classification shifting is another earnings management tool besides accrual management and real economic activity manipulation. Classification shifting is misclassification of items in the income statement (Rahmawati, Sri, & Erna, 2015). Manipulation of real activity is a manipulation by management through daily activities of the company during current accounting period. Therefore, this manipulation can be done for the rest of current accounting period. It is this time that becomes an important part in a company; managers have an incentive to manipulate real activity (Hassan & Ahmed, 2012).

Research on earnings management is used to clarify the use of positive accounting theory and agency theory. Positive accounting theory proves that there is not a single theory that can explain management policies on earnings

management so the explanation could be opposed to the positive accounting theory. Research on earnings management in recent years associated many with Corporate Social Responsibility (for example, research Rahmawati et al., (2007), investor protection (Indriastuti, 2012), and corporate governance (Sari, 2010)).

For investors, earnings management research results can be used as consideration of investment by using accrual information as a component of earnings. Creditors, financial analysts, and auditors are advised to be careful in understanding profit reported by management in financial statements, given the reported earnings can be raised, flattened, or derived by utilizing the flexibility of financial accounting standards and regulations.

The standard setters would be interested in a special accrual used to manage the magnitude and frequency of earnings management. Regulators, for example, Bank Indonesia can detect the banking industry who apply earnings management, by observing the characteristics of banks that have large accrual thus the large difference between profit and cash flow and operations with weak governance structures. Bank Indonesia also needs to be careful in formulating banking regulations because of proven banking regulations related to earnings management.

5. Conclusion and Recommendation

Implementation of corporate governance aims to reduce asymmetrical information to the earnings management actions. This is in accordance with the purpose, in practice what happens is non-functioning of corporate governance policy. The existence of independent commissioners has the effect of reducing the asymmetrical information to the earnings management actions, not significantly applicable. Companies doing aggressive accrual or earnings management practices tend to apply corporate governance. The problem is that disclosure is not informative to investors. Earnings management and corporate governance relation is very strong and reciprocal, so that it can be said earnings management related to corporate governance.

For further research, explaining the company's motivation to use corporate governance is expected, in addition to covering the earning management practice, earnings management practical pattern associated with the corporate governance or reduction asymmetrical information process.

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