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The Drivers of Earning Management: Cases of Firms with Corporate Governance Perception Index

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Abstract: The purpose of this study is to examine whether corporate governance run into financial distress and examine the effect of financial distress, financial leverage and corporate governance on earning management. The study was conducted on companies that obtained a corporate governance perception index in Indonesia. The sample selection uses purposive sampling with a total of 86 companies from 198 companies in 2012-2017. The design of hypothesis testing uses multiple linear regression. The results of hypothesis testing found that financial leverage, financial distress and corporate governance influence the negative direction of earning management. Company that is run into financial distress apparently doing earning management strategy to decrease earning or increase earning. Management is motivated to conduct earning management in conditions of running into financial distress, but on the other hand companies that are managed in a well governed way to reduce earning management practices because of the strict control of corporate governance mechanisms.

Keywords: Earnings Management, Financial Leverage, Financial Distress, Corporate Governance

1. INTRODUCTION

The finding of positive accounting theory evidence presented by Watts & Zimmerman (1978) states that if every manager has the attitude to do something that aims to benefit himself, then the manager will use his position for personal gain, betraying the trust given by shareholders to them. There are management actions that are self interest such as earning management, fake financial report, even fraudulent financial report. Several phenomena related to the case of financial report and fraudulent financial report have occurred both in Indonesia and abroad. These cases, including fake financial report is allegedly committed by a public company in 2015 (Detik Finance, 2015), accounting fraud is allegedly committed by a Toshiba company in 2015 (Sari, 2017), and cases of unusual recording of earning and total revenues Sharia interest in the financial report of a government bank in 2018 (Jatmiko, 2018).

The manager tried to control the actions of management, which aims to personal gain by manipulating financial reports. Various cases of fake financial report that occurs triggered by internal factors which considers that fake financial report is a policy that is taken by the management company in the choice of accounting policies within limit Generally Accepted Accounting Principles (GAAP). In many studies of fake financial report practices such as earning management, if done in the long term earning management practices can lead to fraudulent financial reporting.

Earning management has been widely expressed by previous researchers, such as Fischer & Rosenzweig (1995), Healy & Wahlen (1999) and Leuz, Nanda & Wysocky (2003), Nuraini A and Zain 2007, Ghazali, Shafie & Sanusi (2015) and Abbadi, Hijazi & Al-Rahahleh (2016). In an aggressive perspective earning management is the active manipulation of earning carried out by company managers to achieve targets that have been set from the start with the intention of obtaining some benefits (Nuraini A dan Zain, 2007). In general, earning management practices occur due to flexibility in the selection of accounting policies, which causes a shrinkage of information conveyed to shareholder relating to economic performance that results mistake in decision making. From some literature review literature, there are many factors that cause management do earning management, financial leverage , financial distress and corporate governance.

Alexander & Hengky (2017) suggested that financial leverage is used to assess how much funds are needed by companies in financing. Companies need to get benefit from the level of financial leverage, if the level of financial leverage is high, the information has a meaning that the level of risk that will be obtained by investors is higher in making their investment return along with the benefits they want, and vice versa, if financial leverage is low, then the risk to investors will decrease. Several previous studies have examined the impact of financial leverage on earning management. Evidence found by Bekiris & Doukakis (2011), Ujah, & Brusa (2014), Januarsi, Badina & Febrianti (2014), Ghazali et al., (2015), Mohammadi & Amini (2016), Moghaddam & Abbaspour (2017), Priharta, Rahayu & Sutrisno (2018) and Lazzem & Jilani (2018) stated that a company's financial leverage affects earning management.

A company will form the work concept that will bring up a good level of performance in terms of earning. The work concept is done to bring positive information and management capacity in maximizing the funds were invested by the shareholders in completing their obligations to share holders . In contrast to the evidence findings made by Mahiswari & Nugroho (2014) the value of financial leverage has a negative effect on earning management. The results of this study can be interpreted that high financial leverage is a negative signal which means the company's operational prospects become difficult in the future. The higher the level of financial leverage of a company, the higher the level of supervision conducted by creditors. Supervision of these creditors reduces management flexibility in earning management.

On the other hand, another factor that drives companies engage in earning management practices is financial distress. Hery (2017) suggests that financial distress is a situation where the company is faced with problems of financial difficulties, a situation where the operating earning of the company cannot cover the total costs incurred. Financial difficulties in the concept of financial theory occur because of exogenous and endogenous risk factors.

Endogenous risk factors lead to internal company problems. Therefore, risk can only affect certain companies or a small number of companies in the same line of business . On the other hand, exogenous risk factors are wider which means that exogenous risks influence all companies in the market. There are some evidence of the findings stating that financial distress influence earning management, including those proposed by Lo (2012) Ghazali et al (2015), and Agrawal & Chatterjee (2015) which suggest that there is a negative influence of financial distress on earning management. The management is motivated to do earning management if they are not in a state of high financial distress, and vice versa. In contrast to the evidence revealed by Mohammadi & Amini (2016) which reveals there is a positive relationship between the level of financial distress on earning management, if the financial distress value of a company is high, then the company is encouraged to practice earning management. This was done to show a good and stable company performance.

Another factor influence earning management is corporate governance. revealed that the level of good corporate governance quality, exemplified in low discretionary accrual , can serve the interests of shareholders by reducing information asymmetry and agency costs. Corporate governance is expected to limit the actions of managers to carry out earning management. The results of previous studies Bekiris & Doukakis (2011), Waweru & Riro (2013), Amertha, Ulupui & Putri (2014), Wiyadi, Veno & Sasongko (2015), Abbadi et al (2016), Lehmann (2016), Alzoubi (2017) and Priharta et al (2018) state that corporate governance is negatively related to earning management, that the implementation of good corporate governance can reduce earning management actions. Corporate governance limits the actions of corporate managers in manipulating earning. While some other research results revealed by Alexander & Hengky (2017), that some corporate governance mechanisms such as audit quality and auditor independence have no effect on earning management.

This research is a replication of previous research conducted by Lazzem & Jilani (2018) which focuses on determining whether corporate governance run into financial distress and is actively involved in earning management practices. The difference between this research Lazzem & Jilani (2018) is the development of what has been done by previous studies, namely by adding several variables, including financial distress (Ghazali et al., 2015) and corporate governance (Lazzem & Jilani, 2018). The results of this study found that well-governed corporates run into financial distress and earning management.

The finding of positive accounting theory evidence presented by Watts & Zimmerman (1978) states that if every manager has the attitude to do something that aims to benefit himself, then the manager will use his position for personal gain, betraying the trust given by shareholders to them. There are management actions that are self-interest such as earning management, fake financial report, even fraudulent financial report. Several phenomena related to the case of financial report and fraudulent financial report have occurred both in Indonesia and abroad. These cases, including fake financial report is allegedly committed by a public company in 2015 (Detik Finance, 2015), accounting fraud is allegedly committed by a Toshiba company in 2015 (Sari, 2017), and cases of unusual recording of earning and total revenues Sharia interest in the financial report of a government bank in 2018 (Jatmiko, 2018).

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2. THEORETICAL FRAMEWORK AND DEVELOPMENT OF HYPOTHESES

2.1 Agency Theory

Agency problems that arise in agency relationships can be resolved by monitoring (corporate management) and very detailed contractual agreements for managers (Pepper, 2019). Contracts are made to align interests between the principal and the agent. The formal agency theory began in 1970, behind it there is a long and varied history of important scientists involved during the formative period of agency theory in 1970, including Jensen & Meckling (1976).

Agency theory according to Jensen & Meckling (1976) state that the practice of earning management carried out by a company is promoted by a certain interests that create a confrontation of interests. The agents who should carry out service obligations to the principal apparently have different views about the goals between the agent and the principal. Each party in an agency relationship seeks to maintain earning for themselves.

Shleifer & Vishny (1997) revealed that basically, every individual can see a contract where the principal provides funds to the agent (manager) with certain conditions, including that the principal will retain all residual control rights. However, the principal does not obtain enough information to take an appropriate policy, it becomes the main basis of the contract between the principal and agent by employing the agent. As a result, managers can easily use the company's control rights to allocate operational funds in accordance with their wishes. Conflicts of interest in the principal's relationship with management can be overcome by means of the policy constraints specified in the contract, but the fact is that managers are more flexible in having the majority of residual control rights.

Similar to what was expressed by Jensen & Meckling (1976), Shleifer & Vishny (1997), Amin (2018:73) revealed the concept of agency theory is a relationship of responsibility between agent and principal , where the agent is given the trust by the principal to manage his business, then obliged to provide accountability reports to the principal through financial reports.

2.2 Financial Leverage and Earning Management

According to Lazzem & Jilani (2018) financial leverage is a way to reduce agency disputes between shareholders and managers and is also useful to reduce costs for information asymmetry. Financial leverage can encourage earning management. Managers are encouraged to take earning management actions if the financial leverage of the company is high. This happens because the management wants to bring up a good level of company performance.

The motivation that drives managers involved in earning management practices is to give a positive signal to investors that the investment risk is low in the company. The company formed a working concept that is structured to increase earning, it impacts on investor confidence would be benefits to be obtained, and motivate potential investors or increase the number of investors who will invest in the company.

While the results of Firth & Smith (1992) state that if a company has more debt with a higher level of leverage, the supervision conducted by creditors will become tighter and make the situation of management freedom in carrying out earning management practices to be reduced. The situation explained that the higher the financial leverage, the lower the level of earning management practices undertaken by management. The findings presented by Mahiswari & Nugroho (2014) explain that leverage has a negative effect on earning management. These results mean that the leverage that is high or a signal to indicates that the company's operations become more difficult in the future. The higher the leverage level of a company, the supervision conducted by creditors will also increase. The existence of strict supervision from creditors reduces the flexibility of the company in carrying out earning management, and earning management practices are decreasing, so that the hypothesis can be formulated as follows:

H_1: Financial leverage has negative effects earning management.

2.3 Financial Distress dan Manajemen Laba

The concept of Hery’s theory (2017:34) explains that there are several definitions related to financial distress that can be in the form of: (1) Economic failure, a condition in which a company's revenue is not available to cover the total cost including the cost of capital, but the company can still do operational activities as long as the creditor receives a rate of return below the market. (2) Business failure is a condition in which as or operational activities of the company are terminated, due to loss. (3) Technical insolvency is caused by a company cannot meet its obligation when due date, because the company is running into liquidity shortages. Technical insolvency is an early indication of economic failure, which may be an indication of early signs leading to bankruptcy. Finally (4) Insolvency bankruptcy, namely the book value of debt is higher than the market value of the current assets.

Financial distress conditions influence the performance of the company. The company felt pressured due to financial difficulties, but management did not think about taking action on earning management, but rather focused on solving financial difficulties. Some findings of previous research suggest that financial distress is negatively related to earning management.

Some evidence of the findings state that financial distress has a relationship with earning management, including those proposed by Lo (2012), Ghazali et al (2015) and Agrawal & Chatterjee (2015) which suggest that there is a negative influence of financial distress on earning management. The management is motivated to do earning management if not in a state of high financial distress, and vice versa. There is a tendency for management to conduct earning management if the company run into low financial difficulties. But in conditions of high financial distress, management is usually not motivated to do earning management. In conditions of high financial distress, creditors carry out close supervision so that management is more focused on returning the financial situation to be better, so that hypotheses can be formulated as follows:

H_2: Financial distress has negative effects on earning management

2.4 Corporate Governance and Earning Management

Khan (2011) revealed that corporate governance is a description of processes, habits, policies, laws, and institutions that can direct organizations or companies in the way they act, manage, and control company operations. The implementation of corporate governance forms the working concept that provides quality can suppress fraud actions committed by external and internal parties of the company. One such fraud is the practice of earning management. The working concept that is structured and has integrity in implementation, limits the earning management practices of managers.

Lehmann (2016) explains the high quality of corporate governance, exemplified by the low discretionary accruals, can serve the interests of shareholders by reducing information asymmetry and agency costs. Corporate governance is expected to limit the actions of managers to carry out earning management. Amertha et al (2014) revealed that the conscious with importance of investor and public confidence in support for the survival of the company.

Some of the results of previous studies by oleh Bekiris & Doukakis (2011), Waweru & Riro (2013), Amertha et al (2014), Wiyadi et al (2015), Abbadi et al (2016), Lehmann (2016), Alzoubi (2017) and Priharta et al (2018) state that corporate governance has a negative relationship with earning management. Optimal implementation of corporate governance can reduce earning management actions. This limits the actions of managers and companies in manipulating earning, so that hypotheses can be formulated as follows:

H_3: Corporate governance has negative effects on the earning management

3. RESEARCH METHODS

This research was conducted at the Indonesia Stock Exchange (IDX). This study aims to examine whether corporate governance run into financial distress and earning management. In this study also examines whether financial leverage, financial distress, and corporate governance affect earning management. In this study there are three control variables, namely increasing leverage, return on assets (ROA) and interest expense.

The population in this study is that all companies that received the Corporate Governance Perception Index for the 2012-2017 period. The population are 198 companies. Determination of the number of samples using purposive sampling, as for the sample of this study as follows:

Table 1. Research Samples

Sample Criteria	**Year**						**Total Samples**
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	
Company who obtained CGPI	42	31	23	30	34	38	**198**
Companies not listed on the IDX	(17)	(15)	(11)	(15)	(19)	(25)	**(102)**
The company that suffered losses in the current year	(3)	(1)	(2)	(2)	(1)	(1)	**(10)**
Total Samples	**22**	**15**	**10**	**13**	**14**	**12**	**86**

Source: Processed Data (2020)

Data sources that used in this study are financial report publication data, annually report data accessed through http://www.idx.co.id. While the corporate governance perception index is obtained via CGPI email vivi@iicg.org.

Table 2. Variable Measurement

Variable	**Measurement**
Earning management	$TA_{it}/A_{it-1} = \alpha_i[1/A_{it-1}] + \beta_{1i}[\Delta REV_{it}/A_{it-1}] + \beta_{2i}[PPE_{it}/A_{it-1}] + \varepsilon_{it}$ (Jones, J. J (1991)
Financial leverage	$\frac{\text{Debt Total}}{\text{Assets Total}}$ (Kariyoto, K (2018)
Financial distress	Altman z-score (Cutoff > 2,675 not bankrupt; < 2,675 bankrupt) • Companies that are bankrupt = 1 • Bankrupt companies = 0 (Hery 2017: Atman 1968)

Corporate governance	Score CGPI Score % CGPI 55-69 = adequately governed 70-84 = governed 85-100 = well governed (Solomon 2007: Wiyadi, Veno & Sasongko 2015: Priharta, Rahayu & Sutrisno 2018)

Source: Processed Data (2020)

To test the hypotheses this research was carried out using multiple linear regression methods. The research model as follows:

Regression model 1:

$$DA = a + b_1LEV_1 + b_2FD_2 + b_3CG_3 + e$$

This study uses control variables as a comparison, then the second equation can be arranged as follows:

Regression model 2:

$$DA = a + b_1LEV_1 + b_2FD_2 + b_3CG_3 + b_4Incre\ L_4 + b_5ROA_5 + b_6interest\ L_6 + e$$

Information:

DA	= earning management (Discretionary accrual)
a	= constant
LEV	= leverage
FD	= financial distress
CG	= corporate governance
Incre L	= increased leverage
ROA	= return on assets
Interest L	= interest expense
e	= Error

4. RESULTS AND DISCUSSION

4.1 Descriptive statistics

The descriptive statistical results of the variables used in this study are as follows:

Table 3. Descriptive Statistics

	N	Minimum	Maximum	Mean		Std. Deviation
	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic
Earning management	86	-,16	,29	,0185	,00881	,08172
Financial Leverage	86	,23	,92	,6641	,02330	,21611
Financial Distress	86	,20	15,43	1,7910	,21444	1,98860
Corporate Governance	86	67,55	93,86	85,0495	,54027	5,01024
Increasing Leverage	86	,00	1,00	,4651	,05410	,50171
Return On Asset	86	,00	,29	,0528	,00629	,05830
Interest Expense	86	,00	,10	,0308	,00199	,01848
Valid N (listwise)	86					

Source: Output SPSS (2020)

The results of data processing is known that there are 64% or 55 observations of companies doing earning management strategies to increase earning and 36% or 31 observations of companies doing earning management with a strategy to reduce earning . While based on the data also shows that the company received ratings of corporate governance index, there are 80,23% or 69 observations of companies suspected of bankruptcy, for obtaining the value of Altman Z-score < 2,675, and the others 19,77% or 17 observations of companies not bankruptcy with Altman Z-score >2,675.

Of the total 69 observations of companies suspected of bankruptcy, there were 47 observations of companies doing earning management with a strategy to increase earning and 27 observations of companies doing earning management with a strategy to reduce earning. Furthermore, the management of the company based on corporate governance perception index shows that there are 55 observations where the management of the company performed well governed and 30 observation companies are governed and 1 observation management companies are adequately governed. The results of testing the hypothesis in this study can be seen in the following table 4.

Table 4. Hypothesis Testing Results

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
1 (Constant)	1,847	,401		4,606	,000		
Financial Leverage	-,381	,093	-,481	-4,093	,000	,628	1,593
Financial Distress	-,174	,079	-,257	-2,192	,031	,630	1,588
Corporate Governance	-,125	,041	-,307	-3,071	,003	,867	1,154
Autocorrelation:	DW (Durbin-Watson)					= 1,847	
Coefficient of Determination	Adjusted R^2					= 0,264	
Statistical Test F	Sig.					= 0,000	

a. Predictors (Constants), Corporate Governance, Financial Distress, Financial Leverage

b. Dependent Variable: Earning Management

Source: Output SPSS (2020)

4.2 Effect of Financial Leverage on Earning Management

Financial leverage is measured by using a debt ratio that has a significance value of 0,000 less than 0,05 with a negative direction. It means financial leverage has negative significantly on earning management, which means that the hypothesis H_1 is accepted. The results of this study are in line with research conducted by Mahiswari & Nugroho (2014) which explains that financial leverage has a negative effect on earning management. High leverage makes the situation to create predictions for future operations of the company more difficult. The higher the level of leverage of a company, the supervision conducted by creditors is getting tighter that situation makes corporate flexibility in earning management decreases (Mahiswari & Nugroho, 2014).

When a company has the high amount of debt with higher level of leverage, then the supervision conducted by the creditors is getting tighter and makes the situation of management flexibility in implementing the practice of earning management is reduced. This situation explains that the higher the leverage ratio, the lower the level of earning management practices carried out by management (Firth & Smith, 1992)

4.3 Effect of Financial Distress on Earning Management

Financial distress is measured by using Z-score which has a significance value of 0,031 less than 0.05 with a negative sign. It means financial distress has a significant negative effect on earning management. This evidence makes the reason that the hypothesis H_2 is accepted, namely financial distress has negative effect earning management. These results are in line with research conducted by Lo (2012), Ghazali et al (2015) and Agrawal & Chatterjee (2015) who suggest that financial distress has a negative effect on earning management. The management is motivated to do earning management if it is not in a high financial distress condition, and vice versa, if the situation is low financial difficulties, encourage the management to conduct earning management. This happens because the management is in a situation of high supervision by creditors, and the management is more focused to restore the financial situation for the better.

4.4 Effect of Corporate Governance on Earning Management

Corporate governance is measured by using a score of corporate governance perception index (CGPI) has a significance value of 0,003 is less than 0,05 with the direction of the negative, which means that H_3 is accepted. Corporate governance significant negative effect on earning management. These results are consistent with research conducted by Wiyadi et al (2015) and Priharta et al (2018) that the implementation of good corporate governance reduces earning management action and limit the actions of company managers to manipulate earning. Wiyadi et al (2015) and Priharta et al (2018) suggested that the higher the score Corporate Governance Perception Index then reduce the level of earning management action. Priharta et al (2018) added that it proves that differences in interests between principals and agents that can lead to earning management actions can be reduced by conduct good corporate governancce pratice.

Table 5. Partial Correlation of Control Variables

Control Variabel			Financial Leverage	Financial Distress	Corporate Governance
Increasing Leverage	Earning management	Correlation	-,261	-,101	-,309
Return On Assets		Significance (2-tailed)	,050	,366	,004
Interest Expense		Df	81	81	81
Coefficient of Determination		Adjusted R^2			= 0,334

Source: SPSS Output (2020)

Table 5 shows the partial correlation testing after adding control variables, showing that financial leverage and corporate governance have effect on earning management through control variables with a significance level of 0,050 and 0,004 or both have value < 0,05 (5%), whereas financial distress is not has a partial effect on earning management after adding control variables with a significance value of 0,366 or > 0,05.

Table 5 explained that the value of adjusted R^2 increased after adding the control variables in the regression model. It can be seen from the increase in value of adjusted R^2 are initially in Table 4 (before adding the control variables) has a value of adjusted R^2 of 26,4% increased to 33,4% after adding the control variables in the regression model. An increase of 7% explained that the independent variables and control variables have a simultaneous effect on earning management by 33,4% and the others 66,6% is influenced by other variables outside this research.

5. CONCLUSIONS , LIMITATIONS AND SUGGESTIONS

Based on the discussion above, it can be concluded that financial leverage, financial distress and corporate governance have significant negative effect on earning management in companies that obtain a corporate governance perception index. This test through the addition of control variables increasing leverage, ROA and interest expense showed that financial leverage and corporate governance have effect on earning management, while the financial distress has no effect to earning management, but financial distress has no effect on earning management.

This research still has some weaknesses and limitations where these limitations can be taken into consideration and become a reference for further research, so that perfecting the same research in the future. The limitation in this study is that the number of samples is quite limited, the method of taking samples with a purposive technique so that the results of the study cannot be generalized.

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