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Financial Factors, Corporate Governance and Earnings Management: Evidence from Indonesian Manufacturing Industry

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Abstract –
This research aims to analyze and find empirical evidence about the effect of financial factors on earnings management by using corporate governance variables as a moderating variable. Sampling techniques in this study is purposive sampling and acquired 105 manufacturing companies listed on the Indonesian Stock Exchange during the period of 2014 to 2016. The total observed data is 315 firm-years. Financial factors are Profitability, firm size and financial distress. Earnings management is measured by discretionary accrual that uses Modified Jones Model. Corporate governance variables are measured based on the organization's efficiency by comparing the input and output. The data is obtained from Indonesian Capital Market Directory, Indonesian Stock Exchange database, and from company annual statements. The result shows that the implementation of good governance weakens the relationship between financial distress and earnings management. Meanwhile, Profitability and firm size variables do not support the suggested hypothesis.
Keywords - profitability, firm size, financial distress, corporate governance and earning management

I. Introduction

Financial statement is used by a company to deliver financial information of management responsibility to parties outside who need reliable information about their investment. The earning information is an indicator to measure performance of the company operation. For investors, earning is an increased economic value that will be accepted through dividend pay-out. Therefore, the earnings information is used by investors as an evaluation instrument manager performance, to predict earnings power, and to estimate future earnings that will be obtained by the company (Achyani et al., 2015).

As the trusted parties to manage company sources, the manager will responsible for the reliance by giving the information in the form of financial statement. According to Achyani et al. (2015), financial statement becomes the main instrument to deliver financial information as a form of responsibility in a company. For outside parties, financial statement is needed to give reliable information about their investment in the company. Consequently, the information within the financial statement has important role in taking decision process.

Financial statement, especially earning information, is one of the investor concerns in measuring success or failure of an organization. Since along with earning there is economic value escalation that will be received by investor. Investor interest that only concern on earning and not concern on procedure selection or accounting method in acquiring earnings, often makes a manager tends to take an action that will benefit particular parties (Rice, 2016). The action that will benefit particular parties is one of the deviations that conducted by manager to affect information within financial statement and it is known as earnings management (Herawaty, 2008; Darwis, 2012).

Earnings management is done by increasing the earnings to impress a well company performance (*earnings management up*), distribute the earnings evenly and or decreasing the earnings to avoid particular responsibilities (*earnings management down*). Earnings management occurs when a manager changes financial statement that will mislead some stakeholders about economic performance underlies the company or to affect a contract result that depends on the reported accounting number (Abbadi et al., 2016). Therefore, earnings management can increase biased information within financial statement and it can disturb the statement user who believes at such made up earnings numbers as the true numbers. This manipulation negatively affects the company's future, since a party who uses financial statement to make a decision caused a wrong decision.

Previous researches have been conducted to obtain causal factors of a manager conducts earnings management, such as the research of Herawaty (2008), Darwis (2012), Gunawan et al. (2014), Rice (2016), Dewi and Priyadi (2016), Abbadi et al. (2016), Wang et al. (2016), Poli (2017), Puspita and Kusumanintyas (2017). The studies show different result, but they show that earnings management can be affected by the factors such as firm size, financial distress, Profitability, earnings power, leverage, tax avoidance and etc. The result coincident that earnings management practice is considered disadvantageous as it can decrease the value of financial statement and gives irrelevant information to investor. Besides, earnings management can cause agency cost which comes from roles separation or different interest between shareholders and manager or company management (Herawaty, 2008).

Agency cost presumably happens because agent acts unsuitably with principal interest. Both of shareholder and manager action emphasize on their personal aims, encourage the manager to do an opportunistic action to realize their own aims with the expense of others. As a form of that opportunistic action, earnings management practice is a main characteristic of weak corporate governance since it indicates manger's action and ignoring investor interest (Ridwan and Gunardi, 2013). According to Herawaty (2008), agency theory can gives a point that earnings management issue can be minimized by self-monitoring through corporate governance. Hence, earnings management practice can be minimized through monitoring mechanism to align the different interest between shareholder (principal) and management (agent).

Rice (2016) states that corporate governance can be applied to increase performance effectiveness and shareholders' value. Thus corporate governance implementation minimizes deception action that possibly happens. Abbadi et al. (2016) also states that corporate governance has a role to keep the user's reliance towards financial statement and avoid the occurrence of earnings management. Thus, consistent corporate governance can be a resistor of made up performance that causes financial statement does not depict company's fundamental value (Chtourou et al., 2001).

Previous research performed by Gunawan et al. (2015), Dewi and Priyadi (2016), Amelia dan Hernawati. (2016), and Rice (2016) suggest that financial ratio variable should be added as a variable that affects earnings management practice. Based on the previous research, this research will re-examine financial factor influences such as firm size, Profitability and financial distress towards earnings management practice. According to the previous research suggestion (Dewi and Priyadi, 2016; Rice, 2016), this research emphasizes more on the influence of corporate governance role as moderation variable that can minimize earnings management practice. Therefore, this research aims to analyze and obtain empirical evidence of corporate governance in moderating relationship between financial factor and earnings management practice.

Accordingly, the research question will be 'Can the implementation of corporate governance moderate the association between firm size, profitability and financial distress on earning management practice? By answering the question, this research will contribute to the previous literatures. One of the contributions is explore the relation between firm size, Profitability and financial distress on earnings management practice by implementing corporate governance that can reduce earnings management practice. Hence, it can be used as a consideration for principal, investor and manager that strong corporate governance can overcome earnings management practice.

II. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

This research uses agency theory which is introduced by Jensen and Meckling (1976). According to Herawaty (2008), agency theory perspective is a basic which used to understand corporate governance and earnings management issues. It explains manager behavior as agent and stakeholders as principal in a separate function as company owner and company controller. Agent and principal have different interest that caused agency conflict. Principal expects to maximize return or dividend, while agent expects to get the best compensation. Consequently, it causes agent not corresponding in taking the right decision for principal, especially when the agent is an opportunist parties (Jensen and Meckling, 1976). If both of parties act in their own interest, the conflict between manager and shareholders will increase. As a result, when principal delegates the responsibility to make decision, agent more likely to use the authority to fulfill his/her own interest by choosing an action that not always related to principal's interest.

Also, when the agent has more information than principal and does not want to share the information, it will cause information asymmetry. According to Scott (2011), when one parties in a transaction has relevant information but they cannot (do not want to) share the information, it is called asymmetry information. Agency conflict arises when there is asymmetry information whether it related with activity or agent information. Corporate governance which involves wide spectrum mechanism is intended to overcome agency conflict risk by increasing monitoring quality towards management action and restricting managers' opportunist behavior. Therefore, as concept based on agency theory and to minimize conflict between agent and principal, corporate governance is expected to be an instrument to give investor the reliance that they will receive return of their invested fund. Manager will not steal or invest their money on unprofitable projects related to the invested fund and how they control the manager (Herawaty, 2008).

2.1. Corporate Governance

Forum for Corporate Governance in Indonesia (FCGI) defines corporate governance as a set of rules about the relation between many parties such as shareholders, company's manager, creditor, government, employee and other stakeholders which related to right and obligation between them. Regulation of State-owned Enterprise Ministry Number PER-01/MBU/2011, states that corporate governance is principles that underlies a process and mechanism of company management based on regulation and business ethics. The principles which have to be understood by all parties in order to make a well-managed company are as follows:

1. Transparency is openness action in conducting decision making process and giving material and relevant information about the company.
2. Accountability is the clarity of function, performance, and responsibility organization to make company management runs effectively.
3. Responsibility accordance in managing the company towards regulations and healthy corporation principles.
4. Independency, a condition where the company is managed professionally without any interest crash and influence/stress from any parties that are not accordance with regulation and healthy corporation principles.
5. Fairness, justice and equality in fulfilling stakeholders' right that arise from agreement and regulation.

Herawaty (2008) states that by implementing precise corporate governance principles, it gives benefit such as: (1) minimize agency cost by controlling possible interest conflict between principal and agent; (2) minimize cost of capital by creating positive signal to investor; (3) increase company's image; (4) increase the company value which can be seen from low cost of capital, and (5) increasing of financial performance and stakeholder perception about company's good future.

Several researches on corporate governance result in various mechanism which aims to persuade that management action is in line with shareholders interest (especially minority interest). Corporate governance mechanism is in form of internal mechanism such as board of commissioner composition, managerial ownership, executive compensation, and audit committee. Also, corporate governance takes form of external mechanism such as market control, level debt financing, and external auditor (Herawaty, 2008). These mechanisms are trusted by many researchers to affect company's performance and goal, and can be used to affect and monitor management action which results in lesser earnings management practice (Rice, 2016).

2.2. Corporate Governance, Profitability, Firms Size and Financial Distress, Earnings Management

In this research, the used corporate governances are audit committee, independent commissioner, and audit quality. Audit committee is a committee that works professionally and independently formed by board of commissioner. Its duty is helping and strengthening board of commissioner in conducting monitoring function upon process of financial reporting, risk management, implementation of audit and corporate governance in the company (Restu et al. 2017). Audit committee existence is expected to help board of commissioner performance in informing financial statement to overcome conflict of interest between management and owners and to decrease opportunistic character of management in conducting earnings management practice (Siallagan and Machfoedz, 2006). Xie et al. (2003) conduct a research to analyze committee audit role and then relate them in their effectiveness in detecting earnings management. The result shows that shareholders interest will be protected by audit committee from earnings management practice. Achyani et al. (2015) states that the existence of independent audit committee has an important role to maintain financial statement quality. The quality can be achieved if audit committee member have an independent attitude. An effective monitoring and controlling will decrease the level of earnings management. Therefore, it can be predicted that the more independence audit committee the smaller earnings management practices.

Independent commissioner is a board of commissioner member who has no relation to financial, stewardship, stock ownership and or controller or any other relation that possibly influence his/her ability to act independently (Rahmawati, 2013). Independent commissioner's duty is monitoring manager in doing their duty to statement financial information and implements corporate governance system. Hence, it can decrease deception of statement in Profitability level (Amelia and Hernawati, 2016). Larastomo et al. (2016) explain that the existence of commissioner board and more independent commissioner will make qualified monitoring since they will always demand for transparency of company's statement including Profitability statement. Meanwhile, according to Herawaty (2008), financial statement manipulation will decease if board of director structure comes from more outsider parties. Nevertheless, if board director independence function tends to be weak, there is a tendency of directors' moral hazard for their own interest through accrual estimations that causes earnings management. Several researches show that independent commissioner has a close relationship to earnings management such as the research of Reviani and Sudantoko (2012) which reports that independent commissioner negatively affect as commissioner board proportion can decrease earnings management. Rahmawati (2013) report that independent commissioner negatively affect because of board role in monitoring has given effective contribution towards qualified financial statement.

As one of corporate governance components in this research, audit quality related to earnings quality which is measured by Earning Response Coefficient/ERC (Teoh and Wong, 1993, within Herawaty, 2008). According to Puspita and Kusumanintyas (2017), audit quality is a possibility where auditor will find and statement a violation in client accounting system. In Professional Public Accountant Standard (SPAP in

Indonesian) is stated that audit can be said as qualified if it fulfill auditing standard. Therefore, the company that is audited by qualified Public Accountant will has smaller possibility of earnings management practices. The financial statement will be more trusted by stakeholders since audit is a financial statement monitoring process by external auditor that gives indemnity through their opinion since the statement is based on Financial Accounting Standard (Dewi and Priyadi, 2016). Along with better audit quality, it is expected to return the reliance of statement users especially for company that indicates doing earnings management. Based on the explanation above and the result of previous research, audit quality influence earnings management (Herawaty, 2008; Guna and Herawaty, 2010) and moderate the relationship of financial factor and earnings management (Dewi and priyadi, 2016).

Although the research on financial factors affect earnings management has been conducted, but there are different result. Besides, the previous result shows that the corporate governance role in moderating the relation of social factor on earnings management generates different and inconsistent result. Thus, this research will re-examine and emphasize on testing corporate governance as moderation variable of financial factor on earnings management practice. The factors that can be used are Profitability, firm size and financial distress.

Profitability is a management performance indicator as an agent whose duty managing company's wealth which is mandated by principal. High Profitability portrays a good company performance and vice versa (Ambarwati, 2016). High Profitability will inflict high expectation from regulator and society towards the company to give compensation in form of taxes payment and social program. Too high earnings will increase amount of tax, and low earnings will show bad management performance. A company which earns more or less will not close the possibility of earnings management if the company does not have effective corporate governance system (Amelia and Hernawati, 2016).

Amelia and Hernawati (2016) explain that earnings in one year may be the indicator earnings management happens in a company. Usually, earnings management is done to manipulate loss and earnings component (Guna & Herawaty, 2010). Several researches that examine the effect of profitability on earnings management provide different result. The research of Gunawan et al. (2015) and Amelia and Hermawati (2016) find that the Profitability has no effect on earnings management practice. This is because the amount of earnings of the company does not prevent earnings management occurrence. Ambarwati (2016) find that profitability affects earnings management since profitability is one of the management performance indicators in managing wealth. The higher profit the higher management desires to do earnings management. Additionally, the research by Usman and Kamardin (2015), Rice (2016) and Larastomo et al. (2016) find that the effect of profitability on earnings management can be strengthen by corporate governance variable.

Based on the explanation above, it can be concluded that in any condition management tends to do earnings management if it does not have effective corporate governance. Herawaty (2008) states that the company which implements corporate governance system is able to limit opportunistic earnings management. In consequences, the more qualify an audit quality, the more proportion of independent commissioner and audit committee, which lead to the smaller earnings management practices by management. In other words, the better corporate governance the more transparent and more actual the report. Thus, the proposed hypothesis is:

H1: the stronger corporate governance practice, the weaker association between profitability and earnings management.

irm size is a value which gives portrayal how big a company with proxy that represents firm size through the number of staff, total asset, amount of sales, and market capitalization (Reviani & Sudantoko 2012). The bigger total asset, earning, and company's market capacity so the bigger firm size (Rice, 2016). According Makaombohe et al. (2014), firm size is the size or big of asset. A big company has bigger access to get funds from various sources. A big company generally will get more attention from many parties, analyst, investor, or even government. In other hand, smaller company more flexible in facing uncertainty since small company more quickly reacts to sudden change (Makaombohe et al., 2014).

Scott (2011) states that one of the factors that encourages manager to do earnings management is political motivation. Political motivation within positive accounting explains about management motivation in outwitting various government regulations. The company conducts earnings management to decrease earnings in order to avoid a too high tax income. Accounting method selection in reporting earnings will gives different result towards tax calculation as the basic of tax payment. Big companyies generally avoid drastic earnings fluctuations since drastic increasing of earnings will add more taxes. Otherwise, drastic earnings decrease will give unfavorable view because it indicates the drastic decreasing of company performance. Therefore, big company tends to has bigger tendencies in doing even up earnings which is one of earnings management forms (Widyastuti, 2009).

Several previous researches show close relationship between firm size and earnings management (Widyastuti, 2009; Makaombohe et al. 2014; Amelia and Herawati, 2016). The result says firm size influence earnings management since big company will easily get funds in capital market rather than small company.

Reviani and Sudantoko (2012) state that firm size has significant effect on earnings management due to the needs of money by investor so manipulation of financial statement is conducted to draw investor attention. Meanwhile, Usman and Kamardin research (2015), Rice (2016) and Larastomo et al. (2016) state that interaction between corporate governance and firm size might minimize earnings management practice.

Based on the explanation above, it can be concluded that the bigger a company, the more transparent and the more complete information that should be published to minimize deception in earnings statement. The bigger a company probably will affect the higher audit quality, the bigger independent commissioner and audit committee proportion, which in turn the smaller possibility the company conducts earnings management practice (Herawaty, 2008). Thus, the proposed hypothesis is:

H2: the stronger corporate governance, the weaker association between firm size and earnings management.

Financial distress can be articulated as a condition where a company does not fulfill its obligations (Yuliastary dan Wirakusuma, 2014) and there is a probability of bankrupt or reorganized (Waznah, 2015). Financial distress occurrence can be said as a bad company's financial performance and encourage shareholders to change manager since he/she is considered not capable to well manage the company (Noviantari and Ratnadi, 2015). A company which undergoes financial distress will take a decision to overcome the condition such as operation, manufacture, or division termination, production reduction, not paying dividend, staff reduction even often conduct earnings management (Gunawan et al., 2004). When manager knows there is financial distress in the company, besides reduce cost action, earnings management is practical way to response to financial distress.

The research about financial distress effects on earnings management has been done before, such as Gunawan et al. (2014), Yuliastary dan Wirakusuma (2014), Waznah et al. (2015), Usman and kamardin (2015) and Larastomo et al. (2016). The result of Gunawan et al. (2014) shows that financial distress has negative significant effect on earnings management practice. Meanwhile, Usman and Kamardin (2015) and Larastomo et al. (2016) show that corporate governance moderates the association between financial distress and earnings management. The result proves that when company's net income is negative, management tends to do earnings management by decreasing profit. All expenses will be claimed in current year and in the next year made as if there is maintenance of condition. It is different with Gunawan et al. (2014) research , the research conducted by Waznah et al. (2015) find the result that financial distress positively affect earnings management since manager will still involve in earnings management whether the company is in good or bad condition.

Based on the explanation above, it can be concluded that when a company undergoes financial distress, manager will be stronger in doing earnings management. In order to give relevant and accurate information, good corporate governance is needed to minimize such manipulation in reported earning. Consequently, by audit committee existence and bigger proportion of independent commissioner, the bigger possibility for manager to not conduct earnings management practices (Herawaty, 2008). Thus, the proposed hypothesis is:

H3: the stronger corporate governance, the weaker association between financial distress and earnings management.

2.3. Research Framework

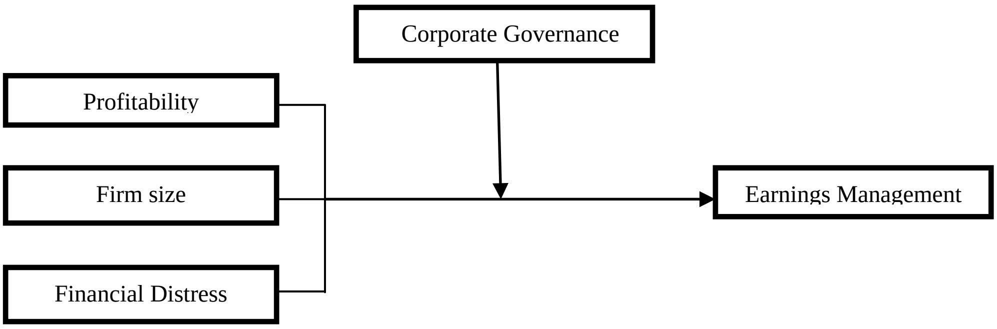
Based on the explanation above, a theoretical research observation model that portrays influence of each variable can be made. The independent variables are Profitability, firm size, and financial distress, while the dependent variable is earnings management. This research uses corporate governance as moderation of independent variables and earnings management relationship. Thus, research model shown in Figure 1.

III. RESEARCH DESIGN

3.1. Sample Selection

This research tests the relation between investment selection on main business and accounting information quality in a company which listed in Indonesian Stock Exchange 2014-2016. The population in this research is all public company listed in Indonesian Stock Exchange (IDX). The sample is chosen using purposive sampling method. The criteria for a sample are: (1) manufacturing company which listed in IDX 2014-2016; (2) company which has complete data; and (3) information within financial statement available for public and has audited by public accountant; (4) company which enclose corporate governance on annual statement. The data are drawn from several sources, which are (1) Indonesian Market Directory (ICMD); (2) website IDX, and (3) each company's website.

Figure 1. Research Framework



3.2. Variables Definition and Measurement

3.2.1. Earnings Management (EM)

The dependent variable in this research is earnings management. Earnings management is a manipulation action which is done by management in presenting financial statement. Earnings management is represented with discretionary accrual using modified Jones model (Dechow et al., 1995), with formulation:

1. Determineing accrual total value with formulation:
   $\mathbf{TA_{it} = NI_{it} - CFO}$ (1)
2. Determineing parameter value $\beta 1, \beta 2, \text{and } \beta 3$ using Jones model with formulation:
   $\mathbf{TA_{it} = \beta 1 + \beta 2 \Delta Rev_{it} + \beta 3\ PPE_{it} + \varepsilon_{it}}$ (2)
   Afterwards, to scale the data, all of the variables divided with asset of previous year (Ai_{t-1})
   $\mathbf{TA_{it}/A_{it-1} = \beta 1\ (1/A_{it-1}) + \beta 2\ (\Delta Rev_{it}/A_{it-1}) + \beta 3\ (PPE_{it}/A_{it-1}) + \varepsilon_{it}}$ (3)
3. By using regression coefficient above, non-discretionary accruals value can be (NDA) calculated with formulation:
   $\mathbf{NDA_{it} = \beta 1(1/A_{it}) + \beta 2(\Delta Rev_{it}/A_{it-1} - \Delta Rec_{it}/A_{it-1}) + \beta 3(PPE_{it}/A_{it-1})}$ (4)

Determine accrual discretionary value using formulation:

$\mathbf{DA_{it} = TA_{it}/A_{it-1} - NDA_{it}}$ (5)

Explanation:

TA_{it}	:	Total accruals of company i in time t
NI_{it}	:	Net income company i in time t
CFO_{it}	:	Cash flow from operation activity of company i in period t
ΔRev_{it}	:	Company's Revenue change from year i from year t-i until year t
PPE_{it}	:	Fixed asset (property, plant, equipment) of company i period t
A_{it-1}	:	Total asset company i in year t-1
NDA_{it}	:	Non-Discretionary Accruals of company i in period t
DA_{it}	:	Discretionary Accruals company i in period t
β1, β2, β3	:	Regression coefficient
ε	:	error

To minimize earnings management calculation because of positive and negative result from discretionary accruals. The absolute value of accrual discretion (ABSDA) is the proxy and measure of earnings management. The higher ABSDA, the bigger earnings management practices. Hence, ABSDA number depicts earnings management practice whether it is earnings management up or earnings management down.

3.2.2. Profitability (PROF)

According to Amelia and Hernawati (2016), Profitability is company's ability to obtain earnings through all its capability and sources such as selling, cash, capital, number of employee, branch, and etc. Profitability formulation in this research uses ROA:

$$\mathbf{Return\ on\ Total\ Asset} = \frac{\mathbf{Net\ Profit\ After\ Tax}}{\mathbf{Total\ Asset}}\ \mathbf{x\ 100} \quad (6)$$

3.2.3. Firm Size (SIZE)

Firm size is a value that depicts small or big the company with proxy used to represent the size which is number of employee, total asset, sales amount, and capital market (Reviani & Sudantoko 2012). According to

Rice (2016) the bigger total asset, earnings, and capital market of a company so the bigger the firm size. Firm size calculation formula is:

Ln= Total Asset (7)

3.2.4. Financial Distress (FDIS)

Financial Distress can be interpreted as a condition in which a company cannot do their obligations and it possibly goes bankrupt or be reorganized (Waznah et. al., 2015). The financial distress measurement uses Altman Z-score model, which is a combination of some financial ratios that can be used to predict the financial distress. If Z > 2,60 so the company is in a good condition, if Z < 1,10 so the company can potentially go bankrupt, but if Z-Score is between 2,59 ≥ Z ≥ 1,11, the company is in grey area. According to Anggraeni (2003)'s research result, this model is the best financial distress prediction model. Therefore, in this research, the financial distress is measured using Altman model. The model formula is as follows:

Z- score = 6,56 (F1) + 3,26 (F2) + 6,72 (F3) + 1,05 (F4) (8)

Explanation:

X1	:	Work Capital Ratio toward Total of Assets
X2	:	Resisted Earnings Ratio toward Total of Assets
X3	:	EBIT Ratio toward Total of Assets
X4	:	Equity Market Value toward Debt Book Value
X5	:	Selling toward Total of Assets

3.2.5. Corporate Governance (CG)

Corporate Governance is an effort to restore the investors' trust in the related institution in capital market. The purpose of applying Corporate Governance is to increase the organization performance and to prevent or reduce the possibility to do manipulation practice and significant error in managing the organization events (Rice, 2016). According to Lehman and Warning (2004), corporate governance is identified based on the efficiency value using Data Envelopment Analysis (DEA) to evaluate the efficiency the organizations by comparing the input and output. Independent commissioner variable, audit committee, and audit quality are the input value. The independent commissioner variable is proxies by comparing the independent commissioner board member to the total of commissioner board members. The audit quality is proxy by using the public accountant office quality especially KAP Big 4. The audit committee composition is counted by comparing the external audit committee to all of audit committee members. Meanwhile, total of assets, income, earnings, and equity are the output value (the result of the benefit and the sources used). Accordance with Kusuma and Ayumardani's research (2016), the efficiency value of corporate governance variable is measured using the formula as follows:

CGEff: $\frac{\sum_{i=1}^{m} uy}{\sum_{j=1}^{n} vx}$ (9)

Explanation:

CGEff	:	corporrate governance efficiency
u	:	corporate governance output
v	:	output number
x	:	corporate governance input
y	:	number of total assets, income, earnings and equity

The analysis method used is multiple regression method. In conducting this method, a classical assumption test is previously conducted (normality, heteroscedasticity and autocorrelation assumptions as well as multicolinearity between independent variable) so that it fulfills the regression estimation characteristic which is Best Linear Unbiased Estimator (BLUES). The multiple linear regression analysis aims to test the effect of Profitability, firm size and financial distress toward corporate governance as the moderating variable. The equality model is as follows:

$EM_{it} = \alpha + {}_{\beta 1}PRO_{it} + {}_{\beta 2}SIZE_{it} + {}_{\beta 3}FDIS_{it} + {}_{\beta 4}CG_{it} + {}_{\beta 5}PRO_{it}*CG_{it} + {}_{\beta 6}SIZE_{it}*CG_{it} + {}_{\beta 7}FDIS_{it}*CG_{it} + \varepsilon_{it}$ (10)

Explanation:

EM_{it}	:	Earning Management of company i in year t
PRO_{it}	:	Profitability of company i in year t
$SIZE_{it}$	:	Firm Size of company i in year t
FD_{it}	:	Financial distress of company i in year t
CG_{it}	:	Corporate governance of company i in year t

The Result of Analysis and Discussion

The sample is taken by annual statement and annual financial statement of the manufacture company that has been registered in Indonesian Stock Exchange (IDX) in period of 2014 to 2016. The sampling method is purposive sampling which then results in 105 manufacture companies of 146 total companies. Based on the purposive and the criteria, there are 315 data collected. Table 1 shows the descriptive statistics of each observed variable.

Based on Table 1, it can be seen that the average of earning management is 0,002927 and the deviation standard is 0,004527 which means that the company average in this research sample tends to apply increasing income strategy or to impress a good company performance (earning management up). Besides, since this research uses the earning management with inverse measure, the bigger the number, the lower the quality. The corporate governance average is 1,202965 and the standard deviation is 0,453729. Due to the corporate governance average value which is more than 100%, it can be stated that the company average in the sample has done good governance. The Profitability average is 0,046759 with deviation standard at 1,599467. Meanwhile, the financial distress average in this research is 3,643903 with deviation standard at 4,517634.

Table 1. Descriptive Statistics

	Mean	Median	Maximum	Minimum	Std. Dev.
EM	0,002927	0,001423	0,047728	0,000009	0,004527
PROF	0,046759	0,036333	0,431698	-0,54847	0,103304
SIZE	28,16331	27,95429	33,19881	24,41416	1,599467
FDIS	3,643903	2,303769	34,83478	-3,2843	4,517634
CG	1,202965	1,082502	2,889153	0,556169	0,453729
CG*PROF	0,072542	0,03798	0,868274	-0,41287	0,147492
CG*SIZE	34,35064	30,31387	81,61265	14,24159	14,51834
CG*FDIS	4,852562	2,546966	59,94485	2,47235	6,92883

To examine the hypothesis, this research employs ordinary least square (OLS). The classical assumption of regression model has been tested before regression analysis is conducted. The result shows that the data are distributed normally, there is no problem with multicollinearity, heteroscedasticity, autocorrelation, and there is no outlier in the data. The regression analysis aims to examine the influence of Profitability, firm size, and financial distress toward earnings management with corporate governance as moderation variable. Even if this research more on testing the corporate governance in its moderation of the financial factor relation and earnings management, this research keeps testing the influence of Profitability, firm size, and financial distress toward earnings management with corporate governance without moderation variable. Therefore, the research equality model (model 10) will be divided into two parts as follows:

$$EM_{it} = \alpha + \beta_1 PRO_{it} + \beta_2 SIZE_{it} + \beta_3 FD_{it} + \varepsilon_{it} \quad (10a)$$

$$EM_{it} = \alpha + \beta_1 PRO_{it} + \beta_2 SIZE_{it} + \beta_3 FD_{it} + \beta_4 CG_{it} + \beta_5 PRO_{it}*CG_{it} + \beta_6 SIZE_{it}*CG_{it} + \beta_7 FD_{it}*CG_{it} + \varepsilon_{it} \quad (10b)$$

The result of regression analysis to examine the hypothesis or to examine earnings management influenced by Profitability, firm size, and financial distress toward earnings management with corporate governance without moderation variable is presented on Table 2. On Panel A, it can be seen that F-statistic with coefficient at 9,101687 is significant on level 1%. It means that this research model (10a) is qualified to be used for this analysis. Adjusted R^2 shows score at 0,0718. It shows that the dependent variable like earnings management is simultaneously influenced by the independent variables such as Profitability, firm size, and financial distress at 7,18% and the rest is influenced by other variables which cannot be involved in the research.

On the Panel B, it can be seen that F-statistics with coefficient at 5,42566 is significant on level 1%. The result shows that the research model (10b) is qualified to be used in the analysis. The adjusted R-squared is 0,0898. In this model, the adjusted R-squared is bigger than in the previous model. Thus, this model with corporate governance as the moderating variable is more appropriate to explain the earnings management variation.

The result of the first model (10a) shows that the earnings management variable as the dependent variable is significantly influenced by firm size and financial distress. The firm size variable coefficient on panel A of Table 2 is -0,00027 with significant level 0,0000. It shows that the firm size variable has significant negative correlation on level 0,01 or 1% toward the earnings management. Since the earnings management is a reverse measure, it indicates that the increasing firm size can minimize the earnings management practice done by the management. Meanwhile, the financial distress coefficient is 0,00006 with significant level at 0,000. It means that the increasing financial distress tends to make the management will do the earnings management practice. It aims to make the management performance keep looking good. Meanwhile, the Profitability variable in Panel A testing does not influence to the earnings management practice.

The main variable examined to prove the 1st hypothesis, 2nd hypothesis, and 3rd hypothesis is the interaction between the corporate governance variable and Profitability, firm size and financial distress variables. The result shows that it is only the 3rd hypothesis that is significantly supported. It states that the interaction between the financial distress and the corporate governance can reduce the earnings management practice. The coefficient of the interaction between corporate governance and financial distress (CG*FDIS) presented in Panel B of Table 2 is -0,00016 with significant level at 0,000. The supported 3rd hypothesis shows that better implementation of corporate governance makes the earnings management practice is less conducted by the management itself. This result also indicates that the sample companies generally keep giving the real financial statement though they are experiencing financial distress. Therefore, this research supports Usman and Kamardin's (2015) and Larastomo et. al. (2016)'s research stating that the corporate governance can minimize the earnings management practice so that the financial statement is secured and detect the financial distress accurately.

The result on Table 4, especially Panel B, shows that the 1st hypothesis testing which is the interaction between corporate governance and Profitability variables (CG*PROF) reached coefficient number at 0,00475 with significant level at 0,000. It means that the CG*PROF variables positively influence to earnings management. On the other hand, this result does not support the 1st hypothesis which has been proposed. It is caused by the earnings management is counted using the reverse measure. Thus, this result indicates that the corporate governance cannot minimize the earnings management practice especially in case of giving information to the company earnings.

Table 4. Regression Analysis

Panel A:

$$\mathbf{EM_{it} = \alpha + {}_{\beta1}PRO_{it} + {}_{\beta2}SIZE_{it} + {}_{\beta3}FD_{it} + \varepsilon_{it}} \quad \textbf{(10a)}$$

Variable	Coefficient		t-Statistic	Sig
Intercept	0,00967	***	6,28702	0,000
PROF	-0,00056		-0,40982	0,682
SIZE	-0,00027	***	-4,82799	0.000
FDIS	0,00006	**	2,20008	0.028
Adjusted R-squared	.0718			
F-statistic	9,1016	***		

Panel B:

$$\mathbf{EM_{it} = \alpha + {}_{\beta1}PRO_{it} + {}_{\beta2}SIZE_{it} + {}^{\beta3}FD_{it} + {}_{\beta4}CG_{it} + {}_{\beta5}PRO_{it}*CG_{it} + {}_{\beta6}SIZE_{it}*CG_{it} + {}_{\beta7}FD_{it}*CG_{it} + \varepsilon_{it}} \quad \textbf{(10b)}$$

Variable	Coefficient		t-Statistic	Sig
Intercept	0,00621	**	2,12184	0,034
PROF	-0,00624	***	-11,4959	0,000
SIZE	-0,00013		-1,55075	0,122
FDIS	0,00026	***	6,06172	0,000
CG	0,00121		0,46236	0.644
CG*PROF	0,00475	***	4,48731	0,000
CG*SIZE	0,00005		-0,70672	0,480
CG*FDIS	-0,00016	***	4,48731	0,000
Adjusted R-squared	.0898			
F-statistic	5,42566	***		

***, ** show that coefficient is significant at 0.01 and 0.05 respectively

According to 2nd hypothesis testing, the interaction between corporate governance and firm size variables (CG*SIZE) reached coefficient number at 0,00005 with significant level at 0,480. It shows that there is a positive relation but not significant. It also means that CG*SIZE variables do not significantly influence to the earnings management practice. Therefore, the 2nd hypothesis stating that the stronger the earnings governance practice, the weaker the firm size influence to earnings management is not supported by empirical data. The researcher suggests that the result is gained because the firm size is still considered as unimportant variable and cannot be used to minimize the earnings management practice. Otherwise, even if the independent commissioner and audit committee number is getting bigger and the quality of audit is getting better, they cannot influence to decrease possibility of the management to conduct the earnings management practice. This result is not in line with the research by Usman and Kamardin (2015), Rice (2016) and Lastomo et. al. (2106) stating that corporate governance can moderate the firm size and earnings management association.

Based on a statement from agency theory, the corporate governance is built to avoid the information asymmetry gained by the principal and to monitor the management so they do not cheat. Based on the hypothesis tests, the statement above is not totally true for there is only 1 of 3 hypotheses that is the interaction between the corporate governance and the financial distress, which can decrease the practice of earnings management. Therefore, it indicates that the corporate governance implication on the sample companies has not been able to prevent management in being opportunistic in informing their company earnings by not doing the earnings management practice. Furthermore, the corporate governance has not been able to monitor all activities of the management and cannot ensure that the management gives the real information about the earnings to the external parties.

Conclusion, Limitation, And Suggestion

This research aims to get the empirical proves about the corporate governance influence in moderating the relation between the financial factor (Profitability, firm size, and financial distress) and the earnings management. The result shows that the stronger corporate governance, the smaller earnings management practice done by the management, as well as the corporate governance practice can predict the financial distress condition more accurately. Moreover, the existence of the corporate governance strengthens the Profitability positive influence to the earnings management though this fact does not support the research hypothesis. Thus, of 3 hypothesis suggested, it is only the third one that is significantly supported and states that the stronger the practice of corporate governance, the weaker the relation between the financial distress and the earnings management practice.

Even if there is only 1 hypothesis that is supported, but this result gives theoretical implication to prove and strengthen the previous theory which states that the corporate governance can weaken the earnings management practice. From practical perspective, this result can be implied to enrich the variable that can be potential in making investment decision particularly related to the presented relevant and reliable information in the financial statement without any manipulation.

There are some limitations of this research. First, this research only uses the data from 1 industry in a state that is Indonesia. It makes the result generalization is limited in Indonesia only or other states with some similarities with Indonesia. Thus, the continual research can be conducted with some states as the data in order to make the result more general. Second, the result is totally different with the hypothesis. The researcher assumed the efficiency grade measure (input and output comparison) would be used for the corporate governance. Though the measure has been tested in the previous *research*, but this research only uses three variables as the input, such as the measurement of independent commissioner, audit committee, and audit quality. Hence, the use of other measurements or even some measurements in the continual research will complete the research result and benefit such as the use of corporate governance index as the corporate governance efficiency proxy. It is because the corporate governance index uses many more and complete variables.

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