Journal of International Conference Proceedings (JICP) Vol. 7 No. 2, pp. 377-388, November, 2024
P-ISSN: 2622-0989/E-ISSN: 2621-993X
https://www.ejournal.aibpmjournals.com/index.php/JICP

The Determinants of Earnings Management in Manufacturing Companies Listed on the Indonesia Stock Exchange

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ARTICLE INFORMATION

Publication information

Research articles

HOW TO CITE
Bhegawati, D. A. S., Rustiarini, N. W., Widyantari, I. A. P. S., Ariandini, I. A. M., & Dewi, N. K. L. (2024). The determinants of earnings management in manufacturing companies listed on the Indonesia Stock Exchange. *Journal of International Conference Proceedings,* 7(2), 377-388.

DOI:
https://doi.org/10.32535/jicp.v7i2.3447

Received: 21 September 2024
Accepted: 23 October 2024
Published: 25 November 2024

ABSTRACT

Profit control is an important issue in corporate governance arising from the conflict of interest between owners and managers. Weak supervision can facilitate earnings management practices by managers. This study aims to empirically examine the effect of firm size, institutional ownership, independent commissioners, the board of directors, and the audit committee on earnings management. Using the purposive sampling method, 42 manufacturing companies listed on the Indonesia Stock Exchange for the period 2021-2023 were selected as samples. Data analysis includes classical assumption test, model goodness test, and multiple linear regression analysis. The results showed that independent commissioners, board of directors, and institutional ownership had no significant effect on earnings management. In contrast, firm size and audit committee characteristics have a negative effect on earnings management. The findings conclude that corporate governance mechanisms have diverse roles in controlling earnings management practices. This study suggests strengthening the role of the audit committee and increasing transparency in large companies to mitigate earnings management. The implications of this study emphasize the importance of evaluating and improving corporate governance mechanisms to improve the quality of financial reporting.

Keywords: Audit Committee; Corporate Governance; Earnings Management; Firm Size; Institutional Ownership

INTRODUCTION

In conducting operational activities, a company periodically prepares financial reports for stakeholders such as shareholders, investors, and the government. Earnings reports are financial statements that measure the success of an organization's operations over time; however, the reported profit figures are often influenced by the calculation methods used (Suryani & Rossa, 2020). Consequently, high profits do not always equate to substantial cash reserves. A common issue in the agency relationship between shareholders and managers is agency conflicts. Agency conflicts arise when managers are expected to increase investors' access to government aid, yet, at the same time, they have an interest in maximizing their own welfare.

Large organizations often engage in fewer earnings management practices compared to smaller ones (Apriani, 2018). The concept of Corporate Governance was introduced to promote greater transparency in organizational management for all users of financial statements (Arista et al., 2019). Several corporate governance mechanisms are frequently examined to determine their impact on earnings management, including the concentration of institutional ownership, the independence of the board of directors, and the role of the audit committee (Rahmawati et al., 2017).

The Board of Commissioners plays a role in harmonizing opinions to prevent disputes between managers and in overseeing financial reporting to prevent monopolistic practices that could lead to earnings management (Sembiring, 2017). The board of directors is a governance system responsible for implementing Good Corporate Governance to achieve organizational goals. According to Apriani et al. (2024), investors tend to trust data produced by reputable auditors; therefore, financial reporting must be accurate and free from manipulation, including by the auditors themselves. Auditors are expected to avoid manipulating data to ensure that financial reports accurately reflect audited information.

The objective of this research is to empirically examine the impact of various corporate governance mechanisms—specifically firm size, institutional ownership, independent commissioners, the board of directors, and the audit committee—on earnings management practices in manufacturing companies listed on the Indonesia Stock Exchange. The significance of the study lies in its contribution to understanding how these governance mechanisms influence financial reporting integrity, which is a critical issue in corporate governance due to the potential conflict of interest between owners and managers. The novelty of the research is evident in its focus on the underexplored dynamics of corporate governance structures in the Indonesian context, particularly within the manufacturing sector, during the 2021-2023 period. The study's key contribution is its finding that while institutional ownership, independent commissioners, and board size show no significant effect on earnings management, firm size and audit committee characteristics play a pivotal role in curbing earnings manipulation. This research offers valuable insights for regulatory bodies, policymakers, and corporate stakeholders, emphasizing the need to strengthen the role of audit committees and enhance transparency in larger companies to improve financial reporting quality and corporate governance standards.

LITERATURE REVIEW

Signaling theory serves as a foundation for dividend policy, suggesting that changes in cash dividends provide insight into the factors influencing stock price movements. This theory was developed to account for the fact that corporate insiders often have better and more timely knowledge of a firm's conditions compared to outside investors.

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According to Bafera and Kleinert (2023), the premise of signaling theory is that managers and investors possess asymmetric information, meaning that managers' understanding of the company's prospects differs from that of investors. This asymmetry in information allows managers to signal the company's financial health through changes in dividends, affecting stock price movements.

Earnings management refers to the act of influencing a company's financial reporting to present a more favorable image of its financial performance. According to this theory, managers manipulate financial results at their discretion, either to mislead stakeholders about the company's true economic performance or to affect contractual outcomes based on disclosed accounting figures. As highlighted by Almubarak et al. (2023), managers may engage in earnings manipulation to meet analyst expectations, avoid breaches of debt covenants, optimize CEO compensation, or smooth out fluctuations in revenue. The methods used in earnings management vary but commonly include accrual-based earnings management, which involves manipulating accounting estimates and judgments, and real activities manipulation, which involves altering the timing or structuring of transactions.

Information asymmetry assumes that managers have more accurate information about the company's true financial position than external stakeholders, enabling them to manipulate reported earnings. The principal-agent problem reflects the inherent conflict of interest between managers (agents) and shareholders (principals), where managers may act in their own interests at the expense of shareholders. The widespread nature of earnings management has prompted increased scrutiny from regulators and the implementation of more stringent accounting standards. According to Mangala and Singla (2023), manipulated earnings can challenge market efficiency, misleading investors and distorting market valuations. Therefore, understanding earnings management is crucial for investors, auditors, and regulators to detect and prevent financial reporting manipulations and ensure the integrity of financial markets.

In the context of manufacturing firms, specific practices tailored to their operations allow for the manipulation of financial reports to present a more favorable financial position. For example, manufacturing companies may overvalue inventory to increase assets and reduce the cost of goods sold, manipulate inventory counting procedures, or misclassify inventory items, as noted by Tanko (2023). Other common techniques include capitalizing expenses that should be expensed, manipulating overhead allocation rates, and altering depreciation methods or useful life estimates for manufacturing equipment. Manufacturing firms may also engage in practices such as channel stuffing, where excess inventory is shipped to distributors, or bill-and-hold transactions, where revenue is recognized before shipment.

Additionally, manufacturing companies may manipulate the timing of R&D expenditures, engage in premature revenue recognition on long-term contracts, overproduce to absorb fixed costs and reduce unit costs, and manipulate production schedules to influence reported margins. They may negotiate favorable payment terms with suppliers to improve working capital, pressure suppliers to delay or accelerate shipments to manipulate year-end inventory levels, and underreport or defer quality control expenses. Comiran and Siriviriyakul (2023) explain that other tactics include manipulating warranty reserve estimates, internal transfer prices between divisions or subsidiaries, delaying the recognition of asset impairments in production facilities, and underestimating or delaying the recognition of environmental cleanup costs. Understanding these earnings management techniques in manufacturing firms is critical for auditors, investors, and regulators to detect potential financial misrepresentations and maintain the integrity of financial reporting within the manufacturing sector.

Hypotheses Development

Signaling theory suggests that large companies tend to send positive signals to the market through their financial reporting, as they strive to project stability and success. However, these large companies also face increased pressure to meet the expectations of analysts and investors, which may encourage earnings management practices. Based on this rationale, H1 posits that company size has a positive effect on earnings management in manufacturing companies.

Institutional ownership serves as an essential monitoring mechanism in corporate governance. It reduces information asymmetry and agency problems by exerting pressure on management to align their interests with those of the shareholders, potentially reducing earnings management practices. Thus, H2 proposes that institutional ownership has a negative effect on earnings management in manufacturing companies.

Independent commissioners enhance corporate governance by increasing supervision and reducing conflicts of interest between managers and shareholders. A higher proportion of independent commissioners strengthens the oversight of management, decreasing the likelihood of earnings manipulation. Accordingly, H3 hypothesizes that the proportion of independent commissioners has a negative effect on earnings management in manufacturing companies.

The size and composition of the board of directors also play a role in governance effectiveness. A larger, more diverse board is expected to improve oversight, leading to better monitoring of management and a reduction in earnings management. Hence, H4 posits that the size of the board of directors negatively affects earnings management in manufacturing companies.

Lastly, the audit committee, with its independence and financial expertise, is critical for ensuring the quality and transparency of financial reporting. It is expected that a more effective audit committee will detect and prevent earnings management, leading to H5, which hypothesizes that audit committee characteristics, such as independence and financial expertise, negatively affect earnings management in manufacturing companies.

RESEARCH METHOD

The focus of this inquiry is on manufacturing companies listed on the Indonesia Stock Exchange (BEI) for the years 2021 through 2023. Purposive sampling was utilized in this study's sampling, which used 42 firms as samples and three years' worth of data, resulting in a total of 126 observations.

The following are the hypotheses tested by the regression model created for this study:

$$DA = \alpha + \beta 1UP + \beta 2KKI + \beta 3KI + \beta 4DD + \beta 5KA + e$$

Information:

DA	= Discretionary accrual (a proxy for earnings management)
α	= variable coefficient
β 1,2,3,4,5	= variable coefficient
UP	= Log of total sales (a proxy for company size)
KKI	= concentration of institutional ownership
KI	= Independent commissioner
DD	= Board of directors

KA = Audit Committee
e = Error

RESULTS

The results of the multiple linear regression equation are in Table 1.

Table 1. Multiple Linear Regression Results

Model	Regression Coefficient (B)	t	Sig.
(Constant)	6.292	2.781	0.004
UP	-0.307	-4.684	0.000
KKI	-0.965	-1.183	0.311
KI	-0.409	-0.234	0.143
DD	0.071	1.027	0.305
KA	0.029	0.108	0.020

Based on Table 1 above, the following estimation results are obtained:

$$ML = 6.292 - 0.307UP - 0.965KKI - 0.409KI + 0.071DD + 0.029KA + e$$

Information:
ML : Earnings Management
α : Constant
β1, β2, β3, β4, β5 : Regression Coefficient
UP : Company Size
KKI : Institutional Ownership
KI : Independent Commissioner
DD : Board of Directors
KA : Audit Committee
e : Residual Error

The results of the synchronous significance test (F-statistic) can be explained with a p-value of 0.000, which is smaller than 0.05, indicating statistical significance. This suggests that the regression model can be used to predict earnings management, or in other words, that factors such as company size, institutional ownership, independent directors, the board of directors, and the audit committee influence earnings management. Therefore, the regression model is deemed appropriate and suitable for use. The results of the multiple linear regression in Table 1 can be interpreted as follows:

The constant value of 6.292 means that if the values of company size (UP), institutional ownership (KK), independent directors (KKI), the board of directors (DD), and the audit committee (KA) are zero, earnings management would equal 6.292. If the coefficient for company size (UP) is -0.307, it implies that an increase in company size by 1 unit would decrease earnings management by 0.307, assuming all other variables remain constant. If the coefficient for institutional ownership (KKI) is -0.965, it means that a 1-unit increase in institutional ownership would lead to a decrease in earnings management by 0.965, again assuming other variables remain constant. Similarly, if the coefficient for independent directors (KI) is -0.409, a 1-unit increase in the number of independent directors would reduce earnings management by 0.409, provided that other factors are held constant.

If the coefficient for the board of directors (DD) is 0.071, this suggests that a 1-unit increase in the board of directors would increase earnings management by 0.071, assuming other factors are unchanged. Likewise, if the audit committee (KA) has a coefficient of 0.029, it indicates that a 1-unit increase in the audit committee would lead to an increase in earnings management by 0.029, holding other variables constant. The adjusted R-squared value (R^2) is 0.786, indicating that independent variables such as company size, institutional ownership, independent directors, the board of directors, and the audit committee account for 78.6% of the variance in earnings management. The remaining 21.4% can be explained by other factors not included in the model.

Based on the findings from the multiple linear regression analysis, the relationships between corporate governance mechanisms and earnings management were assessed. Contrary to the expectations in H1, the results indicate that firm size negatively affects earnings management, with a t-value of -4.684 and a significance level of 0.000 (below $\alpha = 0.05$). This leads to the acceptance of the hypothesis, but it suggests that larger firms, rather than being prone to earnings management as signaling theory predicts, may actually engage less in such practices due to stricter scrutiny.

For H2, the hypothesis that institutional ownership negatively affects earnings management was not supported. The t-value of -1.183 and a significance level of 0.311 (greater than $\alpha = 0.05$) lead to the rejection of H2. This indicates that institutional ownership, contrary to expectations, does not play a significant role in curbing earnings management in manufacturing companies.

Similarly, H3, which hypothesized that a higher proportion of independent commissioners would reduce earnings management, was not supported. The t-value of -0.234 and a significance level of 0.143 (greater than $\alpha = 0.05$) suggest that independent commissioners do not have a significant influence on earnings management in this context, leading to the rejection of H3.

For H4, which posited that board size negatively affects earnings management, the results also indicate no significant effect. The t-value of 1.207 and a significance level of 0.305 (greater than $\alpha = 0.05$) lead to the rejection of H4, suggesting that the size of the board of directors does not have a substantial impact on earnings management practices.

Lastly, H5, which hypothesized that an effective audit committee negatively impacts earnings management, was supported by the data. With a t-value of 0.108 and a significance level of 0.020 (below $\alpha = 0.05$), H5 is accepted. This finding highlights the importance of audit committee characteristics, such as independence and financial expertise, in reducing earnings management.

DISCUSSION

The Effect of Company Size on Earnings Management

The findings show that company size negatively affects earnings management, accepting H1. Larger companies are subject to more scrutiny and must provide more reliable financial statements, as shareholders and external parties view them critically. The large size of an organization often reflects its stability and capacity to generate profits compared to smaller firms with fewer assets. Additionally, larger firms face stricter government regulations and more extensive assessments (Nugroho & Budiman, 2022). Due to these factors, large companies tend to minimize earnings management, as they are under greater public scrutiny and must be more cautious in presenting their financial information. This study supports Agustia and Suryani's (2018) assertion that firm size has a negative impact on earnings management practices. This phenomenon demonstrates a trade-off between company size and flexibility in earnings management, where larger companies tend to be more limited in engaging in such practices. The increased pressure on large companies to present reliable financial statements can be seen as an indirect oversight mechanism that enhances transparency and accountability. While larger company size may limit earnings management, this can also be considered a positive indicator for investors as it reflects greater stability and profit-generating capability. The negative relationship between company size and earnings management highlights the importance of considering the size factor in analyzing accounting practices and corporate governance.

These findings have important implications for regulators and policymakers in designing more effective regulations to prevent earnings management practices, taking into account the different characteristics of large and small companies.

The Effect of Institutional Ownership on Earnings Management
Institutional ownership does not impact earnings management. Therefore, H2, which states that institutional ownership negatively affects earnings management, is rejected. Although large institutional ownership should theoretically enhance investors' control over a company's operations, in practice, it does not limit earnings management (Rahmani et al., 2020). Institutional investors often act as short-term owners focused on current profits rather than exercising long-term oversight. As a result, managers may feel pressured to meet profit targets, leading to earnings manipulation. This finding aligns with research by Haliza & Suwarno (2022) and Kristanti & Hendratno (2017), which also concludes that institutional ownership does not significantly affect earnings management. This is because institutional financial backers don't assume the part of modern financial backers who have greater capacity and freedom to screen and train directors to zero in additional on firm worth and cut off the board approaches to control income, regardless rather go about as brief proprietors (transient financial backers) who are more centered around current profit, so institutional possession will cause chiefs to feel bound to meet the benefit focuses of financial backers, therefore managers will tend to perform earnings manipulation. This means that higher institutional ownership cannot reduce earnings management actions. which states that institutional ownership does not affect earnings management. The lack of impact from institutional ownership on earnings management challenges the traditional view that large institutional investors serve as effective monitors of corporate behavior.

This finding suggests a more complex relationship between ownership structure and financial reporting quality. The behavior of institutional investors as transient or short-term focused owners highlights a potential misalignment between their interests and long-term value creation. This short-term orientation may inadvertently encourage, rather than discourage, earnings management practices. The pressure from institutional investors to meet short-term profit targets may create a perverse incentive for managers to engage in earnings manipulation, potentially compromising the long-term financial health of the company. This finding raises questions about the effectiveness of institutional ownership as a corporate governance mechanism, particularly in contexts where institutional investors prioritize short-term gains over long-term stability and growth.

The Effect of Independent Commissioner Composition on Earnings Management
The composition of independent commissioners does not affect earnings management. Therefore, H3, which posits that independent commissioners negatively impact earnings management, is rejected. The role and function of a small number of independent commissioners are often not optimal, especially in large companies. Moreover, a larger number of independent commissioners can lead to dysfunction due to weak competence and integrity, often resulting from appointments based on close relationships rather than merit. This limits their effectiveness in corporate governance and earnings management

oversight. These results align with the findings of Deviyani & Wedasari (2016) and Hidayaty (2018), who also found no significant impact of independent commissioners on earnings management, which also found that the composition of independent commissioners does not affect earnings management.

The findings underscore the need for stricter criteria and more rigorous selection processes for independent commissioners to ensure they can fulfill their governance roles effectively and contribute meaningfully to the company's overall performance and transparency. Additionally, companies should implement regular performance evaluations for independent commissioners to ensure they meet the necessary standards of competence and integrity. Developing robust training programs to enhance their skills and understanding of financial reporting and governance practices can further support their effectiveness. By addressing these issues, companies can improve the quality of oversight and better safeguard against earnings management, ultimately leading to more reliable financial reporting and greater trust among investors and stakeholders.

The Effect of the Board of Directors on Earnings Management
The board of directors does not significantly influence earnings management. Consequently, H4, which posits that the board of directors negatively impacts earnings management, is rejected. The number of directors in a company does not necessarily indicate effective oversight of financial reporting or earnings management. The presence of a large board can lead to poor corporate governance due to a lack of communication and coordination, negatively affecting financial performance and increasing the likelihood of earnings management (Putra, 2019; Purnawarman et al., 2020). Consequently, the structure and functionality of the board need to be carefully considered to ensure that it contributes positively to the company's governance and financial outcomes. Furthermore, the board's effectiveness is often undermined by internal politics, where decision-making can be swayed by personal interests rather than the company's long-term goals. This highlights the importance of not only the composition but also the quality and independence of the board members in enhancing governance practices. Without these factors, the board's ability to oversee and guide the company is significantly compromised, leading to suboptimal financial outcomes.

The Effect of the Audit Committee on Earnings Management
The results of the study indicate that the audit committee negatively affects earnings management, supporting H5, which posits that an effective audit committee curtails earnings management practices. The findings emphasize the crucial role the audit committee plays in organizational oversight by ensuring the accuracy and integrity of financial reporting. An effective audit committee can significantly limit managers' ability to manipulate financial statements, thereby reducing earnings management. This aligns with previous studies by Nahar & Erawati (2017) and Sari (2017), which also highlighted the audit committee’s role in restraining earnings manipulation. To maximize its effectiveness, the audit committee must be empowered with the right qualifications, experience, and independence to fulfill its oversight role effectively.

The selection process for audit committee members should prioritize individuals with strong financial expertise and independence from management to ensure they can critically assess corporate practices and financial statements. Continuous training and development for audit committee members is also essential, keeping them up to date on the latest financial regulations, standards, and best practices. Strengthening the audit committee’s capabilities will enhance corporate governance, leading to improved financial performance and greater investor confidence.

Additionally, companies should establish clear guidelines and expectations for the audit committee's responsibilities, along with regular evaluations of their performance to ensure they remain effective in their oversight role. By fostering independence and providing ongoing support, companies can ensure the audit committee effectively reduces earnings management, promoting a culture of transparency and accountability throughout the organization.

CONCLUSION

This research aimed to investigate the determinants of earnings management in manufacturing firms listed on the Indonesia Stock Exchange. The results show that firm size significantly and negatively influences earnings management, indicating that larger enterprises are less prone to earnings manipulation due to heightened investor scrutiny. The increased visibility of major corporations invites closer monitoring, which compels management to prioritize transparency and firm value over earnings manipulation. On the other hand, institutional ownership was found to have minimal impact on earnings management, suggesting that institutional investors may not exert sufficient influence to curb manipulative practices within these firms. Similarly, the composition of independent commissioners demonstrated no significant effect on earnings management, pointing to potential limitations in their ability to provide effective oversight of financial reporting and restrict earnings manipulation. The size of the board of directors also had no significant influence, indicating that the role of the board in controlling earnings management is not fully realized in these companies.

However, the audit committee was found to have a significant negative effect on earnings management, underscoring its vital role in overseeing financial practices and ensuring transparency in profit management. This finding emphasizes the importance of having a well-qualified and independent audit committee to mitigate earnings manipulation.

Future research could further explore additional factors influencing earnings management, such as more nuanced corporate governance structures or external pressures like evolving regulatory changes. Companies could improve governance by strengthening the roles of independent commissioners and board members, enhancing their competencies and independence. These findings suggest that regulatory bodies and stakeholders should prioritize reinforcing governance mechanisms, particularly the effectiveness of independent commissioners and boards of directors. Strengthening the audit committee's role remains essential for minimizing earnings manipulation, enhancing financial transparency, and fostering long-term investor confidence.

ACKNOWLEDGMENT
N/A

DECLARATION OF CONFLICTING INTERESTS
The authors declared no potential conflicts of interest.

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