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CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE AS DETERMINANTS OF EARNINGS MANAGEMENT: EMPIRICAL EVIDENCE FROM INDONESIA

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ABSTRACT

Earnings management continues to be a pervasive challenge in corporate reporting, frequently influenced by conflicts of interest between managers and shareholders. This study examines the impact of profitability, firm size, leverage, managerial ownership, and the existence of audit committees on earnings management practices in Indonesian consumer goods companies listed on the Indonesia Stock Exchange from 2020 to 2023. Utilizing a sample of 124 firm-year observations and multiple regression analysis, the results indicate that profitability and audit committees significantly constrain earnings management, whereas firm size, leverage, and managerial ownership exhibit no significant impact. These findings underscore the significance of robust governance frameworks—especially efficient audit committees—in preserving financial transparency. This study adds to the larger conversation about how governance structures and financial performance affect how companies report by giving real-world examples from an emerging market.

I. INTRODUCTION

Financial statements are an important way for companies to talk to their stakeholders. Earnings figures are always of interest because they are a key measure of a company's performance and a basis for making investment decisions. Nevertheless, the reliability of earnings is often scrutinized because of earnings management, which is the intentional manipulation of the financial reporting process to sway stakeholder perception (P. M. Dechow & Skinner, 2000; Healy & Wahlen, 1999). Managers may rationalize earnings management as a strategy to mitigate volatility or indicate stability; however, excessive practices compromise transparency and erode investor confidence, especially in emerging markets where the enforcement of governance standards is weaker (Leuz et al., 2003).

Previous studies in Indonesia have investigated earnings management through the lens of fraud risk factors. Suryandari et al. (2019)discovered that financial targets adversely impact earnings management, whereas other components of the fraud triangle, including financial stability, external pressure, effective monitoring, organizational structure, and auditor switching, exhibited no significant influence. These results underscore that the factors influencing earnings management are significantly contextual. In Indonesia, performance pressures and monitoring mechanisms interact in a manner distinct from developed markets, underscoring the necessity of considering local institutional contexts when evaluating corporate reporting behavior.

Theoretically, earnings management can be elucidated via agency theory and positive accounting theory. Agency theory (Jensen & Meckling, 1976) elucidates that conflicts of interest between managers (agents) and shareholders (principals) create incentives for managers to manipulate earnings to obtain personal advantages, including compensation or job security. Subsequent analyses, including Eisenhardt (1989), broadened the discourse by underscoring agency relationships as a pivotal framework in organizational research, accentuating the significance of monitoring mechanisms in curtailing opportunistic behavior. Positive accounting theory (Watts & Zimmerman, 1986) enhances this by proposing that managers strategically choose accounting policies to maximize results within contractual frameworks, encompassing bonus structures, debt covenants, and considerations of political costs. This theoretical perspective has undergone critical evaluation and subsequent enhancement in later works, underscoring its significance in comprehending earnings management practices (Avelé, 2014). These theories collectively establish a robust framework for examining the influence of firm-specific factors and governance mechanisms on earnings management practices.

Numerous factors influencing earnings management have been extensively analyzed in the literature. Profitability shows how well a business can make money. High profitability may induce managers to smooth income to ensure consistent performance, whereas low profitability may result in upward manipulation to obscure unfavorable outcomes (Anagnostopoulou & Tsekrekos, 2015; Siregar & Utama, 2008). Firm size is another factor that affects manipulation, but the results are mixed. Larger firms are more likely to be watched by the public, which may make them less likely to manipulate (Watts & Zimmerman, 1986). On the other hand, their operational complexity and political costs may give them more freedom to report what they want (Dichev et al., 2012).

Leverage, which shows how much a company depends on debt financing, is often linked to more pressure to avoid breaking covenants, which leads to practices that increase income (Jelinek, 2007). But strong lender monitoring may also stop this kind of behavior, which could lead to different results in different situations. Managerial ownership is anticipated to harmonize the interests of managers and shareholders (Jensen & Meckling, 1976), potentially mitigating opportunism. However, when ownership concentration is too high, managers may dig in their heels and make oversight less strict, giving them more freedom in how they report (Morck et al., 1988). Finally, audit committees are very important for governance because they watch over financial reporting and internal control. Efficient and autonomous audit committees have demonstrated a capacity to reduce earnings manipulation (García-Sánchez et al., 2012; Klein, 2002), although their efficacy may differ in emerging economies owing to variations in institutional enforcement (Nasution & Nengzih, 2020).

Despite extensive research, empirical findings regarding the determinants of earnings management remain disjointed and contingent upon specific contexts. Numerous studies concentrate on developed markets, whereas evidence from Southeast Asia, particularly Indonesia, remains scarce. Additionally, previous studies yield contradictory findings concerning the influence of profitability, firm size, leverage, and managerial ownership on earnings management, indicating that these relationships are influenced by institutional and industry-specific factors. This inconsistency underscores a research deficiency in comprehending the interplay between financial performance and governance mechanisms in shaping earnings management within Indonesia's consumer goods sector, which is economically pivotal due to its direct correlation with daily consumption and consistent demand.

This study's originality resides in the amalgamation of financial performance indicators (profitability, firm size, leverage) with governance mechanisms (managerial ownership, audit committees) within a unified framework, examined in Indonesian consumer goods companies from 2020 to 2023. This time was especially important because businesses had to deal with the chaos caused by the COVID-19 pandemic and its aftermath. By addressing this gap, the study enhances the application of agency theory and positive accounting theory within an emerging market context, while providing practical insights for regulators, investors, and companies aiming to bolster the credibility of financial reporting.

II. METHOD

This study utilizes a quantitative methodology to analyze the impact of financial performance and governance variables on earnings management. The research design is explanatory, seeking to elucidate causal relationships between independent and dependent variables grounded in empirical data.

Research Design and Sample

The population comprises 62 consumer goods firms listed on the Indonesia Stock Exchange (IDX) from 2020 to 2023. The consumer goods sector was chosen because it plays a strategic role in the Indonesian economy, especially when it comes to making important goods that people always need. Using purposive sampling, 31 firms met the selection criteria, which were: (1) publishing annual reports in Indonesian Rupiah, (2) disclosing managerial ownership, and (3) giving full information on audit committees. The final sample consisted of 124 firm-year observations over the four-year observation period.

Table 1. Research Sample Selection Criteria

No.	Sample Selection Criteria	Number
1	Consumer goods industry companies listed on the Indonesia Stock Exchange for the period 2020-2023.	62
2	Consumer goods industry companies that did not present their financial reports in rupiah for the period 2020-2023.	(1)
3	Consumer goods industry companies that did not have management ownership for the period 2020-2023.	(30)
Number of companies in the sample		31
Number of samples during the research period		124

Source: processed data, 2025

Variables and Measurement

The dependent variable in this study is earnings management, which is defined as managerial interference in the financial reporting process to sway stakeholders' views (Healy & Wahlen, 1999). The Modified Jones Model (P. Dechow & Sloan, 1995) is used to figure out how much money a company is making by looking at discretionary accruals. This model separates normal accruals from those that are based on management's discretion.

The first independent variable is profitability, which shows how well a company can make money from its assets. Profitability is an important sign for investors and creditors, but it can also make managers want to change the reported results to keep performance consistent (Anagnostopoulou & Tsekrekos, 2015). Return on assets (ROA) is a way to measure profitability. It is the net income after tax divided by the total assets.

The second independent variable is firm size, which shows how big and visible a company's operations are. Larger companies are more likely to be looked at by the government and the public, which may make them less likely to change their profits. However, their operations may be so complicated that they can report whatever they want (Dichev et al., 2012). Total assets, a common measure in corporate finance studies, are used to measure the size of a company.

The third independent variable is leverage, which shows how much debt a company uses to finance its capital structure. High leverage may compel companies to disclose favorable earnings to avert covenant breaches and reassure creditors (Jelinek, 2007). The debt-to-asset ratio (DAR), which is the total liabilities divided by the total assets, is used to measure leverage.

The fourth independent variable is managerial ownership, which is the percentage of shares owned by managers who are actively involved in making decisions. Agency theory posits that increased ownership harmonizes the interests of management and shareholders, potentially mitigating opportunism; however, excessive concentration may result in entrenchment (Morck et al., 1988). The percentage of total shares held by management is used to figure out managerial ownership.

The last independent variable is the audit committee, which is a governance tool in charge of making sure that financial reporting is accurate, that risks are managed, and that internal controls are in place. There is usually less earnings manipulation when audit committees are strong and independent (García-Sánchez et al., 2012; Klein, 2002). This study evaluates the audit committee based on its membership count, in accordance with corporate governance standards in emerging markets (Nasution & Nengzih, 2020).

Data and Analysis

The research utilizes secondary data sourced from annual financial reports and audited statements available on the IDX official website. The data were examined through multiple linear regression employing the Ordinary Least Squares (OLS) technique. Before testing the hypothesis, classical assumption tests like normality, multicollinearity, heteroscedasticity, and autocorrelation were done to make sure the model was valid. The F-test and the coefficient of determination (R^2) were used to see how well the model fit, and t-tests with a 5% significance level were used to see how each independent variable affected earnings management.

III. RESULTS AND DISCUSSION

Descriptive Analysis

The descriptive statistics indicate significant variability among the observed companies. The range of profitability (ROA) from negative to almost one shows that firms did not perform the same way during the 2020–2023 period. The size of the companies also varied widely, showing that there are both small and large companies in the consumer goods sector. Leverage values ranged from low to high, while the percentage of managerial ownership was usually low, and some companies didn't even have a stake in the management. The average size of an audit committee was about three members, which is the minimum number required by Indonesia's corporate governance rules. These descriptive findings show how different the financial and governance structures are in the sector.

Table 2. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
DA	124	-0.34	0.91	0.759	0.14019
ROA	124	-0.41	0.95	0.370	0.12243
SIZE	124	0.06	186.60	11.9849	34.23515
DAR	124	0.12	1.01	0.4104	0.18024
KM	124	0.01	0.77	0.1512	0.22487
KA	124	2.01	4.01	2.9678	0.25298

Source: processed data, 2025

Regression Results

Table 3. Regression Analysis

Model	Unstandardized B	t	Sig
Constant	0.132	2.350	0.021
ROA	-0.022	-2.358	0.021
SIZE	0.001	0.074	0.943
DAR	0.018	0.657	0.514
KM	0.002	0.235	0.816
KA	-0.107	-3.214	0.003

Source: processed data, 2025

The regression analysis shows that profitability and audit committees have a big negative impact on earnings management. Companies that make more money are less likely to lie about their earnings, which means that good financial performance makes it less tempting to report opportunistically. Likewise, a more powerful audit committee limits earnings manipulation, which strengthens its role as a good way to govern.

Conversely, firm size, leverage, and managerial ownership were determined to exert no significant influence on earnings management. This result suggests that larger companies in Indonesia's consumer goods sector do not necessarily manipulate more or less than smaller companies, even though they are under different levels of scrutiny. Similarly, increased leverage did not consistently result in heightened incentives for manipulation, potentially attributable to the oversight function of creditors. Lastly, the lack of importance of managerial ownership may be because there aren't many managers in the sample who own shares, which limits its usefulness as a way to govern.

Discussion

The discovery that profitability diminishes earnings management corresponds with the perspective that financially robust companies possess diminished incentives to manipulate reported outcomes. This finding is different from studies that say very profitable companies may smooth out their income to keep their performance steady (Siregar & Utama, 2008), but it supports research that says strong profitability signals cut down on opportunistic behavior (Anagnostopoulou & Tsekrekos, 2015). According to positive accounting theory, managers in profitable firms may not require accounting discretion, as the reported performance already aligns with stakeholder expectations.

The substantial adverse impact of audit committees aligns with previous findings indicating that effective oversight limits managerial discretion (García-Sánchez et al., 2012; Klein, 2002). In Indonesia, where the enforcement of regulations has frequently been scrutinized, this finding highlights the essential role of independent and proficient audit committees in bolstering the credibility of financial reporting. This outcome further corroborates agency theory, which underscores the significance of monitoring mechanisms in alleviating conflicts of interest between principals and agents (Jensen & Meckling, 1976).

Conversely, the absence of substantial effects regarding firm size, leverage, and managerial ownership underscores the contextual characteristics of governance mechanisms. The insignificance of firm size may suggest that the advantages of visibility and scrutiny are counterbalanced by the intricacies of extensive operations (Dichev et al., 2012). In the same way, the insignificant role of leverage goes against the debt covenant hypothesis of positive accounting theory (Watts & Zimmerman, 1986). This suggests that creditors in Indonesia may already be keeping a close eye on things, so managers don't need to manipulate earnings as much. Lastly, the limited effect of managerial ownership may be due to the fact that managers in Indonesian consumer goods companies only own a small amount of equity, which makes it less effective as a way to align interests.

In general, these results show that not all mechanisms that are predicted by theory work the same way in all situations. In the Indonesian consumer goods sector, profitability and audit committees are significant factors influencing earnings management, whereas other financial and ownership structures seem to exert minimal impact. This adds to the ongoing discussion in the literature and stresses the importance of understanding earnings management in emerging markets in context.

INCRECS

IV. CONCLUSION

This study analyzed the impact of profitability, firm size, leverage, managerial ownership, and audit committees on earnings management in Indonesian consumer goods companies from 2020 to 2023. The findings indicate that profitability and audit committees significantly inhibit earnings management, whereas firm size, leverage, and managerial ownership do not demonstrate substantial effects.

In theory, these results support agency theory and positive accounting theory by showing that effective monitoring tools, especially audit committees, are still important for stopping managers from taking advantage of their positions. The findings indicate that when companies attain substantial profitability, the motivation to manipulate earnings decreases, aligning with the perspective that favorable performance alleviates the pressure for opportunistic reporting.

From a practical standpoint, the results underscore the necessity of enhancing governance mechanisms in emerging markets. Regulators should keep making sure that audit committees are independent and skilled. Companies should also see profitability as a way to protect themselves from opportunistic behavior, not just as a way to measure performance. These results help investors understand which traits of a company are most likely to show that it is reporting honestly.

In conclusion, this study adds to the growing body of research on earnings management by providing empirical evidence from Indonesia. It shows that financial performance and governance structures do not work the same way in all situations. Future research could augment this study by investigating additional potential determinants, including auditor reputation, free cash flow, or financial distress, to enhance the comprehension of earnings management in emerging economies.

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