

The Influence of Corporate Governance in The Relationship of Firm Size and Leverage on Earnings Management

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Abstract: This study aims to examine the role of corporate governance in relation to the size of the company and leverage earnings management. Earnings management concept adopted the Modified Jones Model measured using a proxy discretionary accruals. Samples are manufacturing companies listed in Indonesia Stock Exchange period 2014 - 2017. The sampling method with purposive sampling. Data were analyzed using Moderated Regression Analysis (MRA). The results showed the effect of firm size on earnings management was positive, while leverage has a positive effect on earnings management. The role of corporate governance in relation to the size of the company and leverage significant earnings management is negative, meaning that when the company has good corporate governance, the large companies and companies with high leverage level will tend to not perform earnings management or what their reported profits.

Keywords:- Firm Size, Leverage, Earnings Management Corporate Governance.

I. INTRODUCTION

The corporate governance perspective starts with agency theory, which identifies potential conflicts of interest between owners (principals) and management (agents). Jensen and Meckling (1976) argue that an agency relationship is a contract between owner and management. A conflict of interest between the owner and management is likely because management did not act in the interests of the owner, which caused agency costs (agency costs). Managers as company managers are more aware of internal information and company prospects than their owners. The manager as the manager is obliged to give a signal about the state of the company to the owner. However, the information conveyed is sometimes not in accordance with the actual conditions. This condition is known as asymmetric information (Cornett, 2006).

Corporate governance is governance that describes the relationships between various parties in a company that determine the direction and performance of the company (Monks and Minow, 2001). The issue of corporate governance is still under discussion is interesting, because

of issues relating to governance is seen as crucial to overcome the financial problems of the company (Rajput & Bharti, 2015). Good corporate governance can reduce agency conflicts and improve the disclosure of which could restrict the information asymmetry. Weak corporate governance considered to play an important role on the bankruptcy of a number of large companies and crises in various countries (Reddy et al., 2010; Ross and Crossan, 2012; Ujunwa, 2012). Jun-Koo (1995) mentions that bad corporate governance as one of the causes of the economic crisis in East Asia in 1997-1998, including Indonesia. In late 2015, the Financial Services Authority announced on the 10 ASEAN countries in the application of good corporate governance, Indonesia still lags behind Malaysia, Singapore and Thailand.

Asymmetry of information between management and owners provides an opportunity for managers to manage earnings (earnings management). Earnings management is the manager's decision to choose a particular accounting policies that are considered to achieve the desired objectives, both to increase profits or reduce the level of losses reported (Scott, 2015: 445). Earnings management as a process that is done intentionally within the limits of accounting principles generally accepted to lead to the expected profit level (Schipper, 1989).

Based on the positive accounting theory (Watts and Zimmerman, 1986), one of the causes of earnings management is a political motive costs that mention the company that concern the government is a big company a monopoly. Governments interested in the company in terms of taxation. Large companies in an effort to evade taxes will tend to understate their profits, so the size of the company is used as a proxy of the political cost hypothesis that motivates companies conduct earnings management. The size of the company can be determined based on total assets, total sales, profits and income tax expense (Brigham and Houston, 2010). One benchmark that shows the size of the company is the total assets of the company (Lee, 2009). Lee and Choi (2002) state that firm size has a negative effect on earnings management. But Rahmani and Mir (2013) find that company size has a positive effect on earnings management.

In addition to the costs of political motives, earnings management is caused by the motives of debt agreements (Watts and Zimmerman, 1986). The debt agreement hypothesis argues that the higher the debt, the greater the chance of a debt contract violation. In Indonesia to obtain data and information about the company's debt covenants are very difficult, so in this study used other indicators that can be used to infer the company that have a tendency to violate the debt contract, the amount owed. Companies that have a contract amount of debt that many will have a tendency to commit breach of contract debts. For representation of breach of contract debts in this study is used as a proxy variable leverage breach of contract debts that can serve as benchmarks to see the behavior of managers in earnings management activities. Because the higher the debt the company, then the company would be getting close to the breach of contract debts, and to meet the company's debt contracts require a fee. To meet these costs, the company will tend to perform earnings management by increasing profits. The company increased the earnings that the leverage ratio is at the desired position. Mamedova (2008) stated that the leverage effect on the management practices of earning management. The research result Zamri et al. (2013) also mentions the positive leverage effect on earnings management. Because the higher the debt the company, then the company would be getting close to the breach of contract debts, and to meet the company's debt contracts require a fee. To meet these costs, the company will tend to perform earnings management by increasing profits. The company increased the earnings that the leverage ratio is at the desired position. Mamedova (2008) stated that the leverage effect on the management practices of earning management. The research result Zamri et al. (2013) also mentions the positive leverage effect on earnings management. To meet these costs, the company will tend to perform earnings management by increasing profits. The company increased the earnings that the leverage ratio is at the desired position. Mamedova (2008) stated that the leverage effect on the management practices of earning management. The research result Zamri et al. (2013) also mentions the positive leverage effect on earnings management. To meet these costs, the company will tend to perform earnings management by increasing profits. The company increased the earnings that the leverage ratio is at the desired position. Mamedova (2008) stated that the leverage effect on the management practices of earning management. The research result Zamri et al. (2013) also mentions the positive leverage effect on earnings management.

II. PRIOR ART RESEARCH AND DEVELOPMENT HYPOTHESIS

A. Influence of company size to Profit Management

The size of the company is a proxy of financial strength as a scale for classifying large or small a company. One benchmark to indicate the size of the companies use the total assets of the company (Dashmash, 2015; Isbanah, 2015; Lee, 2009; Nilres and Velnampy, 2014). Companies that have total assets of the shows the company has reached a stage of maturity. At this stage the company has a positive cash flow and is considered to have good prospects in a relatively long period of time, but it reflects that the company is relatively more stable and better able to generate profits than firms with small asset total.

The size of the company is also dealing with the quality of earnings, because the larger the size of the company, the company's sustainability will be higher in improving financial performance, so companies do not need to make profit manipulation practices. Company said earnings quality if the financial statements are presented in real earnings and describes the company's actual financial performance. Lee and Choi (2002) found that the size of the company with a negative effect on earnings management. Large companies lack the motivation to practice earnings management, as shareholders and outside the company are considered more critical than the smaller companies. But Rahmani and Mir (2013) found that the size of the company and earnings management has a positive effect, because the large-sized company should be able to meet the high expectations of shareholders and investors. Based on the above, the hypothesis developed in this study are:

H_1 : Size effect on earnings management company

B. Effect of Leverage to Profit Management

According to Positive Accounting Theory (Watts & Zimmerman, 1986), the higher the level of leverage of the company, the earnings management conducted by the management will also increase. When a company is in a high level of leverage, meaning the company can be said to be in a state of insolvable. That is, the company is in a state where the equity held smaller than the value of the debt, in other words the majority source of corporate funding comes from debt. Companies with high leverage level is no longer used as a source of funds and the loan will switch to equity financing. Therefore, the company must have a good performance and a high profit to attract potential investors. This is consistent with the hypothesis in the contract of debt (debt covenants hypothesis) which states that managers are motivated conduct earnings management to avoid breaching the debt contract. The manager will manage and administer the profits that its debt obligations which should be completed in a given year may be postponed to next year. This is an attempt to regulate the amount of profit manager which is an indicator of a company's ability to settle its debt obligations. The impact of leverage on earnings management has two different views. On the first hand, shows that companies with a high leverage more interested

in earning management (Dichev & Skinner, 2002; Beatty & Weber, 2003) to maintain the company's financial performance for the benefit of stakeholders. On the other hand, Jensen (1986) suggests that the creation of debt will reduce opportunistic behavior of managers. Managers use discretion to control the cash flow of the company. But the role of debt control starts when the manager has an obligation to pay interest and principal. This implies that high leverage can restrict managers to manage earnings. Based on the above, the hypothesis developed in this study are as follows:

H₂ : Leverage effect on earnings management

C. Influence of Corporate Governance on the relationship between firm size to Profit Management

Lee and Choi (2002) found that company size is a variable that can influence a firm's tendency to manage revenue. Small companies do earnings management to avoid losses than large companies. The results of Shu and Chiang (2013) research on the effect of firm size on earnings management for large companies shows the effect of short-term positive earnings management on wealth and long-term negative effects on wealth. To avoid information asymmetry in the company, the concept of good corporate governance is needed. With good governance, companies will be more transparent, accountable, responsible, independent and fair. So that it will affect the company's earnings management practices. Based on the above, the hypotheses developed in this study are:

H₃: Corporate Governance significant effect in the relationship between firm size and earnings management.

D. Influence of Corporate Governance on the relationship between Leverage Profit Management

Leverage is the ratio between total liabilities and total equity of the company, which shows the amount of assets owned by companies financed with debt. The greater the financing with debt, the greater the leverage used (Ross et al., 2009). Mamedova (2008) stated that the

leverage effect on earnings management practices. In the agency theory, the closer the company with violations of accounting-based debt contracts, it allows managers to choose accounting procedure that removes the reported earnings from future periods to the current period (Watts & Zimmerman, 1986). A system of corporate governance, management believed would limit earnings management, because corporate governance is the concept of improving corporate performance through supervision of management performance and ensure the accountability of management to the stakeholders based regulatory framework. The concept of corporate governance is applied to achieve a more transparent corporate management for all users of financial statements, and corporate objectives and monitoring performance can be accounted for and well done. Based on the above, the hypothesis developed in this study are as follows: and corporate objectives and monitoring performance can be accounted for and well done. Based on the above, the hypothesis developed in this study are as follows: and corporate objectives and monitoring performance can be accounted for and well done. Based on the above, the hypothesis developed in this study are as follows:

H₄ : Corporate governance affects the relationship between leverage with earnings management.

III. RESEARCH METHODOLOGY

The population is all companies listed in Indonesia Stock Exchange until the end of year 2017 as many as 557 companies. Engineering sample selection using purposive sampling method, the sampling method based on specific criteria (Chandrarin, 2017: 127) to obtain a representative sample in accordance with the criteria specified. Criteria for determining the sample is a manufacturing company that publishes an annual report full year research period 2014 - 2017 which contains data related to the variables used in the study, and the company does not lose during the study period. Sample selection procedure is as follows:

Information	Total Company
Companies listed on the Stock Exchange up to Year 2017	557
Companies other than the manufacturing sector recorded on the Stock Exchange up to Year 2017	405
Manufacturing sector companies listed on IDX up to Year 2017	152
The manufacturing company annual report data is not complete year period 2014 - 2017	46
The Company manufactures a full annual report data year period 2014 - 2017	106
Manufacturing companies suffered losses year period 2014 - 2017	40
Total company in the research samples	66

Table 1:- Sample Selection Procedures

Source: Processed Data, 2019

The type of data in this research is quantitative data. The data structure in the form of pooling of data which is a combination of time series and cross-sectional (Chandrarin, 2017: 122). Data were analyzed on the basis of the pooling of data as much as 264 observations (66 companies x 4 years). Source of research data is secondary data.

This study uses a moderating variable of corporate governance as a major part to test his hypothesis. Hypothesis testing is done to determine the effect of corporate governance on the relationship between firm size and leverage to earnings management. Structures are at that describes causal relationships between variables as shown in Figure 1.

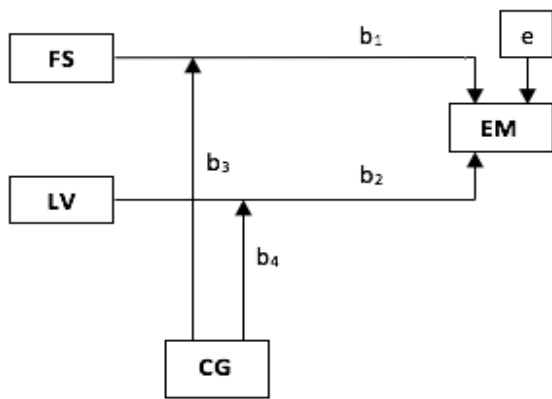


Fig 1:- Framework Concepts Effect of Corporate Governance on the relationship between Leverage and size to Profit Management Company

This study uses Moderated Regression Analysis (MRA) or interaction test. As a hypothesis test equipment that is speciali ed applications in multiple linear regression regression equation contains elements of interaction (multiplication of two or more independent variables) with the following equation:

$$EM = \alpha + FS + LV + FS * CG + LV * CG + \varepsilon$$

Information:

- EM = Earnings Management
- FS = Firm Size
- LV = Leverage
- CG = Corporate Governance
- ε = error

MRA is used to test the hypothesis of the influence of corporate governance moderating variable on the relationship between firm size and leverage to earnings management.

IV. RESULTS AND DISCUSSION

Based on the classic assumption test results, all variables have VIF values below 10; it means that all independent variables are not affected multicollinearity. Normality test results also shows the data (points) spread around and close to the line diagonal. It shows the research data normal distribution, While the autocorrelation test Durbin Watson known values greater than 1.71 (Du) and smaller than 2.26 (4-Du). Meaning it can be concluded that there is no autocorrelation in the regression model. Heteroscedasticity test results, dots irregularly dispersed with no specific pattern, so stated heteroscedasticity does not exist in the regression model.

a) Results of analysis data Moderated Regression Analysis (MRA) to test the effect of corporate governance on the relationship between firm size and leverage to earnings management are presented in Table 1.

Model	Standardized Coefficients beta	t	Sig.
FS	2.961	12.200	0.000
FS* CG	-3.403	-14.019	0.000
LVR	2.947	2.845	0.005
LVR * CG	-2.951	-2.849	0.005

Table 2:- The Effect Of Corporate Governance (The relationship between company size and Leverage to Profit Management) Source: Data processed, 2019.

Interaction between the size of the company and corporate governance on earnings management has a beta coefficient of -3.403 and 0.000 significance value <0.05. Thus the corporate governance as moderator variables affect relations firm size on earnings management, and the influence exerted by corporate governance as a moderator variable is negative correlation with earnings management firm size. This means that the effect of corporate governance is weakened relationship with the management company the size of earnings, meaning that when relations firm size and high corporate governance, the management tended not to make profit management in reporting its financial results or to report what their income, on the contrary when the relationship sized companies and corporate governance is low, management tends to perform earnings management by increasing its profits. In other words, the big companies, with good corporate governance, the management will tend to report financial performance in accordance with the achievement. It shows independent board as a proxy for corporate governance have the expertise, skills and science that is able to run the monitoring process. The expertise effectively prevent acts of earnings management, so that the profits reported to be more transparent. In order to avoid information asymmetry in the company, it takes the concept of good corporate governance, so that the company will be more transparent, accountable, responsible, independent, and fair. In addition to the large companies will be more cautious in making financial reporting and tend to report financial condition accurately because more attention by the public. Large companies more get the attention of the public so that the report will report its financial statements in accordance with actual conditions. The results of this study are consistent with research Lee and Choi (2002) who found that company size is a variable that affects the tendency of companies to manage earnings.

The interaction between leverage and corporate governance has a coefficient value of -2.951 and 0.005 significance value <0.05. Thus the corporate governance as moderator variables affect the relationship leverage to earnings management, and the influence exerted by corporate governance as a moderator variable is negative leverage and earnings management. This means that the effect of corporate governance is to weaken the leverage and earnings management, meaning that when the relationship leverage and corporate governance is high then the management tend to perform earnings management by minimizing their profits, and vice versa when the relationship leverage and corporate governance

is low, management tends to do management profit by increasing its profits. In other words, the company has a high degree of leverage, with good corporate governance, the management will be less likely to make earnings management or management reporting financial results in accordance sebenarnya conditions. In contrast to companies that have a high leverage level, the corporate governance is not good then the management will tend to perform earnings management by increasing profit. According to Positive Accounting Theory (Watts & Zimmerman, 1986), the higher the level of leverage of the company, the earnings management conducted by the management will also increase. This is consistent with the hypothesis in the contract of debt (debt covenants hypothesis) which states that managers are motivated conduct earnings management to avoid breaching the debt contract. The manager will manage and administer the profits that its debt obligations which should be completed in a given year may be postponed to next year. This is an attempt to regulate the amount of profit manager which is an indicator of a company's ability to settle its debt obligations. Corporate governance weakens the leverage and earnings management. Leverage and profit management is a positive influence. Companies with high leverage will make the company's management becomes more difficult to make predictions of future course of the company. The greater the leverage of the company, the more stringent supervision by creditors, so the flexibility of management to manage earnings decreases.

V. CONCLUSION, LIMITATIONS AND RECOMMENDATIONS

Based on the results of this study concluded that company size and leverage significant positive effect on earnings management. Large companies will tend to perform earnings management (Rahmani & Mir, 2013). Likewise, companies that have a relatively high degree of leverage tend to perform earnings management to maximize profits (Dichev & Skinner, 2002). Large companies tend to have a high political cost that companies tend to earnings management practices by increasing the profit (income increasing) in order to maintain the company's reputation in the community. The role of corporate governance in relation to the size of the company and leverage significant earnings management is negative, meaning that when the company has good corporate governance, the large companies tend to not perform earnings management practices and report its performance based on the actual condition of achievement. Likewise, companies that have a relatively high degree of leverage that good governance will enable the company to submit a report based on actual financial performance without any profit management efforts carried out by the management.

Research limitations only use two variables, namely company size, and leverage, while there are still many other variables that affect earnings management. The number of samples is small because the study period was only in the period of 4 years 2014 - 2017. During this

period many companies suffered losses so that they did not meet the criteria as a research sample. The data used is secondary data which may have errors in entering data in the form of numbers. This research is only focused on the corporate internal performance variables in the form of financial ratios by not paying attention to the company's macro factors or other economic risk factors outside the company's performance. Recommendations for further research are expected to increase the scope of research objects by extending the study period and need to pay attention to the company's macro factors or economic risk factors outside of financial performance so as to provide a more comprehensive picture of the results of the study.

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