



## **Good or Bad Financial Reporting Can Cause Changes in Company Management**

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### **ABSTRACT**

The purpose of this study is to determine the effect of earnings management on financial performance. The company's reported profit is not clear because complex interactions include three factors, namely managerial motivation, accounting standards, and the application of accounting standards. Managers have the desire to manage company earnings reports using accrual policies that are permitted by accounting standards with the aim of covering company performance. Accrual accounting aims to help users of corporate financial statements in assessing economic performance during a period through the use of accounting principles, such as the use of accounting for recognition of income and expenses. The unit of analysis in this study is industrial companies in Papua-Indonesia. The results of the study indicate that earnings management has a significant effect on financial performance. Furthermore, it was found that earnings management can change because it affects the financial performance survey of companies of state-owned enterprises in Papua in Indonesian.

**Keywords:** Profit Management, Financial Performance, Earnings Management

**JEL Classification:** G2

### **1. INRODUCTION**

Increasingly intense and intensified business competition has triggered companies to constantly strive to formulate and refine their business strategies so as to create strategic excellence and competitive advantage (DeGeorge et al., 1999; Holthausen et al., 1995). To find out how far the effectiveness of its strategy is implemented, companies must be able to measure their business performance (Sloan et al., 1996): A company is said to have a competitive advantage if the company is seen as superior to its competitors, for example in the quality and price of the products produced (Healy and Wahlen, 1999). The company was established to grow healthy and develop and achieve profits in accordance with predetermined targets (Nelson et al., 2003). The government should have an accrual accounting system to identify, measure and

manage existing resources. (Bartov et al., 2002; Dechow, 1994). Sources of funds other than through bank credit, namely through the capital market over the past decade, capital markets have begun to show an important role in mobilizing funds to support the development of the national economy (Eisenberg et al., 1998; Beatty et al., 2002).

The development of the capital market has been able to provide a substantial contribution to the development of the national economy (Schipper et al., 1989). This can be seen from the number of companies that went public since the Indonesian capital market was reactivated in 1977-1987, namely 24 companies with a total emission value of Rp.679.50 billion, having experienced a large increase to 411 companies in 2004 with emissions total Rp.314.76 trillion. Agrawal and Knoeber (1996). These developments

indicate that many public companies can increase their capital by issuing valuable securities to the public. Through the capital market, available funds can be allocated to the most productive parties in using these resources (Hutchinson, 2003; Cheng and Warfield, 2005). To realize the optimal allocation of resources in the capital market, companies must provide information that is transparent to the public and useful in making economic decisions (Jensen, 1993; Beasley, 1996).

Financial reports provide corporate financial information that is beneficial to a number of report users in economic decision making (Watts, 1986). The main focus of users of financial statements is information about company performance measured by profit and its components (Maassen and Bosch, 1999). Investors and creditors as users of financial statements use past earnings information to help assess company prospects. Although investment and credit decisions reflect the expectations of investors and creditors about the company's performance in the future, these expectations are usually based at least on evaluating the company's financial performance in the past (DeFond and Jiambalvo, 1994; Claessen et al., 2000).

Collins et al. (1995), state that reported earnings of companies contain obscurity or inequity between observable accounting earnings and unobservable economic profits, called earnings opacity. The results of his research indicate that earnings management practices are lower in countries that have large capital markets, spread ownership, strong investor rights, and strong legal enforcement. In the investment community in the United States there is a great deal of attention to earnings management practices that have eroded public confidence and disrupted the flow of efficient capital in the capital market. The community states that managers misuse the flexibility provided by the generally accepted accounting principles (GAAP) and deliberately change the content of information in financial statements that can mislead report users (Warfield, 1986). The research findings of Bhattacharya, Uzun, (2004) on earnings management practices throughout the world show that countries in Asia including Indonesia have a high level of earnings management. The form of earnings management is highlighted in the form of: (1) aggressive earnings reporting (earnings aggressiveness), namely by delaying the recognition of current expenses and losses and/or accelerating recognition of future income and profits (Teoh et al. 1998), (2) avoiding reporting loss (loss avoidance), namely by avoiding negative earnings reporting, increasing earnings reporting, and fulfilling analyst earnings forecasts (Leuz et al., 2003; Coles et al., 2001), (3) earnings smoothing, namely the use of accounting policies to hide economic shocks over company operating cash flow (Denis and McConnell, 2003). For example, speeding up the recognition of future income to hide current bad performance, so that reported profits do not reflect actual performance (Syakhroza, 2005).

Earnings management is inappropriate, and misuse such as earnings management occurs when people take advantage of the inherent flexibility in the application of GAAP in order to obscure actual financial volatility, and in turn hide the consequences of management decisions (Yermark, 1996). Definition of Profit Management Understanding earnings management is important for

accountants because it allows a development of an understanding of net income for reporting to investors and for a contract/agreement (Ball et al., 2000). Some definitions of earnings management are presented as follows: Given that managers can choose accounting, it is natural to expect that they will maximize their own utility and/or market value of the firm. This is called earnings management (Lukviarman, 2001), the purpose of obtaining some private gain (Sylvia et al., 2004). "Earnings management occurs when managers use financial statements to financial reporting to either mislead some stakeholders about the underlying of economic performance of the company (Eddy and Mas'ud, 2003), or to influence contractual outcomes that depend on reported accounting numbers" (In Xie et al. 2003).

Preparation of financial reports that violate GAAP is stated as both earnings management and fraud. According to Welch, (2003), earnings management is a profit manipulation aimed at creating an impression of business performance, for example to meet targets determined by management or predictions made by analysts. The impression of a changed business performance does not always state that earnings management results in meaningless earnings measurements (Young, 2003). For example, the managed earnings number is a better indicator of future earnings expectations. Furthermore, the volatility of earnings figures managed in a series of times provides a more realistic financial risk index compared to the number of unmanaged earnings. However, earnings management can result in negligence and material misstatement of numbers and appropriate disclosures, and this action is intended to deceive or cheat users of financial statements. Scott (2003) suggests two things about earnings management. First, earnings management can reflect opportunistic behavior (opportunistic behavior) of managers to maximize their personal profits in the face of compensation, debt contracts and political costs. Second, viewed from the perspective of an efficient contract (efficient contracting perspective), earnings management can give managers the flexibility to protect themselves and the company in the face of unanticipated conditions of imperfect and rigid contracts. Furthermore, managers can influence the market value of the company's shares with earnings management.

Managers can be asked to do earnings management by reporting changes in permanent earnings separated from temporary earnings to help investors reduce errors in valuation. If temporary earnings that can be estimated statistically written off in the report, managers only report permanent earnings, the reported profits will be smooth all the time. Company Financial Performance Performance is the end result of an activity. Company performance is the accumulation of all the final results of the activities and work processes of the company (Robbins and Coulter, 2005, p. 465). Managers need to provide a tool to monitor and measure company performance. Financial reports provide financial information that is useful for managers to analyze the results of their work in managing the company, and benefit other users in making economic decisions. Financial performance measurement can be done based on accounting performance (accounting measure of performance), and can also be based on market performance (market based measure). (Rhoades et al., 2001, p. 313; Dutta and Reichelstein, 2005, p. 1069).

The debate about measuring financial performance based on the cash flow model or profit model has long been underway. Proponents of performance measurement based on cash flow say that cash is a reality while profit is only an opinion (Peng, 2004 and Hirst and Hopkins, 2000, p. 14). Furthermore, any mechanical relationship between current accruals and future earnings regarding accrual reversals is avoided. However, operating cash flow has a problem with timeliness as a performance metric (Yeo et al., 2002). In particular, negative cash flows can result in investments in projects where the NPV is positive and do not result in poor operating performance. Therefore, operating cash flow is likely to be a good measure of financial performance only for stable companies. This motivates the use of profit based metrics as other measurements for financial performance, for example return on assets (ROA), return on investment, and others (Leuz, et al., 2003).

The effectiveness of auditing to prevent earnings management or financial fraud will vary with audit quality. The results of audit quality cannot be directly observed, therefore the researchers try to find a substitute indicator of audit quality by asking the opinions of experts to determine the input and output of audit quality (Williamson, 1987). Furthermore, Lesi Hertati (2015) examines if company management works well and is submissive and obedient to the rules, the company's profits will increase in the long run. Various dimensions of audit quality used by researchers include: (a) the size of the public accounting firm, which is most widely used as a measure of audit quality, namely among others by Becker et al. (1998), Francis et al. (1999), Krishnan, (2003a). The findings of Francis et al. (1999) research, shows that companies audited by Big 6 have a higher total accrual rate than companies audited by Non-Big 6, but Big 6 clients report lower discretionary accruals. These findings provide evidence that companies that tend to generate more accruals are more likely to employ big-six auditors to increase reported earnings credibility, and prove that Big Six auditors reduce the potential for earnings management based on accrual policy. Industrial specialization owned by big-six auditors is able to detect earnings management and offer higher audit quality than non-specialist auditors.

The results of Warfield et al. (1995) different from the findings of Gabrielsen et al. (2002) which uses Danish capital market data, shows that there is a positive relationship between managerial ownership and discretionary accruals. This means that greater managerial ownership will improve earnings management. This opposite result is due to the different characteristics of corporate ownership structures between America and Denmark, managerial ownership in companies in Denmark is very high, which is an average of 59% when compared to companies in America which is only 17%. However, managerial ownership can reduce extreme accrual policies in companies in regulated industries, namely in transportation companies and public facilities. Furthermore, Hertati (2015) found that reported profits must actually be derived from complete and accurate data rather than modified profits in such a way that the company looks healthy.

The negative relationship between institutional ownership and earnings management is supported by research conducted on the Jakarta Stock Exchange by Pranata and Mas'ud (2003), using

data from non-banking and insurance companies in 1995-2000. But in other literature, namely in Bushee (1998), Matsumoto (2002) states that institutional investors are transient owners who are very focused on short-term earnings, and therefore pressure managers to make earnings management that increases short-term profits. Earnings management can influence investors by providing false information. Information is very important in the capital market, because capital markets use financial information to set securities prices, investors use financial information to determine their investment decisions, and market efficiency is based on information flow to the capital market. If information is incorrect, it is impossible for the capital market to properly assess its securities.

Earnings management can obscure actual financial performance and reduce the ability of shareholders in decision making, so that earnings management is seen as a problem and agency costs (Xie et al. 2003, p. 297) Based on the theoretical foundation and previous research, the variables used in this study are earnings management, corporate financial performance (i.e. cash flow from operations [CFO], ROAs and stock returns [RET]) and corporate governance mechanisms (i.e. proportion of independent commissioners, number of boards commissioners, the existence of audit committees, managerial ownership, institutional ownership and the quality of external audits). Earnings management can have a positive effect on financial performance when the mechanism of corporate governance is effective. But on the contrary, ineffective governance mechanisms can result in earnings management having a negative effect on the company's financial performance. Therefore, the corporate governance mechanism is a moderating variable that is tested for its influence on the relationship between earnings management and the company's financial performance using an interaction model (Bobko, 1995, p. 217). The relationship between earnings management variables, financial performance and corporate governance mechanisms is presented in Figure.

## 2. HYPOTHESIS

Hypotheses are interpreted logically about the relationship between two or more variables expressed in the form of statements that can be tested for truth. Earnings management allows managers to inform their private information about the company so that financial statements reflect the company's true financial performance and provide benefits to investors in their decision making. Earnings management has a positive effect on the company's financial performance. (Scott, 2003; Gul et al., 2003; Bowen et al., 2004) Earnings management is used by managers for their personal interests, and therefore reported profits do not reflect the actual condition of the company so that misleading report users will ultimately reduce the company's financial performance. In this case, earnings management has a negative influence on the company's financial performance (Rangan, 1998; Scott, 2003).

## 3. EARNINGS MANAGEMENT VARIABLES

Earnings management is measured using Absolute value of abnormal accruals, namely the size of the adjustments made



by managers to arrive at reported earnings figures, the higher the absolute value presented by the greater the accounting discretion (policy) by managers (Bowen et al., 2004). Abnormal (discretionary) accruals are measured by reducing normal (non discretionary) accruals from total accruals. To measure discretionary accruals used performance-matched Jones model (1995) proposed by Kothari et al. (2002), namely by entering company performance (ROAs) into the Jones (1995) model. The formula for estimating discretionary accruals is as follows:

$$DAC_{it} = TAC_{it}/A_{it-1} - [\alpha(1/A_{it-1}) + \beta_1(\Delta REV_{it}/A_{it-1}) + \beta_2(PPE_{it}/A_{it-1}) + \beta_3(ROA_{it-1})]$$

Where:  $DAC_{it}$  = Discretionary Accruals for companies in year  $t$   
 $TAC_{it}$  = Total accruals (net income - CFO) for company  $i$  in year  $t$   
 $A_{it-1}$  = Total Assets for company  $i$  in year  $t-1$   
 $\Delta REV_{it}$  = change in net sales of the company  $i$  year  $t-1$  with year  $t$   
 $PPE_{it}$  = Gross Property, Plant and Equipment for company  $i$  in year  $t$   
 $ROA_{it-1}$  = ROAs for company  $i$  in year  $t-1$   
 $\alpha$ ,  $\beta_1$ ,  $\beta_2$  and  $\beta_3$  are industry specific estimated coefficients from the following cross-sectional regression:

$$TAC_{it}/A_{it-1} = \alpha(1/A_{it-1}) + \beta_1(\Delta REV_{it}/A_{it-1}) + \beta_2(PPE_{it}/A_{it-1}) + \beta_3(ROA_{it-1}) + e_{it}$$

### 3.1. Company Financial Performance

The company's financial performance is measured by three performance measures, namely: operating performance (ROAs and CFOs), and market performance (stock return) (Bowen et al., 2004), as follows:

The operating CFO is calculated by the formula:

$$CFO = CFO: Total Assets$$

Performance ROA:

$$ROA = Income Before Extraordinary Item: Total Assets$$

Stock Return (RET) is calculated using the weighted average daily stock price for the 12 month period ending December 31, with the formula:  $RET = (Pricet - Pricet-1) : Pricet-1$

## 4. EFFECT OF EARNINGS MANAGEMENT ON CORPORATE FINANCIAL PERFORMANCE

The results of hypothesis testing show that earnings management has a negative effect on the company's financial performance, the negative influence reflects the opportunistic behavior of the company's management Guidry et al. (1999). Management seeks to cover the actual operating performance of the company in order to report better performance for its own sake and/or its company, but the company's financial performance shows a downward trend in the long run. The results of this study provide empirical evidence supporting the allegations of Bowen et al. (2004) which states that if managerial opportunism is a trigger for earnings management, it can be estimated that there is a negative relationship between

earnings management and the company's financial performance. Regarding agency theory, opportunistic behavior that is not expected by parties related to contracts with companies is the result of unresolved agency problems. In this case, the agent acts in his own interests and deviates from the interests of the principal. This study supports the view of earnings management in the perspective of managerial opportunistic behavior, and supports the results of research by Xie et al. (2003) who found a negative relationship of earnings management with the company's financial performance showed that the opportunistic behavior of managers in corporate financial reporting reduced the company's financial performance (measured by book value of total assets, sales and market value of equity). This study does not support the results of the study of Bowen et al. (2004) which states earnings management in the perspective of efficient contracting and concludes that shareholders benefit from earnings management that can provide a signal about managerial competence or the company's financial performance in the future.

The results showed that earnings management negatively affected the company's market performance (stock return), but the effect was very small. This supports the efficient market hypothesis (also called the "no-effect hypothesis") in capital market theory which states that there are no changes in stock prices related to changes in accounting procedures. Investors have anticipated manager's behavior in financial reporting and have entered the prevailing stock price. The negative influence of earnings management on stock returns shows that the market is aware of the opportunistic motivation of earnings management practices carried out by the company. Consequently, greater earnings management will lead to lower returns on shares (stock returns) (Sweeney et al., 1994). The findings of this study support some of the results of previous studies. The results of Xie et al. (2003) showed a negative correlation between earnings management and company stock performance (measured by market value of equity), and the results of research by (Spira, 1999) which showed that earnings management had a negative effect on firm value (measured by stock market returns).

Associated with business ethics, earnings management is unethical if there is a fictitious transaction that deliberately deceives the users of the company's financial statements. As revealed by Skinner et al. (1999), that basically there is universal agreement for an ethical or unethical action. But sometimes managers disagree with their auditors about what is considered reporting that is not in accordance with generally accepted accounting principles with deceptive intentions. For example, in the case of Worldcom, the company's financial manager firmly justified his decision to capitalize instead of directly charging the telephone access fee of 3.8 billion dollars. The background of this capitalization is based on his understanding of the appropriate accounting standards. In the manager's view, "fraudulent reporting" is ethical and in accordance with GAAP.

Whereas regulators seem to believe that earnings management is a problematic thing, and see that earnings management is not feasible because it is a company manager's intervention to hide the company's operating performance by using accounting and

estimations that are fraudulent and unreasonable. It is very difficult to determine whether the earnings management actions carried out by company managers are ethical or unethical, because it is difficult to determine whether a manager has passed the boundary and violates generally accepted accounting principles, and there are no signs that state “the heart careful: don’t skip this line.” It is also a manager’s personal ethics and the ability to know that deviant and deceptive financial reporting is part of a series of actions that stems from an attempt to polish financial statements but can end up as a full fraud. An important consideration for managers is whether the exact timing of transactions or changes in methods or accounting estimates is done to communicate the economic performance of a business better, or whether earnings management techniques are used with deceptive intentions. In this regard, Bhattacharya (2003) state that if earnings management is done to trick potential investors, lenders, government, and other parties with an interest in the company, earnings management has a real risk of loss of credibility in the future, and many people believe that action to fool others is wrong, regardless of the economic consequences that arise.

## 5. MATERIALS AND METHODS

Research Methods, Population and Samples. This study aims to test hypotheses (hypothesis testing) which are developed based on theory and previous research. The research method used is explanatory research and causal study, namely research that states what and to what extent factors are expected to influence a variable with the aim of testing the hypothesis (Kothotari, 2002). Field studies were conducted in Papua Province. The unit of analysis in this study are related units in regionally owned enterprises in the West Papua and Papua regions. The time horizon of this study is a one shot or cross sectional study, namely research conducted with data that is only collected once during one period to answer research questions.

From Table 1 it can be seen that the highest average earnings management occurred in 1998, a year after the monetary crisis, which amounted to 14.80% of the total assets of an average of Rp1,551.42 billion, or amounting to Rp227.91 billion. The lowest average earnings management occurred in 2004 amounted to 7.58% and in 1999 amounted to 7.84%, in other years the level of earnings management averaged above 10%, namely in 2000 amounted to 12.68%, in 2002 amounted to 11.12%, and in 2003 amounted to 12.06% (earnings management data is available in Appendix 3). The company’s financial performance, namely return on assets (ROA), CFO and stock return (RET), presented in the following Table 2.

Table 2 shows the company’s financial performance, both the lowest ROA, CFO and RET occurred in 1998, namely ROA of -9%, CFO of 6%, and RET of -52%. In 1999 there was an improvement in the company’s financial performance, reported a positive average ROA of 5%, while the average CFO was 11% and RET an average of 64% was the highest performance during 1998 to 2004. But in the following years it happened again a decline in company performance, especially new stock prices recovered in 2004. (Data on financial performance of manufacturing companies studied is presented in Appendix 3). The study was conducted using pooled data for 93 state-owned enterprises for 7 years for the period 1998 - 2004, so the observation unit was 651 (or N = 651). The description of the research object, namely earnings management (DAC), corporate financial performance (CFO, ROA and RET) and corporate governance mechanisms (BDCOM, BDSIZE, TENURE, AUDCOM, BIG4, TENURE, MGR and INST) using pooled data are presented statistically descriptive in the following Table 3.

Testing the first hypothesis using simple regression analysis is briefly presented in the following Table 4.

Table 4 shows that earnings management (DAC) has a negative effect on all company financial performance, CFO with R square

**Table 1: Earnings management and total assets manufacturing companies in 1998-2004**

Year	Earnings management (%)			Earnings management (billion Rp)			Total assets (Billion. Rp)		
	Min.	Average	Max.	Min.	Average	Max.	Min.	Average	Max.
1998	0,54	63,23	14,80	0,33	3.103,59	227,91	29,55	29.168,15	1.551,42
1999	0,02	33,90	7,84	0,04	1.634,49	116,06	34,86	24.025,99	1.844,67
2000	0,22	60,31	12,68	0,97	5.412,21	200,28	34,31	22.203,52	1.814,85
2001	0,16	98,97	9,96	0,18	2.315,07	156,67	38,16	26.862,74	2.065,26
2002	0,10	83,98	11,12	0,46	4.036,76	183,93	39,26	26.573,55	2.102,92
2003	0,10	214,63	12,06	1,58	1.319,10	158,61	33,40	26.185,61	2.059,64
2004	0,16	66,29	7,58	0,60	2.629,72	120,78	34,16	27.404,31	1.923,56

Source: Results of data processing

**Table 2: Corporate financial performance: ROA, CFO, and RET manufacturing companies in 1998-2004**

Year	ROA			CFO			RET		
	Min.	Average	Max.	Min.	Average	Max.	Min.	Average	Max.
1998	-0,71	0,25	-0,09	-0,67	0,35	0,06	-0,92	0,75	-0,52
1999	-0,41	0,33	0,05	-0,34	0,52	0,11	-0,89	6,92	0,64
2000	-1,02	1,16	-0,05	-0,24	0,31	0,07	-0,72	1,66	0,16
2001	-0,61	1,49	0,01	-0,35	0,42	0,07	-0,91	1,25	-0,33
2002	-1,11	2,50	0,10	-0,87	0,37	0,06	-0,77	1,65	-0,07
2003	-0,55	4,68	0,08	-0,32	0,95	0,07	-0,74	2,22	0,05
2004	-1,44	0,40	0,004	-0,32	0,87	0,07	-0,78	1,92	0,32

Source: Results of data processing. ROA: Return on assets; CFO: Cash flow from operations; RET: Stock returns

0.015352, ROA with R square 0.000073 and RET with R square 0.000714. Based on the results of these tests, earnings management can explain variations in the company's cash flow (CFO) by 1.5%, while the ability of earnings management to explain ROA and RET is very small at 0.0073% and 0.0714%. Regression coefficient shows that earnings management influences CFO decrease by 14.50%, decreases ROA 1.69%, and decreases RET 15.66% testing the second hypothesis is done to find out how the influence of earnings management interaction with corporate governance mechanisms on the company's financial performance. Testing this hypothesis uses multiple regression analysis with interactive models, and the results of the analysis are summarized in the following Table 5.

**Table 3: Descriptive statistics of profit management, corporate financial performance and the governance mechanisms of manufacturing companies 1998-2004**

	Min.	Average	Max.	Standard deviation
DAC	0.0001	0.98392	0.09921	0.11122
CFO	-0.8715	0.94569	0.07426	0.13015
ROA	-1.4404	2.50294	0.01314	0.22019
RET	-0.9157	6.92477	0.03837	0.65165
Bdcom	0	0.75000	0.32636	0.16916
Bdsize	2	14	4	1.68234
Audcom	0*	1*	0.41475	0.49306
Big4	0*	1*	0.76805	0.42240
Tenure	1	16	8	4.39850
Mgr	0	0.44125	0.02392	0.05878
Inst	0.02764	0.97971	0.66614	0.19313

\*Data uses a dummy variable. ROA: Return on assets, CFO: Cash flow from operations, RET: Stock returns, DAC: Discretionary Accruals for companies

**Table 4: Results of analysis of the effect of profit management on company financial performance**

Variable dependent	CFO	ROA	RET
Variable independent	Koefisien	Koefisien	Koefisien
DAC	-0.144985	-0.016959	-0.156602
R Square	0.015352	0.000073	0.000714

ROA: Return on assets, CFO: Cash flow from operations, RET: Stock returns, DAC: Discretionary Accruals for companies

**Table 5: Results of the analysis of the effect of profit management interaction with governance mechanisms on corporate financial performance**

Dependent variable	CFO coefficient	ROA coefficient	RET coefficient
<b>Independent variable:</b>			
C	0.093166	0.007419	0.065018
DAC	-0.528566	-0.069755	-0.840865
DAC*Bdcom	-0.417161	0.714861	0.175711
DAC*SmallSize	-0.062537	-0.160108	-0.147771
DAC*BigSize	0.472151	0.076014	-0.918793
DAC*Audcom	-0.098283	0.103031	0.098044
DAC*Big4	0.107018	-0.981779	0.694821
DAC*ShortTen	0.498921	-0.125482	0.760320
DAC*LongTen	-0.286432	0.078124	-0.287033
DAC*Mgr	0.570221	1.348976	-1.478164
DAC*Inst	0.119720	1.159279	0.034335
R-squared	0.064994	0.088008	0.009611

Source: Data processed. DAC: Discretionary accruals for companies, ROA: Return on assets, CFO: Cash flow from operations, RET: Stock returns

The results of testing the hypothesis in Table 5 show that R-squared is not equal to zero, meaning that interaction of earnings management with corporate governance mechanisms (proportion of independent commissioners, number of board of commissioners, existence of audit committees, Big-4 Auditors, Tenure, managerial ownership and institutional ownership) influences the company's financial performance (CFO, ROAs and Stock Return). In other words, the mechanism of corporate governance influences the relationship between earnings management and the company's financial performance. Earnings management interactions with corporate governance mechanisms can explain changes in the company's financial performance, namely: cash flow from the company's operations (CFO) of 6.5%, the company's ability to generate profits (ROA) of 8.8%, and stock profits (RET) by 1%. The results of the partial analysis of the effect of earnings management interaction with the corporate governance mechanism on the company's financial performance are outlined as follows: Earnings management interactions with a tenure of 3 years or less have a positive effect on the CFO of 49.89% and RET 76.03%, but the negative effect on ROA is 12.55%. Earnings management interaction with tenure 9.

- ahun atau kurang berpengaruh positif terhadap ROA 7,82%, namun berpengaruh negatif terhadap CFO sebesar 28,64% an RET 28,70%
- The interaction of earnings management with managerial ownership has a positive effect on CFO of 57.02% and ROA of 134.90%, but a negative effect on RET is 147.82%.
- Earnings management interaction with institutional ownership has a positive effect on all financial performance, namely CFO 11.97%, ROA 115.93%, and RET of 3.43%.

The results of hypothesis testing show that earnings management has a negative effect on the company's financial performance Bonn et al. (2004), the negative influence reflects the opportunistic behavior of the company's management. Management seeks to cover the actual operating performance of the company in order to report better performance for its own sake and/or its company, but the company's financial performance shows a downward trend in the long run. The results of this study provide empirical evidence supporting the allegations of Bowen et al. (2004) which states that if managerial opportunism is a trigger for earnings management, it can be estimated that there is a negative relationship between earnings management and the company's financial performance. Regarding agency theory, opportunistic behavior that is not expected by parties related to contracts with companies is the result of unresolved agency problems. In this case, the agent acts in his own interests and deviates from the interests of the principal (Carcello and Nagy, 2004).

This study supports the view of earnings management in the perspective of managerial opportunistic behavior, and supports the results of research by Xie et al. (2003) who found a negative relationship of earnings management with the company's financial performance showed that the opportunistic behavior of managers in corporate financial reporting reduced the company's financial



performance (measured by book value of total assets, sales and market value of equity (Burgstahler and Dichev, 1997). This study does not support the results of the study of Bowen et al. (2004) which states earnings management in the perspective of efficient contracting and concludes that shareholders benefit from earnings management that can provide a signal about managerial competence or the company's financial performance in the future (Gabrielsen et al., 2002; Balatbat et al., 2004) The results showed that earnings management negatively affected the company's market performance (stock return), but the effect was very small (Belkaoui, 2004). This supports the efficient market hypothesis (also called the "no-effect hypothesis") in capital market theory which states that there are no changes in stock prices related to changes in accounting procedures. The results of Xie et al. (2003) showed a negative correlation between earnings management and company stock performance (measured by market value of equity) Bedard et al. (2004), and the results of research by Arya et al., (2003) which showed that earnings management had a negative effect on firm value (measured by stock market returns).

It can be seen that the average earnings management (DAC) is 9.92%. The amount of earnings management is higher when compared to the average earnings management from previous studies. The average earnings management in Agrawal and Knoeber (1996) study was 3%, in the study of Bowen et al. (2004) showed that the average earnings management was 5.8%, while in the study of Xie et al. (2003) earnings management average of 1.05%. The company's financial performance shows an average CFO of 7.43%, an average ROA of 1.31% and an average RET of 3.84%. The average financial performance in this study is lower when compared with the average financial performance in the study of Bowen et al. (2004), namely the average CFO of 11.3%, the average ROA of 16.8% and the average RET of 25.3%.

## 6. CONCLUSION

Earnings management has a negative effect on the company's financial performance, reflecting the opportunistic behavior of the company's management in financial reporting which influences the decline in the company's financial performance. Earnings management interaction with institutional ownership has a positive effect on the company's financial performance (CFO, ROA, and RET). These results indicate that institutional ownership can take its role as a large shareholder in controlling the management of the company, thereby reducing opportunistic managerial behavior in financial reporting and improving the company's financial performance.

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