Real Earnings Management, Firm Performance, and Corporate Governance Mechanism

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Abstract

The purpose of this study is to analyze the impact of real earnings management on firm performance and the impact of corporate governance as an intervening variable in the relationship between real earnings management and firm performance. The object are companies include in Corporate Governance Perception Index during 2015-2019 and listed in Indonesia Stock Exchange (IDX) and analyzed by using path analysis method.
Real earnings management has a significant effect on the firm performance. Furthermore, with corporate governance mechanism within the company, real earnings management significantly affect firm performance. This research is meaningful, but has limitations. The result cannot be generalizing because the sample only companies that listed in CGPI and IDX period 2015-2019. The research implication are as follows: top level management should be cautious about credit policy, cash flow from operation, discretionary expenditures, and production.
Earnings management is one of variable that the most prevalent in recent studies but the proxy for earnings management in the recent studies used discretionary accrual. In this research, real earnings management is used to indicate earnings management which measured by abnormal cash flow from operation. Thus, it may provide some contribution to the literature.

Keywords: corporate governance, firm performance, real earnings management

I. INTRODUCTION

According to the International Accounting Standards 1, the purpose of financial reports is to provide information about the financial position, financial performance, and cash flow of an entity which is useful for financial statements' users in making economic decisions. The financial statements must be prepared in accordance with the accounting standards and have been audited by auditor. This aims to maintain the quality of the financial statements, so that they can

provide an accurate representation of the company's financial performance, mainly profit information.

Profits are important because it describes the financial assurance and health of the company. Profits manifests how the corporation is financially advantageous and attaching amount to the shareholder's capital. Potential investors perform investment decisions based on the attractiveness of companies in different sectors for investment prospects and thus stock prices will increase. When earnings are a dominant symbol of the future of stock prices, companies attempt to reach forecast earnings from previous targets. Managers practice a type of legal and sometimes illegal tactics and methods to accomplish specific personal goals which commonly referred to earnings management [1].

[2] classified earnings management into 3 categories: fraudulent accounting, accrual earnings management, and real earnings management. Accrual earnings management is the managerial manipulation of earnings by using accounting estimates and methods, which has no direct impact on cash flows. Meanwhile real earnings management is the earnings manipulation through operational activities, which directly affects cash flows. Research by [3] showed that managers have switched from accrual-based earnings management to real earnings management after the Sarbanes-Oxley Act (SOX) period to avoid detection by auditors and regulators. [4] also provided empirical evidence that managers tend to engage in real earnings management activities compared to accrual earnings management because real earnings management activities are difficult to distinguish from normal business decisions and are more difficult to detect, even though the costs used in these activities are economically significant for the company. [3] and [5] argued that real earnings management was less attractive to auditors than accrual settings because real earnings management was a real decision about determining product prices and the amount of production which was not inevitably scope of auditors' examination. The existence of this real earnings management action will increase the company's profit so that it will also have an impact on improving the firm performance.

Corporate governance or often referred to as Good Corporate Governance is a system designed to direct corporate management in a professional manner based on the principles of transparency, accountability, responsibility, independence, fairness and equality. From economic crisis period (1997) until now, Indonesia authorities has improved corporate governance through organization and regulation. The milestones of corporate governance in Indonesia are (1) Establishment of the National Committee on Corporate Governance Policy (2) Law on Limited Liability Company (3) Good Corporate Governance Codes [6].

The implementation of Good Corporate Governance can affect firm performance and also be taken into consideration by investors in determining investment decisions on a company. This can be seen from the following survey results conducted by [7]:

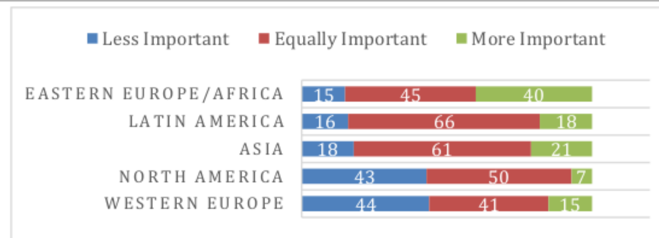

Figure 1. Investor's Perception: Importance of Corporate Governance in Investing Decision

Figure 1 concluded that the implementation of corporate governance is an important factor for investors in making investment decisions, especially in developing countries. In addition to increasing investor confidence, good corporate governance is also expected to control management policies, especially in controlling the company's earnings management practices. With the existence of good corporate governance, it is expected that the company will properly carry out real earnings management through policies taken to increase company profits.

The results of previous studies from [1], [8], [9], and [10] concluded that real activity earnings management positively impacts on firm performance. By contrast, real earnings management is more aggressive in company with less corporate governance [11]. [12] found that audit committees with high additional directorships are less effective in constraining real earnings management. The various results of previous studies encourage the authors to re-reveal the impact of real earnings management on firm performance with the Corporate Governance mechanism as an intervening variable.

II. LITERATURE REVIEW

1. Agency Theory

Agency theory describes the relationship between principal and agent. Agency theory helps to predict individual behavior when the principal delegates work to the agent, with the expectation that the agent will make decisions which are profitable for the principal [13].
Conflict between the principal and agent arises when the incentive structure imposes personal costs on the agent if he/she takes actions that maximize the principal's objective [14]. Furthermore, the agent has a lot of information about how the company is managed compared with the principal. The amount of information held by the agent can make it easier to perform actions that can lead to information asymmetry. Information asymmetry is a condition where not all information submitted to the principal or even different conditions reported with reality in the

field. Thus, information asymmetry may encourage agents or manager to perform earnings management [9]. Opportunistic managers can also disguise the company's financial statements, in which company's performance poor but report it as if the company has high performance [15].

2. Firm Performance

According to [16], firm performance is the company's ability to manage and control its resources. Firm performance measurement is a process that is done to increase business activities in order to achieve company's goals. In this study, firm performance is measured by using Return On Asset (ROA). ROA is a ratio used to measure company's ability to generate net income based on certain asset levels [17]. A high ROA level indicates the better the company's financial performance. Evaluation of firm performance is important because ([18]; [19]):

a) Help the company to assess whether it is receiving the expected contribution of employees and suppliers;
b) Help the company to assess whether each stakeholder group is supporting the company to achieve its main objectives;
c) Assist the company in building and implementing processes that contribute in achieving the strategic objectives;
d) Help the company to assess and monitor strategic planning in accordance with the agreements negotiated with key stakeholders.

3. Real Earnings Management

Earning management is a process of management intervention in external financial reporting by manipulating the available options so that the expected profit level is achieved [20]. Real earnings management can be defined as management actions that deviate from normal business practices with the main objective of achieving profit targets [3], [5]. Real earnings management that carried out by management shows a good short-term performance of the company but will potentially reduce firm value because the actions taken by managers to increase current year's earnings will have negative impact on the company's performance (earnings) in the next period [5]. To get optimal profit, management tends to use or choose accounting policies that can benefit them. Company management also often postpones real activities or important company plans in order to reduce costs in order to increase company profits. Earnings management is more often seen as an accrual engineering business, while real earnings management is more directed at the manipulation of real activities and is more difficult to find because it is carried out throughout the period [21].
Real earnings management can be done in 3 (three) ways [5]:

a. Sales manipulation

Sales manipulation is an attempt to temporarily increase sales within a certain period by offering excessive product price discounts or providing more lenient credit terms. This strategy can increase sales volume and profit for the current period, assuming positive margins. However, discounting rates and more lenient credit terms will reduce current cash flows.

b. Decrease in discretionary expenditures

Companies can reduce discretionary expenditures such as research and development expenses, advertising, and sales, administration, and general expenses, especially in periods where these expenses do not directly cause revenue and profit. This strategy can increase profit and cash flow for the current period but risky the future cash flow.

c. Overproduction

To increase profits, managers can produce more than necessary amount with the assumption that a higher level of production will lead to lower fixed costs per unit product. This strategy can reduce the cost of goods sold and increase operating profit.

4. Corporate Governance Mechanism

Corporate governance can be defined as a set of rules governing the relationship between shareholders (principal), company's management (agents), creditors, government, employees, and other internal and external stakeholders regarding their rights and obligations. Corporate governance is a system that regulate and control the company. The corporate governance mechanism in this study was measured using a Corporate Governance Perception Index (CGPI). CGPI is a research program and ranking of Good Corporate Governance (GCG) implementation in Indonesian companies through research design that encourages companies to improve the quality of the implementation of the concept of corporate governance through continuous improvement by carrying out evaluation and benchmarking.

The implementation of the Corporate Governance Perception Index (CGPI) is based on the importance of knowing the extent to which public companies have implemented Good Corporate Governance. CGPI is held annually, where it was first carried out in 2001. Corporate Governance Perception Index (CGPI) conducted by The Indonesian Institute for Corporate Governance (IICG). Companies listed in the Corporate Governance rating score are proven to have implemented good governance and directly increased the value of their shares. Since 2016, the aspects and assessment indicators in CGPI are as follows:

1. Governance Structure

The governance structure aspect is an assessment of the adequacy of the company's structure and infrastructure in managing change based on the principles of good corporate governance.

2. Governance Process

The governance process aspect is an assessment of the effectiveness of systems and mechanisms for managing change based on the principles of good corporate governance.

3. Governance Outcome

Aspects of governance results are an assessment of the quality of outputs, results, impacts and benefits of managing change based on the principles of good corporate governance.

The following is the assessment classification of the CGPI:

Table 1. CGPI Classification

Score	Category
55,00-69,99	Trustworthy enough
70,00-84,99	Trusted
85,00-100	Very trustworthy

5. Hypotheses and Research Framework

The hypotheses in this study can be formulated as follows:

Ha_1: Real earnings management affects firm performance

Ha_2: Real earnings management affects firm performance with a corporate governance mechanism

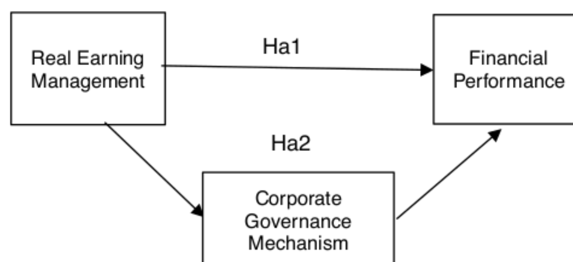

Figure 2. Research Framework

III. RESEARCH METHODS

This research uses quantitative analysis to prove the existence of a causal relationship between real earning management and firm performance with the corporate governance mechanism as an intervening variable. There are 3 variables involved in this research framework. The independent variables are real earning management. The intervening variable is corporate governance mechanism and the dependent variable is financial performance.

a) Firm Performance [17]

Firm performance (ROA) = Net Income / Average total assets

b) Real Earning Management

Real earnings management in this study measured as follows [5] :

1. Abnormal cash flows from operation

$$REM = CFO_t / TA_{t-1} - R_CFO_t$$

REM = Real Earnings Management

CFO_t = Cash flow from operation period t

TA_{t-1} = Total $asset_{t-1}$

R_CFO_t = Estimated cash flow from operation period t

$$CFO_t/TA_{t-1} = \alpha_0 + \alpha_1 (1/TA_{t-1}) + \beta_1 (\Delta Sales_t/TA_{t-1}) + \beta_2 ((\Delta Sales_t/TA_{t-1}) + e$$

CFO_t = Cash flow from operation period t

TA_{t-1} = Total $asset_{t-1}$

$\Delta Sales_t$ = Changes in sales

The operating cash flow estimates are obtained from:

$$R_CFO_t = \alpha_0 + \alpha_1 (1/TA_{t-1}) + \beta_1 (\Delta Sales_t/TA_{t-1}) + \beta_2 ((\Delta Sales_t/TA_{t-1}) + e$$

c) Corporate governance mechanism

Corporate governance mechanism variable is measured by Corporate Governance Perception Index (CGPI) score issued by The Indonesian Institute for Corporate Governance (IIGC).

The data used in this study are secondary data from the financial statements of companies listed on the IDX and CGPI during 2015 - 2019. Data obtained through www.idx.co.id and the IDX library. The population in this study were companies listed on the IDX period 2015-2019 and selected using purposive sampling method and the analytical method used is path analysis.

IV. FINDINGS AND RESULTS

To analyze the effect of real earnings management on the firm performance with the corporate governance mechanism, path analysis is used. Table 2 shows the hypothesis test results:

Table 2. Hypothesis Results

	REM ROA	REMGCG	REMGCGROA
R	0.59	0.932	0.619
Adjusted R Square	0.317	0.862	0.322

F	11.205	138.870	6.217
Sig. F	0.003	0.000	0.002
B_1	0.372	39.831	0.354
Sig. t_1	0.003	0.000	0.005
B_2	-	-	0.002
Sig. t_2	-	-	0.004

Based on table above, the test for the direct effect of real earnings management (REM) on firm performance (ROA) shows a beta value of 0.372 and significant at 0.003, which indicates that real earnings management has a significant direct effect on the firm performance. In the output of the second regression equation, the REM beta value shows a value of 39,831 and is significant at 0.000, while the beta value of corporate governance (GCG) shows a value of 0.002 and is significant at 0.004. These results indicate that real earnings management has significant effect on firm performance. In the output of the third regression equation, the REM beta value shows a value of 0.354.831 and is significant at 0.005, while the corporate governance (GCG) beta value shows a value of 0.002 and is significant at 0.004. The results of the path analysis indicate that real earnings management can have a direct effect on the company's firm performance and can also have an indirect effect on firm performance through corporate governance. The magnitude of the direct effect of real earnings management on firm performance is 0.372, while the magnitude of the indirect effect is 0.079662, so the total effect of real earnings management on firm performance is 0.451662. The magnitude of the influence of corporate governance mediation is 0.079662 and the standard error value of the indirect effect coefficient (Sp2p3) is 0.0399.

When compared with the Sobel test value, the t value is 1.99288. Because the value of t count is greater than t table (t = 1.96), it can be concluded that the mediation coefficient of 0.079662 is significant, which means that there is a mediation effect of corporate governance on the effect of real earnings management on firm performance.

V. DISCUSSION

From these results, it can be concluded that the management strategy by taking real earnings management actions is proven to improve the firm performance. Management actions that control company's cash flow and set the level of sales lead to an increase in the company's profits. From the data seen, the increase in real earnings management activities

caused the company's ROA to increase about 37.2%. Real earnings management actions that are estimated to be done by majority of sample companies are sales manipulation. This is supported by data that 75% of the sample data experienced a significant increase in sales, with an average of 11.7%.

Real earnings management activities also increase supervision carried out through Good Corporate Governance (GCG). The result above shows that the existence of real earning management triggers the implementation of Good Corporate Governance in the company to increase by 3983%. It proves that the principal (shareholders) certainly wants the agent (management) in managing the company to stick to the appropriate law and rules. The implementation of Good Corporate Governance is one of the ways for the principal to supervise agent so that not to take too much use of management discretion. The increase in GCG implementation is seen from the CGPI rating of sample companies that experienced an increase. A total of 64.28% of the sample experienced an increase in real earnings management followed by an increase in the value of its CGPI index.

The last results showed that the existence of real earning management increase the implementation of good corporate governance, and in the end it can still improve the firm performance. The firm performance increase by 35.4% due to real earnings management actions that are intervene by the implementation of GCG in the company. Those increase is smaller than the increase in company performance resulting from the direct influence of real earnings management which is 37.2%. This indicates that the implementation of GCG can reduce the effect of the company's real earnings management on the firm performance (down by 1.8%), nevertheless the company still experiences an increase in performance. These results provide positive support for the implementation of good corporate governance because it is proven to reduce management discretionary actions without adversely affecting the firm performance results. In the future, it is recommended that companies improve the implementation of good corporate governance because it can increase the transparency of financial reports.

VI. CONCLUSION

Based on the tests that have been carried out, the conclusions can be obtained:

a) Real earnings management has a significant effect on the firm performance. This result supports studies conduct by [1], [8], [9], and [10].
b) Real earnings management has a significant effect on the firm performance with a corporate governance mechanism. Real earnings management triggered the

implementation of corporate governance in the company and indirectly improved the firm performance.

This research has limitation. The result cannot be generalizing because the sample only companies that listed in CGPI and IDX period 2015-2019. Future research should compare between the impact of real earnings management measured by abnormal cash flows from operation and the impact of earnings management measured by discretionary accruals towards firm performance.

VII. ACKNOWLEDGEMENT

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