Histori Publikasi

Paper ini sebelum diproses submit ke Australasian Accounting, Business and Finance Journal terlebih dahulu diikutkan prereview di **EDITAGE** dengan histori seperti berikut:

Histori Prereview:

1. Hasil Prereview_1 Tanggal 11 Januari 2018
2. Hasil Prereview_2 Tanggal 24 Mei 2018
3. Hasil Prereview_3 Tanggal 25 Juni 2018

Histori Publikasi

4. Pembuatan Akun di Jurnal: 11 Juli 2018
5. Submit ke jurnal: 13 Juli 2018
6. Balasan Editor (Hasil Review): 12 Agustus 2021
7. Submit Revisi: 2 April 2022
8. Balasan Editor (Paper diterima): 11 Oktober 2022
9. Balasan Editor (Paper Published): 29 Oktober 2022

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Fahmi Rizani <dr.fahmi.rizani@gmail.com>

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noreply@bepress.com <noreply@bepress.com> Wed, Jul 11, 2018 at 6:57 PM
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Cc: The Authors <authors-aabfj-1861@ro.uow.edu.au>, The Editors <editors-aabfj-1861@ro.uow.edu.au>

A new submission for Australasian Accounting, Business and Finance Journal has been uploaded by "Fahmi Rizani" <dr.fahmi.rizani@gmail.com>.

The authors are:
"Fahmi Rizani" <dr.fahmi.rizani@gmail.com>
"Akhmad Yafiz Syam" <yafiz@stiei-kayutangi-bjm.ac.id>
"Lisandri ." <lisandri@stiei-kayutangi-bjm.ac.id>
The title is:
"Mediating Effect of Earnings Management on Financial Performance: The Importance of Good Corporate Governance"

The keywords are:
corporate governance, corporate financial performance, earnings management, institutional ownership, managerial ownership, Indonesia

The submission has been assigned #1861. Please refer to this number in any correspondence related to the submission.

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Australasian Accounting, Business and Finance Journal

Fahmi Rizani <dr.fahmi.rizani@gmail.com> Tue, Jul 24, 2018 at 2:09 PM
To: fahmirizani@yahoo.com

[Quoted text hidden]

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Gmail Fahmi Rizani <dr.fahmi.rizani@gmail.com>

MS #1861: Update submitted for "Mediating Effect of Earnings Management on Financial Performance: The Importance of Good Corporate Governance"

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The changes made are:

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"Fahmi Rizani" <dr.fahmi.rizani@gmail.com>
"Akhmad Yafiz Syam" <yafiz@stiei-kayutangi-bjm.ac.id>
"Lisandri ." <lisandri@stiei-kayutangi-bjm.ac.id>

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MS #1861 - Australasian Accounting, Business and Finance Journal

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To: =?UTF-8?Q?=22Fahmi_Rizani=22?= <dr.fahmi.rizani@gmail.com>
Cc: The Authors <authors-aabfj-1861@rouow.bepress.com>

Dear Fahmi Rizani, Akhmad Yafiz Syam, and Lisandri .

"Mediating Effect of Earnings Management on Financial Performance: The Importance of Good Corporate Governance" has been accepted into Australasian Accounting, Business and Finance Journal subject to minor revisions. Your article has been scheduled to appear in AABFJ Volume 16, Issue 4 due for publication in August / September, 2022. Please add DOI numbers to your reference list (see instructions attached).

Please submit your revised manuscript addressing your reviewers' comments (linked below) by March, 2022 to csmark@uow.edu.au. Please also include in the email notes showing how you have considered the reviewers' comments.

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Fahmi Rizani <dr.fahmi.rizani@gmail.com> Sat, Apr 2, 2022 at 10:47 PM

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Cc: dr.fahmi.rizani@gmail.com

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Ciorstan Smark <editor-aabfj-1861-1961657@rouow.bepress.com> Tue, Oct 11, 2022 at 8:39 AM
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Cc: The Authors <authors-aabfj-1861@rouow.bepress.com>

Dear Fahmi Rizani, Akhmad Yafiz Syam, and Lisandri .

Your submission "Mediating Effect of Earnings Management on Financial Performance: The Importance of Good Corporate Governance" has been accepted into Australasian Accounting, Business and Finance Journal.

The August / September issue of AABFJ is running a bit late (health issues with my young daughter). I aim to have your proofs to you in the next ten days. We aim to go online on 31 October, 2022. My apologies for the delay.

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Thank you,

Ciorstan Smark
Editor

Australasian Accounting, Business and Finance Journal

View Review

Review by: Reviewer #1

Review date: Feb 3 2020 4:24 PM PST

The review:

This is an excellent article. It is well written and the original contributions well established. Does not seem to reference any articles of AABFJ, would be a good idea to do so as would make choice of journal clearer.

Has been added 2 (two) references published on AABFJ

Review by: Reviewer #2

Review date: Feb 3 2020 6:50 PM PST

The review:

The paper is relatively interesting and quite well written. There are a number of areas which the author(s) should consider addressing before the paper would be ready for publication.

* CG needs to be better defined 'control and monitoring' are not the only aspects of CG. It also includes direction - maybe look at some formal definitions (standards; industry bodies; Acts) to formulate a definition for the paper. Current definition/explanation in paper too vague.

has been added: "*…in Law no. 10 of 1998 concerning Banking, in general, provisions related to GCG have been regulated, including the governance structure, governance process, and governance outcome. In particular regarding governance outcomes, Bank Indonesia has also issued several regulations, including transparency regarding bank financial conditions and increasing the role of external auditors. Banks are required to disclose non-performing loans (NPLs), controlling shareholders and affiliates, and risk management practices in financial reporting….*"

"In implementing GCG in Indonesia, all stakeholders participate. The National Committee on Corporate Governance Policy, which was changed to the National Committee on Governance Policy in early 2005, issued GCG guidelines in March 2001. These guidelines were then followed by the issuance of the Indonesian Banking GCG Guidelines, Guidelines for audit committees, and guidelines for independent commissioners in 2004. All these publications are deemed necessary to provide a reference in implementing GCG."

* CG is seen only from a company perspective and its role in profit and earnings management - CG is also very important in not-for-profit orgs and government sector. Currently the paper has a heavy bias towards companies - needs to at least acknowledge different types of orgs use CG.

has been added:
"Stakeholders use earning as a key indicator for economic decision making. Indeed, they rely on it to make investment decisions; lenders rely on it to make credit decisions; the government, for calculating corporate income tax; and employees (labour organization), to ensure employee welfare."

* Profit and earnings used interchangeability - I don't think this is correct.

has been added: *"Profits and earnings are often used interchangeably, but they are different. Overall, these terms are primarily differentiated by the adjectives that precede them. For example, net earnings, or gross profit. The term earnings is most commonly used when discussing the bottom line of a company's income statement. The term profit is commonly associated with the three most important points on the income statement: gross profit, operating profit, and net profit. These items reflect a company's operational efficiency…."*

* The sentence "The implementation of sound CG principles (ie., decline in earnings management)" does not make sense. A decline in earnings management is not a sound CG principle. *The sentence "CG is a management control tool". CG is much more than just a tool - this could be better worded.

The error has been fixed.

* Figures 1 & 2 need to be explained and discussed in more detail - currently they seem to just be added to the paper with limited/no discussion.

has been added

* Why Indonesia? What is interesting/unique about Indonesia? Can the findings from Indonesia be extrapolated to other jurisdictions? This needs to be clarified - maybe the author(s) could present the paper as an Indonesian case?

has been added: "*This study illustrates empirical evidence in Indonesia, especially in the banking sector……"*

* Author(s) need to clarify management share ownership? Are shares allocated as part of salary or bonus? Is the management share ownership consistent across the banks? If not how may this impact the findings?

Added description, share as a bonus.

* Conclusion - author(s) mentions discretionary accruals - how can management manipulate these accruals? Is there any evidence this actually happened/happens? How does CG actually reduce this happening?

has been added

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Fahmi Rizani <dr.fahmi.rizani@gmail.com>

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bepress support 3363 <editor-aabfj-1861-2613922@rouow.bepress.com> Wed, Oct 26, 2022 at 7:06 AM
To: Fahmi Rizani <dr.fahmi.rizani@gmail.com>, Akhmad Yafiz Syam <yafiz@stiei-kayutangi-bjm.ac.id>, "Lisandri ." <lisandri@stiei-kayutangi-bjm.ac.id>

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The authors are:
"Fahmi Rizani" <dr.fahmi.rizani@gmail.com>
"Akhmad Yafiz Syam" <yafiz@stiei-kayutangi-bjm.ac.id>
"Lisandri ." <lisandri@stiei-kayutangi-bjm.ac.id>

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To: Fahmi Rizani <dr.fahmi.rizani@gmail.com>, Akhmad Yafiz Syam <yafiz@stiei-kayutangi-bjm.ac.id>, "Lisandri ." <lisandri@stiei-kayutangi-bjm.ac.id>
Cc: The Editors <editors-aabfj-1861@rouow.bepress.com>

Dear Fahmi Rizani, Akhmad Yafiz Syam, and L. Lisandri,

Your submission "Mediating Effect of Earnings Management on Financial Performance: The Importance of Good Corporate Governance" (MS #1861) has been published to Australasian Accounting, Business and Finance Journal.

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Australasian Accounting, Business and Finance Journal

Analysis of the Effect of Corporate Governance on Corporate Financial Performance with Earnings Management as an Intervening Variable

Fahmi Rizani
Universitas Lambung Mangkurat, Banjarmasin

Akhmad Yafiz Syam, Lisandri
STIE Indonesia, Banjarmasin

ABSTRACT

This research is intended to obtain empirical evidence of Corporate Governance influence proxies with managerial ownership and institutional ownership of Corporate Financial Performance through Earning Management. Using Path Analysis method to the banking data listed on IDX, this research proves Corporate Governance negatively affects earnings management, and earnings management has a negative effect on company's financial performance. This means that any increase in managerial ownership and institutional ownership leads to a decrease in earnings management. While the decline in earnings management can increase the company's financial performance. Between the direct and indirect influence of corporate governance on the financial performance of the firm, it is inferred that greater indirect influence, in the context of this research through earnings management as intervening variable.

Keywords : *corporate governance, corporate financial performance, earning management, good corporate governance, institutional ownership, managerial ownership.*

Commented [A1]: The title partially reflects the focus of the study and it can be reworded with a better way.

Please consider the following title: "The Effect of Corporate Governance on Financial Performance: The Mediating Role of Earnings Management".

Commented [A2]: Dear Author,

Thank you for providing us with the opportunity to review the manuscript. This study tries to test the effect of corporate governance on financial performance using the intervening role of earnings management. Based on our assessment we have added comments that, if addressed, will improve the overall quality of the manuscript.

Briefly, the main points are:

1. The manuscript should be restructured into sections. The author should redesign the manuscript as:
   -1. Introduction
   -2. Theoretical Framework and Hypotheses
   -3. Methodology
   -4. Data
   -5. Findings
   -6. Discussion and Policy Implications
   -7. Conclusion
2. Regression analysis indicates that the author uses OLS regression for mediating role. Author needs to use the correct methodology as per the suggestion in the methods section.
3. The results are written with item by item description in a very mechanical way. Once the author uses the correct method, the results and the discussion need to be revised with the suggestions below.
4. Most of the suggested references are from non-prestigious journals such as Jurnal Akuntansi Bisnis, Diponegoro Journal of Accounting, E-Journal Akuntansi, Journal of Modern Accounting and Auditing, Jurnal Akuntansi: Kajian Ilmiah Akuntansi, International Journal of Economics and Financial Issues, etc. The author needs to add references from prestigious publishers such as ScienceDirect, Taylor & Francis, Sage, Springer, etc.

Commented [A3]: We suggest revising this as "The aim of this study is to find the effect of corporate governance on bank performance with the mediating role of earning management for Indonesian banks".

Commented [A4]: We suggest revising the method as "structural equation modeling".

Commented [A5]: We suggest restructuring the abstract as:
- Firstly explaining the aim of study with a few sentences,
- Secondly, explaining the theoretical framework with a few sentences,
- Thirdly, explaining the data used in this study,
- Fourthly, explaining main findings,
- And lastly explaining the policy implications.

Commented [A6]: Please consider revising the results with structural equation modelling. Note that you also need to add a sentence for policy implication at the end of the abstract.

INTRODUCTION

Corporate governance is one of the management concepts in order to improve the performance of the company through the mechanism of control and monitoring management performance as well as ensuring corporate accountability to stakeholders. The implementation of Corporate Governance (CG) can be a strategic function in achieving Good Corporate Governance (GCG) that controls the behavior of today's business entities. GCG is expected to meet the demands of society and the international world, and create stakeholder value that is also a strategic requirement of the business world to survive in today's competitive environment. The present value of the company is determined by three aspects of management's economic, environmental and social performance. These three aspects are known as Triple Bottom Line (Halpern, et al., 2013).

Although environmental and social aspects are important, the main performance of the company is still measured by earning. Because earnings have a high relevance value for statistics related to stock price increases and declines, and can be used to predict future company performance. Stakeholders use the profit figure as the basis for economic decision making.

Shareholders use the profit figure to make an investment decision, the lender uses the profit figure as the basis for making the credit decision, the government uses the profit figure as the basis for calculating the corporate income tax, the employee uses the company's profit figure to ensure workers' welfare, and many other stakeholders using the rate of profit or income in the company. As a result, in accounting for its performance, management in its report remains focused on achieving profit under its operational control. In this case there is a conflict of interest between the stakeholders as principal and management as the agent against the measurement of corporate profits (Watts and Zimmerman, 1983) known as agency theory effects (Jensen and Meckling, 1976).

Problems will occur if profits as a company's performance measurement tool are reported asymmetrically, inconsistent with actual circumstances due to managers' behavior that opportunistically manipulates earnings reporting, so that stakeholders gain misleading information. This happens because of the conflict of interest of managers as agents, on the one hand and shareholders as principals on the different side of the company outcome.

The flexibility of generally accepted accounting principles in profit reporting methods allows managers to use accrual accounting as the subject of their managerial policies, by making earnings management. Earnings management is an attempt by managers to manipulate accounting information through the selection of accounting methods without conflicting with generally accepted accounting principles. The efforts of shareholders to prevent and control the possibility of conflict of interest as the effect of agency theory can lead to considerable agency cost (Jensen and Meckling, 1976). Agency cost is the burden issued by the principal to overcome or prevent the problem of manipulation practices (earnings management) undertaken by managers.

Commented [A7]: The author needs to link the short paragraphs and write the introduction section with 4-5 longer paragraphs.

According to Jensen and Meckling (1976) earnings management problems can be avoided or at least suppressed by self-control mechanisms through Corporate Governance to align differences in interests between owner and management by (1) managerial ownership; (2) institutional ownership of shares. Through corporate governance mechanisms with a significant amount of ownership can monitor the management of the impact of reducing the manager's motivation to earn earnings management (Fama, 1980). Agency costs are lower because there is a common interest between shareholders and management. Managerial ownership can reduce agency conflicts, because the actions of managers are in line with shareholder desires and provide managers with the opportunity to engage in shareholding to make managers more cautious because they will share the consequences of their decisions.

The implementation of the principles of Corporate Governance is expected to have a strong influence on the quality of corporate performance as reflected in the decline in earnings management. Some features of Corporate Governance may be motivated by an incentive-based managerial behavior model. In the agency model, differences in managerial and stakeholder interests cause managers to take costly action for shareholders. Contracts cannot block this activity if shareholders cannot observe managerial behavior directly, but ownership by managers can be used to encourage managers to act in the interests of shareholders (Bhagat and Bolton, 2008). In this setting, ownership can be used to induce the disclosure of a manager's personal information about his ability to generate cash flows, which cannot be directly observed by shareholders.

This study aims to examine the relationship between managerial ownership and institutional ownership of the entity's financial performance through earnings management. Much of the previous research has discussed many corporate governance mechanisms together with the proportion of independent board of commissioners, board of commissioners and audit committees and other variables with CSR, sustainability report, but still lack of research that links corporate governance mechanisms to corporate financial performance.

Suteja, et al. (2016) examined the effect of moderating earnings management on the relationship between CSR disclosures and bank profitability in Indonesia, the results of his research proved that CSR disclosure positively and significantly affected the profitability of the company. In contrast, earnings management has a negative and significant influence as a moderator variable on the relationship between CSR and corporate profitability. Prior, et al. (2008) examined panel samples from 593 multi-national corporations from 26 countries between 2002 and 2004, finding a positive impact of earnings management practices on CSR. In addition, many studies have shown that the combination of earnings management and CSR has a negative impact on financial performance, such as research: Septia and Rahmawati (2011); Anggit and Shodiq (2014); Johnson and Greening (1999); Khabibah, et al. (2013). But especially in Indonesia to the knowledge of the author is still not much research that connects the influence of Corporate Governance on corporate financial performance with earnings management as an intervening variable. The importance of this research is to remember the need to effectively reduce conflicts of interest and motivate managers to improve management performance and enhance corporate value through corporate financial performance. In addition, there are still many inconsistencies of previous research results between one with other research.

This study focuses on empirical proof of the implementation of Corporate Governance as a management control solution to overcome the tendency of earnings management action by managers, mainly due to agency theory factor. In this context, this study does not discuss the disclosure and reporting of certain components related to financial statements. The contribution of this research is to provide additional reference on how to overcome or suppress the occurrence of conflict of interest between the owner (principal) and manager (agent) which impact on company value or financial performance of company.

Commented [A8]: Before "Theoretical Framework and Hypotheses" section, we suggest adding a paragraph like: "The rest of this study is organized as follows. The next section explains theoretical framework and hypotheses. Third section explains the data……".

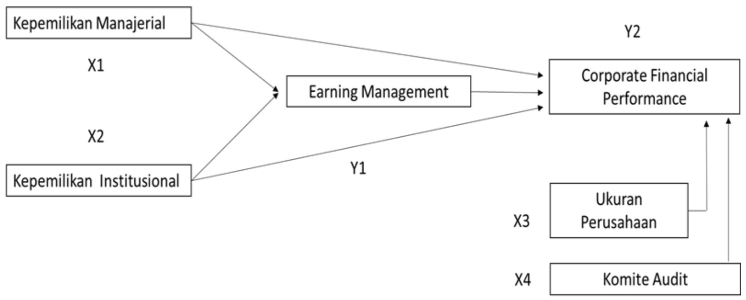
CONCEPTUAL FRAMEWORK AND HYPOTHESES DEVELOPMENT

Corporate governance proxies with managerial ownership and institutional ownership (Jensen and Meckling, 1976) can be the motivation of agents and principals to avoid agency conflicts, as they have a common interest in corporate performance. Managerial ownership incentives should reduce or minimize management's earnings management actions, as well as the ownership of institutions or investors directly involved in managing management, should be more effective in managing management to achieve maximum profit or financial performance goals. Based on this, the theoretical framework of this research can be described as follows:

Commented [A9]: The author missed important references on the effect of corporate governance and earnings management on firm performance as:
1. Siregar SV, Utama S. (2008). Type of earnings management and the effect of ownership structure, firm size, and corporate-governance practices: Evidence from Indonesia. International Journal of Accounting, 43(1), 1-27.
2. Cornett MM, Marcus AJ, Tehranian H. (2007). Corporate Governance and Pay-for-Performance: the Impact of Earnings Management" Journal of Corporate Finance, vol. 15 pp. 412-430.
3. Xie B, Davidson WN, DaDalt PJ. (2003). Earnings management and corporate governance: the role of the board and the audit committee. Journal of Corporate Finance, 9(3), 295-316.
4. Cornett MM, McNutt JJ, Tehranian H. (2009). Corporate governance and earnings management at large U.S. bank holding companies. Journal of Corporate Finance, 15(4), 412-430.
5. Garcia-Meca E, Sánchez-Ballesta JP. (2009). Corporate Governance and Earnings Management: A Meta-Analysis.Corporate Governance: An International Journal, 17(5), 594-610.
6. de Andres P, Vallelado E. (2008). Corporate governance in banking: The role of the board of directors. Journal of Banking & Finance, 32, 2570–2580.

Diagram 1. Conceptual framework

Commented [A10]: This path includes foreign words. These should be replaced with "managerial ownership", "institutional ownership", "Company Size" and "Audit Committee".



Agency Theory

The agency relations perspective is the foundation used to understand corporate governance within the context of this research. According to Jensen and Meckling (1976) agency relations is a contract between manager (agent) and investor (principal). According to Eisenhardt (1989) there are three assumptions of human nature in agency theory: (1) generally self-interested humans, (2) the limited human mindset of the bounded rationality, 3) human always avoid risk (risk averse). From the assumptions of human nature, it can be concluded that the conflicts of agency that occur between manager and shareholders arise because humans will act opportunistic, namely by prioritizing personal interests (Chung, et al., 2002)

The consequence of a conflict of interest between the owner and the agent for the company is the agency cost. According to Jensen and Meckling (1976) agency cost can be divided into three namely (1) monitoring cost; (2) bonding cost; (3) and residual cost. Monitoring cost is a burden that companies spend to observe, control, and limit the behavior of agents to not do activities that harm the principal. Bonding cost is the burden on the agent to establish and adhere to a mechanism that ensures that the agent acts in the interests of the principal. While the residual cost is the burden of the principal in the form of reduced principal prosperity due to differences in agency decisions and principal decisions. The way to minimize the burden of supervision by shareholders is to involve a third party in the supervision.

Commented [A11]: This sub-section seems to be not related with the topic this study. Therefore, please clarify why this is added here or consider excluding.

Earning Management

Watts and Zimmerman (1983) define earnings management as managers acting in the use of accounting policies in reporting accounting figures that are not in accordance with the actual conditions of the company, and causing the number of earnings misleading the stakeholders in economic decision-making. This can happen mainly because managers have more access to information and the ability and ease of selecting appropriate accounting methods but not deviating from generally accepted accounting principles. If the company cannot get the desired profit target then the management can use alternatives to modify reported earnings. Intentional actions within the limits of standards or rules, to lead to a desired level of reported earnings are called earning management (Assih, 1998).

The relationship between earnings management and agency theory has been investigated by Davidson et al. (2004) concludes that the separation between the principal and the agent in the company causes the information asymmetry, so the agent can act opportunistically because it has interests that are different from the principal. In this case, earnings management is the actions of managers who tend to defend their personal interests by issuing financial statements that do not present the actual corporate economic picture. As a consequence, shareholders can make the wrong decision.

Commented [A12]: Here the earning management is used as a mediator but hypotheses doesn't include this hypothesis (it should be the first hypothesis 1a). Please check and revise.

Managerial Ownership (KM) and Earning Management (EM)

Commented [A13]: Please remove all Indonesian abbreviations such as KM: Kepemilikan Manajerial.

Jensen and Meckling (1976) argue that managerial ownership can be a way of working that can reduce agency problems from managers by aligning the interests of managers and the interests of shareholders. If the manager owns shares in the company, it will have the same interests as the other shareholders. Thus, with the unity of interest, it is expected that agency conflicts can be reduced and managers will be motivated to improve the company's performance and shareholder wealth.

Mahariana and Ramantha (2014) found that managerial ownership proved to negatively affect earnings management, while Anggit and Shodiq (2014) proved that managerial ownership had no effect on earnings management. The Siregar (2017) study also found that managerial ownership has a significant effect on earnings management. This shows that empirically the effect of managerial ownership on earnings management still shows an inconsistent result.

Based on the above description, the proposed hypothesis is:

H1: Managerial ownership (KM) has a significant effect on earnings management.

Institutional Ownership (KI) and Earning Management (EM)

Institutions have a vested interest in investments including stock investments. So the institution usually assigns responsibility to a certain division to manage the company's investment. According to Chung, et al. (2002), using discretionary accounting accruals as a measure of earnings management, concluded that the presence of large institutional holdings discourages managers from increasing or decreasing reported earnings to levels that managers want. Institutional ownership allows the institution to professionally monitor its investment development, so the level of control over management actions is so high that the potential for fraud can be suppressed. Koh (2003), concludes that institutional investors can act as complementary corporate governance mechanisms in reducing aggressive earnings management by firms when they have high levels of ownership. Ajinkya, et al. (2005) concludes that institutional ownership has a relationship to earnings management measures. While other research, including: Andini and Sulistyanto (2011); Anggit and Shodiq (2014) concluded that institutional ownership had no effect on earnings management.

Based on the above description, the proposed hypothesis is:

H2: Institutional ownership (KI) has a significant effect on earnings management.

Commented [A14]: Please suggest specifying that these are hypotheses 2a and 2b and explain the hypotheses of ownerships on earnings management together.

Managerial Ownership and Corporate Financial Performance (CFP)

According to Jensen and Meckling (1976) conflict of interest managers with owners becomes increasingly large when the ownership of managers of companies is getting smaller, and vice versa. The greater the ownership of managers within a company, the more productive the manager actions in maximizing the value of the company - the financial performance (Corporate Financial Performance). Murwaningsari (2009) study proves managerial and institutional ownership has an influence on company performance.

Based on the above description, the proposed hypothesis is:

H3: Managerial ownership (KM) has a significant direct effect on company's financial performance (CFP).

Institutional Ownership and Company Financial Performance (CFP)

As noted earlier, Jensen and Meckling (1976) argue that institutional ownership has a very important role in minimizing agency conflicts between managers and shareholders. The existence of institutional investors can be an effective monitoring mechanism in every decision taken by managers. This is because institutional investors are involved in making strategic decisions so as to reduce earnings manipulation, which in turn improves the company's performance. The results of Mahariana and Ramantha (2014) studies suggest that institutional ownership affects the firm's value. While Putra and Fidiana (2017) stated that institutional ownership does not affect the value of the company. From the previous research proved inconsistent results. Therefore it is necessary to reexamine the fourth hypothesis of this study are:

H4: Institutional ownership (KI) has a direct significant effect on the Company's financial performance (CFP).

Commented [A15]: Please suggest specifying that these are hypotheses 3a and 3b and explain the hypotheses of direct effects on financial performance together.

The Effect of Managerial Ownership and Institutional Ownership on the Company's Financial Performance (CFP) through the Earning Management (EM)

Good Corporate Governance (GCG) has become a fundamental part of the behavior of today's business entities. In this context, GCG is a strategic function of corporate governance that is operationally proxies with managerial ownership and institutional ownership, is expected to meet the demands of stakeholders, in particular and create stakeholder value as an internal strategy to survive and continue to grow in a competitive environment. Corporate governance or in this context as ownership structure is thought to have an effect on CFP through earnings management. Profit management as a moderator variable has been widely studied, among others by Suteja, et al. (2016) which concluded that earnings management variables successfully moderate the influence of CSR disclosure on banking profitability. Similarly Septia and Rahmawati (2011) stated that profit management variables successfully moderate the influence of CSR on corporate value. But at least as far as the writer, especially in Indonesia is still rare research that puts earnings management as an intervening variable between CG influences on CFP. It is therefore necessary to propose the following hypotheses:

H5: Managerial ownership affects (KM) the Company's financial performance (CFP) through Earning Management (EM).

H6: Institutional ownership (KI) affects the Company's financial performance (CFP) through Earning Management (EM).

METHODS

Data Collection Technique

The data used for the development of this research model is secondary data from the annual report of banking companies listed on the Indonesia Stock Exchange (IDX) in 2010-2014. Samples are chosen by using purposive sampling with the following criteria: banking companies are listed on the IDX and consistently publish audited financial statements, presenting managerial and institutional ownership structures, and financial reports can be accessed through IDX Corner STIE Indonesia Banjarmasin. Based on these criteria, the total sample consists of 15 banking companies (Table 1).

Table 1 Sample Research

Description		Amount
Banking Companies Listed on BEI 2010-2014		30
Companies that not accordance with criteria:		
1. Inconsistent issuing of financial statements	7	
2. Not providing complete information on ownership structure, board of directors, and audit committee	8	
Issued from sample	15	
Total sample		15

Commented [A16]: Audit committee is also an indicator for corporate governance; therefore, please consider adding hypothesis 4 for this variable.

Commented [A17]: It seems that you have mixed literature review and hypotheses. We suggest moving all the explanation and definitions to the introduction section and keep only hypotheses-related explanations here.

Commented [A18]: This hypotheses should be moved to "earnings management" sub-section and should be shown as 1b and 1.c.

Commented [A19]: This heading should be revised as "Data"

Commented [A20]: The number of sample size is too small. Only nonparametric statistics can be used with a sample size of 15. Therefore, the author needs to add other banks by finding necessary information related with financial statement and corporate governance.

Note that if the author can find the data for other countries it would be much better to write a manuscript for the banks in the Asian region.

Commented [A21]: The authors use panel data from 2010 to 2014. Please explain how single bank level variable was calculated from panel data.

Commented [A22]: The authors need to add "descriptive statistics and correlation" table.

Variables and Measurements

1. Dependent variable

The Company's Financial Performance (CFP)

CFP is measured using CFROA (Cash Flow Return on Assets). CFROA is a cash flow derived from the results of operations whose funds have been received cash by the company and burdened with a burden that is cash and actually has been issued by the company.

$$\textbf{CFROA} = \frac{\textbf{EBIT + Dep}}{\boldsymbol{Assets}}$$

Notes :

CFROA = Cash flow return on assets

EBIT = Earnings before interest and taxes

Dep = Depreciation

Assets = Total assets

2. *Independent Variables*

1) Managerial ownership.

Managerial ownership is the number of shares held by management in a company. The proportion of managerial ownership is measured by the percentage of ownership. The formula is:

$$\textbf{Percentage of Managerial Ownership} = \frac{\textbf{Number of Management shares}}{\textbf{Number of shares outstanding}}$$

2) Institutional ownership.

Institutional ownership is the number of shares owned by an institution within a company. The Proportion of Institutional Ownership is measured by the percentage of ownership. The formula is:

Percentage of Institutional Ownership = (Number of Institutional Shares) / (Number of Shares Outstanding)

$$\textbf{Percentage of Institutional Ownership} = \frac{\textbf{Number of Institutional Shares}}{\textbf{Number of Shares Outstanding}}$$

Commented [A23]: Variables explanations should be written under the data section and the author needs to remove sub-headings as well as mechanical explanations.

3) Intervening Variable: Earning Management (EM)

Intervention variable used in this research is earnings management (EM). This study uses Jones' accrual model variables used Dechow, et al. (1996) in his research to detect EM. Modified Jones models estimate the accrual rate as a function of the difference between revenue changes and receivable changes and levels of property, plan, and equipment. The model is written as follows:

Commented [A24]: Dechow et al. (1996) uses change in current assets-change in current liabilities-change in cash/cash equivalents + change in debt included in current liabilities - depreciation and amortization expense. In this part it is not clear how you estimate earnings management and linked to Dechow et al. (1996).

a. Total Accruals actually:

TAC = NIit – CFit

Note:

Niit == net income of company i in period t

Cfit = cash flow of operation of company i in period t

b. The total accruals estimated by the OLS (Ordinary Least Square) regression equation are:

TACt / TAt-1 = (β) 1 (1 / TAt-1) + (β) 1 (Δ SALt / TAt-1) + (β) 3 (PPEt / TAt-1) + e

Note:

TACt = total accruals in period t

TAt-1 = total asset of period t-1

(Δ) SAL = change of income or net sales in period t

PPEt = property, plan, and equipment period t

(β) 1, (β) 2, (β) 3 = regression coefficient

c. Non-accrual discretionary

NDTACt = (β) 1 (1 / TAt-1) + (β) 2 [(Δ SALt - Δ RECt) / TAt-1] + (β) 3 (PPEt / TAt-1) + e

Information:

(Δ) RECt = change of accounts receivable in period t

(β) 1, (β) 2, (β) 3 = fitted coefficient obtained from the regression result on the accrual total calculation

d. Total accrual discretionary

DTACt = TACt / TAt-1-NDTACt

Information:
DTACt = total discretionary accrual year t
TACt = total accruals year t
NDTACt = non accrual discretionary in year t
3. Control Variables
This research model uses two control variables that impact on EM and CFP activities. The control variables used in this study consist of:

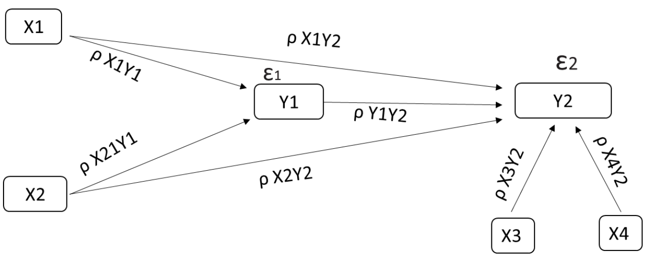
Company Size
According to Prior, et al. (2008) firm size is the size of a company that can be seen from the level of sales, the amount of equity, or the amount of assets owned by the company and its stock market capitalization. The size of the company shows some of the assets owned by the company. The size of the company in this study uses natural log proxy from total assets. Total assets are used as proxies with consideration of total assets of firms relatively more stable than total sales and market capitalization.

Audit Committee
The size of the audit committee is the total number of audit committee members in a single company. Based on Bapepam Letter no. SE-03 / PM / 2000 states that the audit committee of an Indonesian public company comprises at least three members and is chaired by an independent commissioner of the company with two independent external persons. The audit committees in this study, measured by dummy variables, of which 1 for firms with audit committees and 0 for firms with no audit committee.

Analysis Technique
Data analysis technique used in this research is Path Analysis by using Statistical Product and Service Solution (SPSS) V.22. Based on this path technique, the research model can be described in the following diagram.

Commented [A25]: Please move this section to the “Methodology” section. Note than in this section you need to explain structural equation modelling as well as the reason of using this method (to test the mediating role of earnings management).

Diagram 2. Development of Research Model



The path equations for this study are as follows:

$Y1 = \rho\ X1\ Y1 + \rho\ X2Y1 + \epsilon 1$ .... (Model 1)

$Y2 = \rho\ X1Y2 + \rho\ X2Y2 + \rho\ X3Y2 + \rho\ X4Y2 + \rho\ Y1Y2 + \epsilon 2$ .... (Model 2)

Information:
Y1 = EM (Earning Management)
Y2 = CFP (Corporate Financial Performance)
X1 = KM (Managerial Ownership)
X2 = KI (Institutional Ownership)
X3 = Size (Enterprise Size Control Variable)
X4 = KA (Audit Committee Audit Variables)
ρ = Path Coefficient
ε = Error Level

Commented [A26]: Please add explanation for the structural equation modelling.

RESULTS AND DISCUSSION

Commented [A27]: Please consider removing regression analysis and adding the results of structural equation modelling.
Please add Construct validity and Goodness-of-fit for this method.

Before the model is used, first classical assumption test is performed. In path analysis, there are four assumptions to be met, namely assumption of normality, multicollinearity, heteroscedasticity and autocorrelation. Test results show that all assumptions are met. Table 2 and Table 3 each present the conclusions of the test results (see appendix 1 and 2) of the first and second model statistics related to the hypotheses tested in this study.

Table. 2 Test of Regression Model 1 Result

Model		Coefficients (Path)	t	Sig.
1	KM (X1)	-,301	-4.516	,008
	KI (X2)	-,430	-3.478	,003
R2 = .478				
F Count = 15,231				
Sig. F = ,000[a]				

Source: Data Processed, SPSSV.22

Regression Model Analysis 1

The results of the first model test show that simultaneously Manager Ownership (KM) and Institutional Ownership (KI) have a significant effect on earnings management (EM) with significance below 0.05 (p = 0,000), and R2 value coefficient of 47.8 or rounded to 48 percent, which means that earnings management is influenced by the observed variables. The remaining 52 percent is explained by other factors outside the model. Based on the path coefficient value, ρ Y1 X1 = 0.301 or 30 percent; and ρ Y1 X2 = 0,430, and significant with sig <0,008 at path X1, sig <0,003 at path X2. This explains that simultaneously and partially Managerial Ownership (X1) and Institutional Ownership (X2) can be an influential variable on earnings management. Furthermore, the empirical causal influence between the variables (X1) and (X2) can be described by sub-structural equations 1 (first):

Y1 = ρ Y1 X1 + ρ Y1 X2 + ρ Y1€1, or Y1 = 0,301 X1 + 0,430 X2 + 0,722 €1.

Table. 3 Test Regression Model 2 Result

Model		Coefficients	t	Sig.
1	(Constant)	16,780	,591	,002
	KM	,401	1,220	.003
	KI	,550	3,137	.104
	EM	-,372	-,215	.000
	Size	1,040	7,831	.256
	KA	-,004	-,249	.123
R2 = ,536				
F Count = 19,003				
Sig. F = ,000[b]				

Source: Data Processed, SPSSV.22

Regression Model Analysis 2

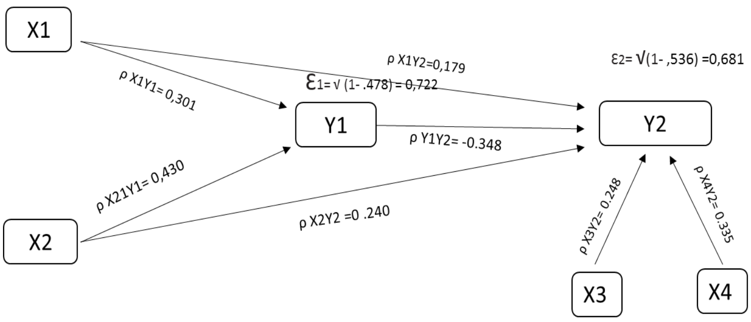
The results of the second model test show that simultaneously Managerial Ownership (KM), Institutional Ownership (KI), Earning Management (EM), Size Control Variables, Control Audit Committee Variable (KA)) with significance below 0.05 (p = 0,000), and the R2 value coefficient of 53.6 or rounded to 54 percent, which means that the company's financial performance (CFP) is influenced by the observed variables. The remaining 46 percent is explained by other factors outside the model. While partially, based on the coefficient value, can be explained on the two structural equations below. Based on the 0.05 significance, the KI, SIZE and KA variables are not significantly influenced on the company's financial performance (CFP). Partially, only KM and EM have a significant effect on CFP. Furthermore, the empirical causal influence between these variables can be illustrated by the following two sub-structural equations:

Y2 = ρ Y2 X1 + ρ Y2 X2 + ρ Y2 Y1 + ρ Y2 X3 + ρ Y2 X4 + €2, or

Y2 = 0.179 X1 + 0.240X2 + (-0.348) Y1 + 0.248X3 + 0.335X4 + 0.681 €2.

Based on the results of the analysis and the above equation, it can be obtained diagram of the following research model :

Diagram 3: Model Research Results Diagram



RESULTS AND DISCUSSION

Commented [A28]: Discussion and policy implications section should not be written separately for each of the items. The author should write this section with continuous paragraphs, preferably 3 to 4 long paragraphs. In this section the author should discussion the findings with the previous literature, should explain policy implications, and should explain limitations.

1. Managerial Ownership (KM) has a significant effect on EM (Earning Management).

Based on significance test, KM has significant effect on EM, with significance P = 0,008 <0,05. The magnitude of KM effect on EM is equal to - 0.301 or rounded to -30 percent. The coefficient of X1 line is marked negative, which means that the increase in KM can affect the decrease of EM by 30 percent. Thus, the hypothesis H1: KM (Managerial Ownership) has a significant effect on EM (Earning Management) is accepted. The results of this study do not confirm the results of research Anggit and Shodiq (2014) who reject the hypothesis of managerial ownership effect on earnings management. This research is in line with research done by Mahariana and Ramantha (2014) which proves that managerial ownership proved to negatively affect earnings management. Research Anggit and Shodiq (2014) and Mahariana and Ramantha (2014) conducted on manufacturing companies listed on the Stock Exchange. While the research was conducted on banking companies listed on the IDX.

2. Institutional ownership (KI) has a significant effect on EM (Earning Management).

KI has a significant effect on EM with significance P = 0.003 <0.05 the magnitude of KI direct effect to EM is -0.430 or rounded to -43 percent. The coefficient of path X2 is also marked negative which means that the increase in KI can affect the decrease of EM by 43 percent. Thus this study confirmed the hypothesis H2: KI (Institutional Ownership) have a significant effect on EM (Earning Management). These results support the research of Chung et al. (2002); Ajinkya, et al. (2005). However, this study is not in line with Mahariana and Ramantha (2014) and Anggit and Shodiq (2014) studies.

3. Managerial Ownership (KM) has a direct significant effect on the company's financial performance (CFP).

Based on KM significance test significantly influenced CFP with significance P = 0,003 <0,05. The magnitude of KM direct effect on CFP is 0,179 or rounded to 18 percent. The coefficient of X1 line is marked positive, which means that the increase in KM is able to affect the 18 percent increase in CFP. Based on this analysis, the hypothesis H3: KM (Managerial Ownership) has a direct significant effect on Company's financial performance (CFP) is acceptable. This result is in line with Murwaningsari (2009); which shows Good Corporate Governance that managerial and institutional ownership have influence to company performance (as measured by TOBINS'Q).

4. Institutional ownership (KI) has a direct significant effect on the company's financial performance (CFP).

Based on the significance test, KI did not significantly affect the CFP, because the significance of P = 0,104> 0,05. Thus the hypothesis H4: KI (Institutional Ownership) has a significant direct effect on the company's financial performance (CFP) is rejected. This is not in line with Chung's research, et al. (2002); Murwaningsari (2009);

5. Effect of Enterprise Size Control (SIZE) and the Audit Committee on Company's financial performance (CFP).

In this study there are two control variables, namely Company Size (SIZE) and Audit Committee. Based on the results of data and analysis, it is known that these two control variables have no significant effect on the company's financial performance, with respective significance above 0.05, ie P = 0.256 and P = 0.123.

6. Indirect influence of Managerial Ownership (KM) and Institutional Ownership (KI) on Company's financial performance (CFP).

The direct effect of KM on EM is 0.179. While the indirect effect of KM to CFP, that is through .EM = 0,301 X -0.348 = 0,104. Thus the total path coefficient between KM (X1) to CFP (Y2) is 0.179 + 0.104 = 0.283. Thus, the effect of KM on CFP through EM is 0.283 or 28 percent, it can be concluded that the indirect effect (28 percent) is greater than the direct effect (18 percent). Thus, hypothesis H5: Managerial ownership affects the Company's financial performance (CFP) through Profit Management. This is in line with the study (Chung et al., 2002).

The direct effect of KI on EM is 0.240. While the indirect effect of KI to CFP, ie through .EM = -0.430 X -0.348 = 0.149. So the total path coefficient between KI (X2) to CFP (Y2) is 0.240 + 0.149 = 0.389. Thus, the effect of KM on CFP through EM is 0.389 or 39 percent, it can be concluded that the indirect effect (39 percent) is greater than the direct effect (24 percent). In conclusion, hypothesis H6: Institutional ownership affects the Company's financial performance (CFP) through profit management is acceptable. The results of this study also confirmed the study (Chung, et al., 2002).

Monks and Minow, 1995 in Chung, et al. (2002) concludes that the ability of managers to opportunistly earn earnings management is limited by the effectiveness of external monitoring by institutional stakeholders, or by other titles, institutional investors. Institutional investors have the opportunity, resources, and ability to monitor and influence managers. The more the number of stock ownership, the less marketable and usually persist for longer periods of time. In this situation, institutional investors have greater opportunities to gather information, monitor management actions, and promote better performance. McConnell and Servaes

(1990) also reported a statistically significant relationship between firm value (as measured by Tobin's Q) and the percentage of institutional investor stock ownership.

Conclusion

In some circumstances, managers have an incentive to change reported gains from what should happen, using discretionary accruals. This profit management action benefits managers with little or no (or even negative) benefits to shareholders. Managerial share ownership, through bonuses, can reduce the motivation of managers to earnings management, because they have an interest in the investment they have. The greater the managerial ownership, the more reduction the impetus of opportunistic actions managers make earnings management. Similarly, institutional ownership roles, or in other words, institutional investors with significant investment in the firm will monitor accounting choices that will be made by managers, and can force change if it is believed that managers are making opportunistic earnings management.

The results of this study provide empirical evidence: First, managers who have a tendency to make earnings management using discretionary accruals for their benefit. Secondly, managers who have shares (managerial ownership) are motivated to avoid or reduce the effects of agency theory so as to seek to improve their performance without performing earnings management. Third, institutional investors (institutional ownership) with significant shareholding can hamper managers to use opportunistic discretionary accruals.

This finding implies that corporate governance proxies with managerial ownership and institutional ownership is quite effective in monitoring and limiting managerial opportunistic behavior. In other words, managerial ownership and institutional ownership become a strategic part of achieving good corporate governance (CGC).

There are some limitations in the study among others: (1) The number of samples is relatively small, i.e. only 15 banking companies; (2) data taken from 2010-2014, as it concerns the availability and completeness of published corporate financial statement data; (2) the research sample covers only the banking company, so it cannot be generalized as a general business portrait; (3) the interpretation of the results of this study is not supported by personal experience of corporate managers, as it only uses secondary data.

Suggestion

For further research, it is advisable to conduct a similar study using the longer observation period and the year closest to the current year. It should also be considered to use a sample of companies other than banks, which are also listed on the Indonesia Stock Exchange, and add qualitative reviews through personal experience of corporate managers, so that the conclusions of the research will be more comprehensive.

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Commented [A30]: This part should be moved to the discussion section.

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Commented [A31]: Please consider adding the references suggested earlier.

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Appendix 1 :

Regression Model Results 1

Variables Entered/Removed [b]

Model	Variables Entered	Variables Removed	Method
1	X2, X1[a]	.	Enter

a. All requested variables entered.
b. Dependent Variable: Y1

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.659[a]	.478	.465	4.78663

a. Predictors: (Constant), X2, X1

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1662.977	2	811.488	15,231	.000[a]
	Residual	1741.732	73	22.848		
	Total	3404.709	75			

a. Predictors: (Constant), X2, X1
b. Dependent Variable: Y1

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	11.223	5.317		1.613	.182
	X1	-.441	.094	-.301	-4.516	.008
	X2	-.360	.103	-.430	-2.777	.003

a.Dependent Variable : Y1

Appendix 2 :

Regression Model Results 2

Variables Entered/Removed[B]

Model	Variables Entered	Variables Removed	Method
1	Y1,X4, X3, X2, X1[a]	.	Enter

a. All requested variables entered.

b. Dependent Variable: Y2

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.649[a]	.536	.626	3.24409

a. Predictors: (Constant), Y1,X4, X3, X2, X1

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	2249.456	5	656.492	70.257	.000[a]
	Residual	911.461	70	10.153		
	Total	3260.917	75			

a. Predictors: (Constant), Y1, ,X4, X3, X2, X1

b. Dependent Variable: Y2

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.642	4.268		-.071	.944
	X1	.212	.068	.179	2.177	.003
	X2	.225	.082	.240	2.777	.104
	Y1	-.554	.084	-.348	-4.676	.000
	X3	.220	.124	.248	1.767	.256
	X4	.264	.106	.335	3.336	.123

a.Dependent Variable : Y2

The Mediation of Earnings Management on Financial Performance

ABSTRACT

Purpose: This study investigates the effect of corporate governance on corporate financial performance by taking into account the mediation of earnings management.

Design: Using structural equation modeling and a sample of listed banks in Indonesia, observed between 2010 and 2015, this research proves that good corporate governance has a significant effect on earnings management, and in turn, earnings management has an adverse impact on a company's financial performance.

Findings: An increase in managerial ownership and institutional ownership leads to a decrease in earnings management, which can improve the company's financial performance.

Originality: This research shows that, by applying good corporate governance mechanisms, a company can minimize earnings manipulation by managers, and obtain reliable company performance valuations.

Keywords: corporate governance, corporate financial performance, earnings management, institutional ownership, managerial ownership, Indonesia

Article classification: Research paper

Introduction

Corporate governance (CG) is a management concept that refers to all mechanisms for controlling and monitoring management performance, as well as ensuring corporate accountability to stakeholders. The implementation of CG mechanisms is strategically important to achieve good CG (GCG), which controls the performance of business entities. GCG is expected to meet the demands of national and international stakeholders, creating value in order to survive the increasing competition essential in the business world. Corporate and stakeholder values are determined by the management's economic, environmental, and social performance. These three aspects are known as the *Triple Bottom Line* (Halpern *et al*., 2013).

While environmental and social aspects are important aspects of measuring the company's current performance, the firm's core value is still measured by financial performance, which is closely linked to the rise and declines in stock prices, and is also easier to use in order to predict future company performance.

Stakeholders use profit as the key indicator for economic decision making. In fact, they rely on it to make investment decisions; lenders rely on it for taking credit decisions; the government, for calculating the corporate income tax; and employees, to ensure employee welfare. As a result, the management focuses on achieving profit as a key indicator of its performance. Therefore, a conflict of interest arises between the stakeholders (the principal) and the management (the agent) regarding the measurement of corporate profits (Watts and Zimmerman, 1983), which is known as agency theory effect (Jensen and Meckling, 1976).

Issues may arise when the earnings of a company are reported asymmetrically (Brealey *et al*., 1977) and utilized as a performance measurement tool. The management has incentives to manipulate the reporting of earnings, providing stakeholders with misleading information as a result of the conflict of interest and

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agency problem that affect the relationship between a company's management and stakeholders. The flexibility of generally accepted accounting principles in profit reporting allows managers to use accrual accounting as the subject of their managerial policies. The accounting literature documents that these factors have a major impact on earnings management, while the financial literature suggests that they also affect financial performance (Cornett *et al*., 2008).

Several studies have examined and proved the relationship between CG mechanisms and earnings management by corporate managers (Ajinkya *et al*., 2005; Cornett *et al*., 2008; Davidson *et al*., 2004; Iraya *et al*., 2015, Koh, 2003; Siregar and Utama, 2008; Xie *et al*., 2003).

By applying CG mechanisms, a company can minimize the manipulation of earnings by managers, and ensure that the reported performance can describe the actual economic situation of the company. The implementation of sound CG principles has a substantial impact on the quality of financial statements as reflected by the decline of earnings management.

The purpose of this study is to investigate the relationship between CG and the financial performance of a company by assessing the role of earnings management. The focus is on empirically proving the application of CG as a management control solution to overcome the tendency toward earnings management actions by managers. This research contributes to the literature by providing evidence on how to overcome the conflict of interest between the owners (principal) and the managers (agent), which affects the value and financial performance of the company. The findings recognize the need to effectively reduce conflicts of interest, and motivate managers to improve their performance and enhance corporate value through corporate financial performance.

The remainder of the paper is organized as follows. Section 2 introduces the theoretical framework and research hypotheses, section 3 outlines the methodology, section 4 describes the data and empirical results, and section 5 provides our concluding remarks.

Theoretical framework and research hypotheses

Jensen and Meckling (1976) suggested that earnings management problems can be avoided or solved by a self-control mechanisms based on CG to align the differences in interests between the owners and the management, namely: (1) by the ownership of the company's shares by the management (managerial ownership), and (2) by the institutional ownership of shares.

CG has a recognized impact on the company's performance. Cornett, McNutt, *et al*. (2009) examined whether CG mechanisms affect earnings management and financial performance at the largest holding companies of US public banks. The results of this research show that CG mechanisms, board independence, and capital are positively associated with earnings, which in turn, are negatively related to earnings management. Bhagat and Bolton (2008) concluded that better governance positively and significantly correlates with more current and future operating performance. The accounting literature documents that these factors have a significant impact on earnings management, while the financial literature suggests that they also affect a company's financial performance (Cornett *et al*. 2008). In this study, CG is proxied by the managerial and the institutional ownership. Based on the theoretical framework described above, the approach of this research can be described as follows (see Figure 1):

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Figure 1. Theoretical framework

CG and corporate financial performance

The greater the ownership of managers within a company, the more the management is expected to maximize the company's value and financial performance (Brealey *et al*., 1977; Cornett *et al*., 2008, Cornett, McNutt, *et al.* 2009; Jensen and Meckling, 1976; McConnell and Servaes, 1990) in order to prove that CG mechanisms have an impact on a company's performance. Jensen and Meckling (1976) argued that institutional ownership has an essential role in minimizing agency conflicts between managers and shareholders. The existence of institutional investors can be an effective monitoring mechanism in every decision taken by managers. McConnell and Servaes (1990) also reported statistically significant relationships between corporate values and the share ownership of institutional investors. This is because institutional investors are involved in making strategic decisions to reduce earnings manipulation, which in turn, improves the company's performance. Siregar and Utama (2008) found inconsistent evidence regarding the impact of institutional ownership, size of the company, and the practice of CG on profit management. A good accountant or financial economist devotes considerable attention to the impact of the structure of CG and compensation scheme on the company's behavior (Cornett *et al*. 2008).

Based on this description, two hypotheses are proposed:

H1a: Managerial ownership has a significant impact on corporate financial performance.

H1b: Institutional ownership has a significant effect on corporate financial performance.

CG and earnings management

The agency relations perspective is used to address CG in this research. According to Jensen and Meckling (1976), an agency relationship is a contract between the manager (agent) and the investor (*principal*). Eisenhardt (1989) identified three assumptions regarding human nature in the agency theory, namely: (1) human selfishness (*self-interest*), (2) the limited power of thought that humans have about future perceptions (*bounded rationality*), and (3) humans always avoid risk (*risk averse*). These assumptions suggest that agency problems arise between managers and shareholders because humans act opportunistically by prioritizing personal interests. Institutional ownership allows institutions to professionally monitor their investment, and the level of control over management actions is so high that the potential for fraud can be suppressed (Ajinkya *et al*., 2005. Cornett *et al*., 2008; Chung *et al*., 2002; Koh, 2003).

tested CG mechanisms that affect earnings and profit management at the largest public holding company in the US. They concluded that adjusting the impact of earnings management substantially increases the importance of CG variables and reduces the effect of incentive-based compensation on corporate performance.

Further, Abed *et al*. (2012) confirmed the existence of a significant relationship between CG mechanisms and earnings management. Based on the previous research, the following hypotheses are proposed:

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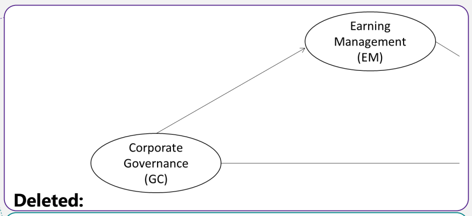

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H_{2a}: Managerial ownership has a significant effect on earnings management.

H_{2b}: Institutional ownership has a significant impact on earnings management.

The mediating role of earnings management

According to Jensen and Meckling (1976), agency costs can be divided into three categories, namely: (1) *monitoring cost*; (2) *bonding cost*; (3) *residual cost*. Monitoring cost is a cost incurred by the company to observe, control, and limit the behavior of agents that could harm the principal. Bonding cost is the cost faced by an agent to conform to the interests of the principal, while the residual cost is the cost incurred by the principal in the form of reduced prosperity because of differences in agent decisions and principal decisions. Agency costs will impose a burden on the earnings of the company; the higher the agency cost, the most significant the reduction of corporate profits. In addition to imposing agency costs to the company, earnings management can also reduce the value of the firm because of the opportunistic behavior of managers (Balsam, 2002). The way to minimize the supervisory costs borne by shareholders relies on managerial ownership and institutional ownership (Jensen and Meckling, 1976). Several studies have examined the relationship between earnings management and the information content of earnings, and found mixed results. Warfield *et al*. (1995) found evidence that earnings management leads to a less informed earnings report. Abed *et al*. (2012) supported the application of the principles of CG to control the behavior of the board of directors, which may cause distortions in the annual financial statements. These findings suggest that the reliability and transparency of financial reports can be improved. Based on the above description, the following hypotheses are proposed:

H_{3a}: Managerial ownership affects corporate financial performance through earnings management.

H_{3b}: Institutional ownership affects corporate financial performance through earnings management.

Methods

Research setting and sample

To examine the above-mentioned hypotheses, a structural equation modeling and partial least squares (PLS) approach were employed to deal simultaneously with multiple dependent and independent variables. In addition, PLS can handle relatively small sample sizes and multicollinearity among independent variables; it does not require a normal distribution assumption (Kock, 2011; Hair Jr. *et al*., 2014). In this study, we used the Warp–PLS version 06.00 software.

This paper uses secondary data from the annual report of banking companies listed on the Indonesia Stock Exchange (IDX) in 2010–2015. The sample is built by using purposive sampling with the following criteria: banking companies are listed on the IDX, and consistently publish audited financial statements; and present managerial and institutional ownership structures and their financial statements can be accessed through IDX Corner STIE Indonesia Banjarmasin. Based on these criteria, the final sample comprises 20 banks, and the number of observed data panels is 6*20 = 120.

Variables and measurements

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This section clarifies how the research variables are measured, given the theoretical framework and hypothesis formulation mentioned above.

Corporate financial performance (CFP)

CFP is measured using *cash flow return on assets* (CFROA), a measure derived from the results of operations whose funds have been received by the company in cash, with the burden that the contribution is cash and has been issued by the company. The CFROA can be expressed as:

$$\text{CFROA} = \frac{\text{EBIT} + \text{Dep}}{Assets},$$

where:

CFROA = cash flow return on assets;
EBIT = earnings before interest and taxes;
Dep = depreciation; and
Assets = total assets.

Managerial ownership

Managerial ownership is linked to the number of shares owned by the management in a company, and can be expressed as follows:

$$\text{Managerial ownership percentage} = \frac{\text{The number of shares of the manager}}{\text{The number of outstanding shares}}.$$

Institutional ownership

Institutional ownership is the number of shares owned by an institution in a company. The proportion of institutional ownership is measured as the percentage of ownership, and can be expressed as follows:

$$\text{Institutional ownership percentage} = \frac{\text{The number of institutional shares}}{\text{The number of outstanding shares}}.$$

Earnings management

This research uses modified accrual as in Jones model (Dechow *et al.*, 1995) to detect earnings management. The modified accrual assesses level estimates as a function of the difference between the revenue changes and changes in the level and receivable property, plan, and equipment. The model can be described as follows:

a. Total actual accrual:
TAC = NIit – CFit.

where:
Niit == net income the company *i* in period *t*; and
Cfit= operating cash flow (cash flow of operation) of company *i* in period *t*.

Total accruals are estimated by ordinary least square (OLS) as follows:

$$\frac{\text{TACt}}{\text{TAt}-1} = (\beta)1\,\frac{1}{\text{TAt}-1} += (\beta)2\,\frac{\Delta\ \text{SALt}}{\text{TAt}-1} + (\beta)3\,\frac{\text{PPEt}}{\text{TAt}-1} + e$$

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where:
TACt= total accruals in period *t*;
TAt-1= total asset period *t-1*;
(Δ)SAL = change in the revenues or net sales in period *t*;
PPEt = property, plan, and equipment in period *t*; and
(β)1, (β)2, (β)3 = regression coefficients.

b. Discretionary non-accrual:

$$\mathrm{NDTACt} = (\beta)1\,\frac{1}{\mathrm{TAt}-1} += (\beta)2\,\frac{\Delta\ \mathrm{SALt} - \Delta\,\mathrm{RECt}}{\mathrm{TAt}-1} + (\beta)3\,\frac{\mathrm{PPEt}}{\mathrm{TAt}-1} + e$$

where:
(Δ) RECt = change in accounts receivable in period *t*; and
(β)1, (β)2, (β)3 = *fitted coefficient* obtained from the results of the regression analysis of the total accrual.

c. Discretionary total accrual

$$\mathrm{DTACt} = \frac{\mathrm{TACt}}{\mathrm{TAt}-1} - \mathrm{NDTACt}$$

where:
DTACt = discretionary total accrual in year *t*;
TACt= total accruals in year *t*; and
NDTACt = non-accrual discretionary in year *t*.

Results and discussion

Table 1 reports the results of the analysis performed using Warp PLS SEM version 6.0.

[Table 1 here]

The mean value of managerial ownership is 0.0499, which indicates that the average 4.99% of the company's shares is owned by the management, the average 61.74% of the company shares is owned by institutions (institutional ownership), and the average earnings management of banking companies is 7.19%. The average CFP of the company is 31.06%.

[Table 2 here]

The correlation analysis between the latent variables indicates the presence of a positive and significant correlation between managerial ownership and CFP (r = 0.148; p-value = 0.038). A positive and significant correlation is also found between institutional ownership and CFP (r = 0.276; p-value = 0.049). This result suggests that these two variables are essential for explaining the performance of the company. The relationship between managerial ownership and earnings management is negative and significant (r = -0.083; p-value = 0.006). The relationship between institutional ownership and earnings management is also negative and significant (r = -0.225; p-value = 0,039). This result indicates that an increase in the managerial and the institutional ownership can decrease earnings management. The relationship between earnings management and CFP is significant and negative (r = -0.396; p-value =

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0.001); it indicates that a decrease in earnings management is associated with an increase in the CFP (see Table 2).

Structural model analysis

In line with the literature review and research hypotheses adopted in this paper, the following structural model has been implemented (see Figure 2):

Figure 2. Research model

Note: MO = Managerial ownership; IO = Institutional ownership; EM = Earning management; CFP = Corporate financial performance.

This paper tests the quality and suitability of the model based on the calculation of the Warp-PLS applications (Table 3). Three main indicators are considered, namely, the value of average path coefficient (APC), average R-squared (ARS), and average block VIF (AVIF). The results show that the quality of the model meets the required criteria.

[Table 3 here]

The value of APC (0.224) is significant at the 5% level (p-value = 0.014), and ARS = 0.350; this means that the determinant coefficient is significant at the 5% level (p-value = 0.002). The AVIF is 1.209; acceptable values should be smaller than or equal to 5, and ideally, smaller than or equal to 3.3. Similarly, the value of the goodness of fit (GoF) is 0.387; acceptable values can be small> = 0.1, medium> = 0.25, or large> = 0.36. This result suggests that the proposed model is supported by relevant and reliable data.

[Table 4 here]

Table 4 shows that the R^2 (R-Squared) relative to earnings management is 0.23 and 057 for CFP. This result identifies the exogenous variables hypothesized to have a positive correlation with the endogenous variables. The full collinearity VIFs indicate that the result of the free model testing for multicollinearity bias must be below 3.3 (Kock, 2011). Table 3 shows that each variable has a value below 3.3. Therefore, this research model is free from vertical, lateral, and common collinearity. In line with Q^2 (Q-squared) testing procedures, it is useful to test the predictive validity and relevance of the predictor and criterion variables, with criteria that must be greater than 0. Table 5 shows that Q2> 0,0, that is, all model variables are valid.

Hypothesis testing And Discussions

The hypothesis testing procedure comprises two stages (Hair Jr. *et al.*, 2014), as listed below:

1. Verify the direct effect of managerial ownership (MO) and institutional ownership (IO) on CFP, and managerial ownership (MO) and institutional ownership (IO) on earning management (EM).

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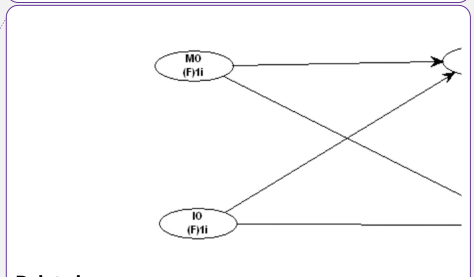

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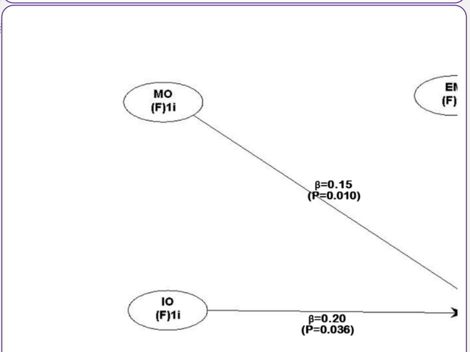

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Figure 3. Direct effect of MO and IO on CFP

Based on the results of direct effect testing (Figure 3) between MO and IO on CFP, the effect of MO on CFP is 0.15 (p-value = 0.01), while the impact of IO on CFP is 0.20 (p-value = 0.03). This result implies that all variables have a positive and significant effect. Therefore, Hypotheses H_{1a} and H_{1b} are supported. The results of this study confirm the findings from Abed *et al.* (2012), Ajinkya *et al.* (2005), Cornett *et al.* (2008), Chung *et al.* (2002), and Koh (2003).

Figure 4 reports the results of the direct effect test of the impact of MO and IO on EM.

Figure 4. Direct effect of MO and IO on EM

The effect of MO on EM is 0.15 (p-value = 0.031), while the impact of IO on EM is -0.29 (p-value = 0.006). The result shows that all variables have a negative and significant influence on EM. This means that the bigger the managerial and the institutional ownership, the lower the earnings management. Therefore, Hypotheses H_{2a} and H_{2b} are supported. These results also support findings from Ajinkya *et al.* (2005), Chung *et al.* (2002), and McConnell and Servaes (1990).

2. Verify the indirect effects considering the earnings management mediation.

The indirect effect test of the effect of MO and IO on CFP through EM mediation is carried in using a structural model. The results are reported in Figure 5.

Figure 5. Estimation of the indirect effects: Structural model

The influence of the earnings management mediation can be tested by *variance accounted for* (VAF), which measures how much the role of earnings management absorbs the direct influence of exogenous variables on endogenous variables. A VAF score above 80% indicates a full mediation role, between 20–80% indicates a partial mediation, and less than 20% indicates no mediation (Hair Jr. *et al.*, 2014).

[Table 5 here]

The VAF analysis shows that earnings management can act as a partial mediator between managerial ownership and CFP with the variance of the mediation effect equal to -0.30. The value of the mediation in the presence of institutional owners is also negative. The managerial and the institutional ownership are considered proxies for good governance, and can improve CFP by decreasing earnings management of 30% and 27%, respectively. This shows the importance of good governance in avoiding the occurrence of earnings management while improving company performance. This result is in line with Chung *et al.* (2002), who concluded that managers' ability to opportunistically exploit earnings management is

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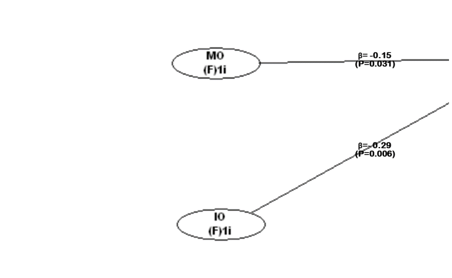

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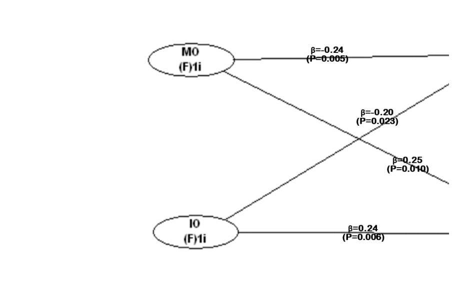

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limited by the effectiveness of external monitoring by institutional stakeholders or investors. Institutional investors have the opportunity, resources, and ability to monitor and influence managers and gather information, monitor management actions, and promote better performance. McConnell and Servaes (1990) also reported a statistically significant relationship between firm value and the percentage of institutional investor stock ownership.

Conclusions

In some circumstances, managers have an incentive to manipulate a company's reported gains using discretionary accruals. This profit management practice benefits managers with little or no (or even negative) benefits to shareholders. Managerial share ownership, through bonuses, can reduce the manager's inventive toward earnings management. The greater the managerial ownership, the more the potential for opportunistic actions by managers, through earnings management, is reduced. Similarly, institutional ownership would help monitor accounting choices made by managers, and could force changes if managers are believed to be conducting opportunistic earnings management.

The results of this study provide new empirical evidence in the field of CG. First, our findings show that managers tend to carry on earnings management using discretionary accruals for their benefit. Second, managers who own shares in a company (managerial ownership) are motivated to avoid or reduce the effects of earnings management to improve their performance without conducting manipulative actions in financial reporting. Third, institutional investors (institutional ownership) with significant shareholding can prevent managers from using opportunistic discretionary accruals. In other words, managerial ownership and institutional ownership play a strategic role in achieving good CG.

There are several limitations in this study. First, the variables used in the analysis focus on the mechanism of share ownership, both from the managerial and institutional point of view, regardless of other variables or proxies that may contribute to good CG. Second, the sample includes only banking companies, and the peculiarities of financial institutions are not accounted for in measuring their performance. Third, the interpretation of the results is not supported by personal experience of corporate managers, as the analysis only uses secondary data.

Future research should conduct similar analyses using a longer and more recent observation period. They should also consider using a sample of companies other than banks, which are also listed on the Indonesia Stock Exchange, and add qualitative reviews that address the personal experiences of corporate managers. In this way, the conclusions of the research would be more easily generalized.

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Mediating Effect of Earnings Management on Financial Performance: The Importance of Good Corporate Governance

ABSTRACT

Purpose: This study investigates the effect of corporate governance on financial performance by taking into account the mediating effect of earnings management.

Design: By using a structural equation modeling and partial least squares approach and a sample of listed banks in Indonesia observed between 2010 and 2015, this research proves that good corporate governance has a significant effect on earnings management and, in turn, that earnings management has an adverse impact on a company's financial performance.

Findings: An increase in managerial and institutional ownership leads to a decrease in earnings management, which can improve a company's financial performance.

Originality: This research shows that by applying good corporate governance mechanisms, a company can avoid agency conflicts, minimize earnings manipulation by managers, and obtain reliable company performance valuations.

JEL classification codes: xxxx

Keywords: corporate governance, corporate financial performance, earnings management, institutional ownership, managerial ownership, Indonesia

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INTRODUCTION

Corporate governance is a management concept that refers to all the mechanisms used to control and monitor management performance as well as ensure corporate accountability to stakeholders. The implementation of corporate governance mechanisms is strategically important to achieve good corporate governance, which controls the performance of business entities. Good corporate governance is expected to meet the demands of national and international stakeholders, thereby creating value to achieve competitive advantage. Corporate value and stakeholder value are determined by management's economic, environmental, and social performance. These three aspects are known as the Triple Bottom Line (Halpern *et al*., 2013).

While environmental and social aspects are important for measuring a company's performance, the firm's core value is still measured by financial performance, which is closely linked to the rise and decline of stock prices and is easier to use to predict future company performance. Stakeholders use profit as the key indicator for economic decision making. Indeed, they rely on it to make investment decisions; lenders rely on it to make credit decisions; the government, for calculating corporate income tax; and employees, to ensure employee welfare. As a result, management focuses on achieving profit as a key indicator of its performance. Therefore, a conflict of interest arises between the stakeholders (the principal) and management (the agent) regarding the measurement of corporate profits (Watts and Zimmerman, 1983), which is known as the agency theory effect (Jensen and Meckling, 1976).

Issues may arise when the earnings of a company are reported asymmetrically (Brealey, Leland, and Pyle, 1977) and used as a performance measurement tool. According to the agency problem, management has an incentive to manipulate the reporting of earnings (Jensen and Meckling, 1976). The flexibility of generally accepted accounting principles allows managers to use accrual accounting, and this affects earnings management as well as the reporting of financial performance (Cornett, Marcus, and Tehranian, 2008).

Several studies have shown the relationship between CG mechanisms and earnings management by corporate managers (Ajinkya, Bhojraj, and Sengupta, 2005; Cornett, Marcus, and Tehranian, 2008; Davidson *et al*., 2004; Iraya, Mwangi, and Muchoki, 2015, Koh, 2003; Siregar and Utama, 2008; Xie, Davidson, and DaDalt, 2003). By applying CG mechanisms, a company can minimize the manipulation of earnings by managers and ensure that the reported performance best describes the actual economic situation of the company. The implementation of sound CG principles (i.e., decline in earnings management) thus has a substantial impact on the quality of financial statements.

Based on the foregoing, this study investigates the relationship between CG and the financial performance of a company by assessing the role of earnings management. The focus is on empirically proving the application of CG as a management control tool to prevent earnings management by managers. This research contributes to the literature by providing evidence on how to overcome the conflict of interest between the owners (principal) and managers (agent), which affects the value and financial performance of the company. The findings recognize the need to effectively reduce conflicts of interest and motivate managers to improve their performance and enhance corporate value through corporate financial performance (CFP).

The remainder of the paper is organized as follows. Section 2 introduces the theoretical framework and research hypotheses, section 3 outlines the methodology, section 4 describes the data and empirical results, and section 5 provides our concluding remarks.

THEORETICAL FRAMEWORK AND RESEARCH HYPOTHESES

Jensen and Meckling (1976) suggested that earnings management problems can be avoided or solved by adopting a self-control mechanism based on CG to align the differences in interests between owners and management, namely. Such mechanisms include the ownership of the company's shares by management (i.e., managerial ownership) and the institutional ownership of shares (i.e., institutional ownership). Cornett, McNutt, and Tehranian (2009) examined whether CG mechanisms affect earnings management and financial performance at the largest holding companies of US public banks, finding that CG mechanisms, board independence, and capital are positively associated with earnings, which in turn are negatively related to earnings management. Bhagat and Bolton (2008) concluded that better governance positively and significantly correlates with higher current and future operating performance. In this study, CG is proxied by managerial and institutional ownership. Based on the theoretical framework described above, Figure 1 illustrates the approach of this research.

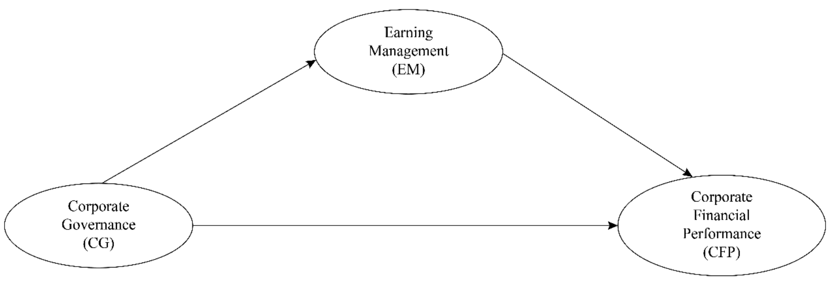

Figure 1. Theoretical framework

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CG and CFP

The greater the ownership of managers within a company, the more management is expected to maximize the company's value and financial performance (Brealey, Leland, and Pyle, 1977; Cornett, Marcus, and Tehranian, 2008, Cornett, McNutt, and Tehranian, 2009; Jensen and Meckling, 1976; McConnell and Servaes, 1990) to prove that CG mechanisms affect firm performance. Jensen and Meckling (1976) argued that institutional ownership plays an essential role in minimizing agency conflicts between managers and shareholders. The existence of institutional investors can be an effective monitoring mechanism in every decision taken by managers. McConnell and Servaes (1990) also reported statistically significant relationships between corporate values and the share ownership of institutional investors. This is because institutional investors are involved in making strategic decisions to reduce earnings manipulation, which in turn improves the company's performance. However, Siregar and Utama (2008) found inconsistent evidence on the impact of institutional ownership, company size, and the practice of CG on profit management. Nonetheless, a good accountant or financial economist pays considerable attention to the impact of the structure of CG and compensation scheme on the company's behavior (Cornett, Marcus, and Tehranian, 2008). Hence, the following two hypotheses are proposed:

H_{1a}: Managerial ownership has a significant effect on CFP.

H_{1b}: Institutional ownership has a significant effect on CFP.

CG and Earnings Management

Eisenhardt (1989) identified three assumptions about human nature in agency theory: (1) human selfishness (self-interest), (2) the limited power of thought about future perceptions (bounded rationality), and (3) the avoidance of risk (risk aversion). These assumptions suggest that agency problems arise between managers and shareholders (Jensen and Meckling, 1976) because humans act opportunistically by prioritizing personal interests. Institutional ownership allows institutions to professionally monitor their investment, and the level of control over management actions is so high that the potential for fraud can be suppressed (Ajinkya, Bhojraj, and Sengupta, 2005; Cornett, Marcus, and Tehranian, 2008; Chung, Firth, and Kim, 2002; Koh, 2003).

Cornett, McNutt, and Tehranian (2009) tested CG mechanisms that affect earnings and profit management at the largest public holding company in the United States. They concluded that adjusting the impact of earnings management substantially increases the importance of CG variables and reduces the effect of incentive-based compensation on corporate performance. Further, Abed, Al-Attar, and Suwaidan (2012) confirmed the existence of a significant relationship between CG mechanisms and earnings management. Hence, the following two hypotheses are proposed:

H_{2a}: Managerial ownership has a significant effect on earnings management.

H_{2b}: Institutional ownership has a significant effect on earnings management.

Mediating Role of Earnings Management

According to Jensen and Meckling (1976), agency costs can be divided into three categories: (1) monitoring costs, (2) bonding costs, and (3) residual costs. Monitoring costs are incurred by the company to observe, control, and limit the behavior of agents that could harm the principal. Bonding costs are incurred by an agent to conform to the interests of the principal, while residual costs are incurred by the principal in the form of reduced prosperity because of the differences between agent and principal decisions.

Agency costs impose a burden on the earnings of the company; the higher agency costs, the more significant is the reduction in corporate profits. In addition to imposing agency costs on the company, earnings management can also reduce the value of the firm because of the opportunistic behavior of managers (Balsam, 2002). The way in which to minimize the supervisory costs borne by shareholders relies on managerial and institutional ownership (Jensen and Meckling, 1976).

Several studies have examined the relationship between earnings management and the information content of earnings and found mixed results. Warfield, Wild, and Wild (1995) found evidence that earnings management leads to a less informed earnings report. Abed, Al-Attar, and Suwaidan (2012) supported the application of CG principles to control the behavior of the board of directors, which may distort annual financial statements. These findings suggest that the reliability and transparency of financial reports can be improved. Hence, the following two hypotheses are proposed:

H_{3a}: Managerial ownership affects CFP through earnings management.

H_{3b}: Institutional ownership affects CFP through earnings management.

METHODS

Research Setting and Sample

To examine these hypotheses, a structural equation modeling (SEM) and partial least squares (PLS) approach was employed to deal with the multiple dependent and independent variables simultaneously. PLS can handle relatively small sample sizes and multicollinearity among independent variables; hence, it does not require the assumption of a normal distribution (Kock, 2011; Hair *et al*., 2014). In this study, we used Warp–PLS version 06.00 software.

We collected secondary data from the annual report of banking companies listed on the Indonesia Stock Exchange (IDX) in 2010–2015. The sample was built by using purposive sampling with the following criteria: (i) banking companies are listed on the IDX and consistently publish audited financial statements and (ii) banking companies present managerial and institutional ownership structures and their financial statements can be accessed through IDX Corner STIE Indonesia Banjarmasin. Based on these criteria, the final sample comprised 20 banks and the number of observed data panels was 6×20 = 120.

Variables and Measurements

CFP

CFP was measured by using *cash flow return on assets* (CFROA), a measure derived from the results of operations whose funds have been received by the company in cash, with the burden that the contribution is cash and has been issued by the company. CFROA can be expressed as

$$\text{CFROA}=\frac{\text{EBIT + Dep}}{Assets},$$

where:

EBIT = earnings before interest and taxes;

Dep = depreciation; and

Assets = total assets.

Managerial ownership

Managerial ownership is linked to the number of shares owned by management in a company, and can be expressed as follows:

$$\text{Managerial ownership percentage} = \frac{\text{The number of shares of the manager}}{\text{The number of outstanding shares}}.$$

Institutional ownership

Institutional ownership is the number of shares owned by an institution in a company. The proportion of institutional ownership is measured as the percentage of ownership, and can be expressed as follows:

$$\text{Institutional ownership percentage} = \frac{\text{The number of institutional shares}}{\text{The number of outstanding shares}}.$$

Earnings management

This research uses modified accruals as in the Jones model (Dechow, Sloan, and Sweeney, 1995) to detect earnings management. Modified accruals assess level estimates as a function of the difference between revenue changes and changes in the level of property, plants, and equipment. The model can be described as follows:

a. Total actual accruals:

TAC = NIit – CFit.

where:

NIit = net income of company *i* in period *t*; and

CFit = operating cash flow of company *i* in period *t.*

Total accruals are estimated by ordinary least squares (OLS) as follows:

$$\frac{\text{TACt}}{\text{TAt}-1} = (\beta)1\ \frac{1}{\text{TAt}-1} += (\beta)2\ \frac{\Delta\ \text{SALt}}{\text{TAt}-1} + (\beta)3 \frac{\text{PPEt}}{\text{TAt}-1} + e$$

where:

TACt = total accruals in period *t*;

TAt-1 = total assets in period *t-1*;

(Δ)SAL = change in revenue or net sales in period *t*;

PPEt = property, plants, and equipment in period *t*; and

(β)1, (β)2, and (β)3 = regression coefficients.

b. Discretionary non-accruals:

$$\text{NDTACt} = (\beta)1\ \frac{1}{\text{TAt}-1} += (\beta)2\ \frac{\Delta\ \text{SALt} - \Delta\text{RECt}}{\text{TAt}-1} + (\beta)3 \frac{\text{PPEt}}{\text{TAt}-1} + e$$

where:

(Δ) RECt = change in accounts receivable in period *t*; and

(β)1, (β)2, and (β)3 = fitted coefficients obtained from the results of the regression analysis of total accruals.

c. Discretionary total accruals

$$\mathrm{DTACt} = \frac{\mathrm{TACt}}{\mathrm{TAt} - 1} - \mathrm{NDTACt}$$

where:

DTACt = discretionary total accruals in year *t*;

TACt = total accruals in year *t*; and

NDTACt = non-discretionary total accruals in year *t*.

RESULTS AND DISCUSSION

As shown in Table 1, the mean value of managerial ownership is 0.0499, which indicates that 4.99% of the company’s shares are owned by management on average. By contrast, an average of 61.74% of the company’s shares are owned by institutions and the average earnings management of banking companies is 7.19%. Average CFP is 31.06%.

Table 1. Descriptive statistics of the variables of interest

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Variables	N	Minimum	Maximum	Mean	Std. Dev
Managerial ownership (MO)	120	.0107	.3182	.0499	.0817
Institutional ownership (IO)	120	.1076	.9306	.6174	.1911
Earnings management (EM)	120	.0017	.1669	.0719	.0471
CFROA (CFP)	120	.0190	.7340	.3106	.1780

The correlation analysis between the latent variables indicates the presence of a positive and significant correlation between managerial ownership and CFP (r =

0.148; p-value = 0.038). A positive and significant correlation is also found between institutional ownership and CFP (r = 0.276; p-value = 0.049). This result suggests that these two variables are essential for explaining firm performance. The relationship between managerial ownership and earnings management is negative and significant (r = -0.083; p-value = 0.006). The relationship between institutional ownership and earnings management is also negative and significant (r = -0.225; p-value = 0,039). This result indicates that an increase in managerial and institutional ownership decreases earnings management. The relationship between earnings management and CFP is significant and negative (r = -0.396; p-value = 0.001); this finding indicates that a decrease in earnings management is associated with an increase in CFP (see Table 2).

Table 2. Correlation and P values

Correlations among indicators				
Indicator correlations				
	MO	_IO	EM	CFP
MO	1.000		-0.083	0.148
_IO		1.000	-0.225	0.276
EM	-0.083	-0.225	1.000	-0.396
CFP	0.148	0.276	-0.396	1.000
P values for correlations				
	MO	_IO	EM	CFP
MO	1.000	<0.001	0.006**	0.038**
_IO	<0.001	1.000	0.039**	0.049**
EM	0.006	0.039	1.000	0.001***
CFP	0.038	0.049	0.001	1.000

Note:
** Significant at the 0.05 significance level
*** Significant at the 0.01 level of significance

Structural Model Analysis

In line with the literature review and research hypotheses tested in this study, the structural model in Figure 2 was implemented.

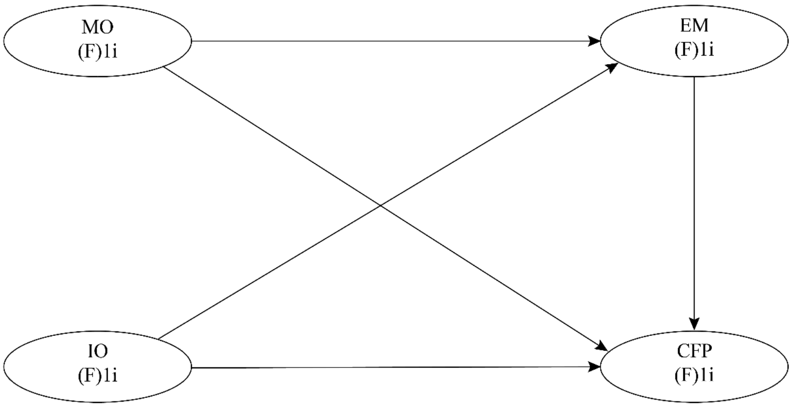

Figure 2. Research model

Note: MO = Managerial ownership; IO = Institutional ownership; EM = Earnings management; CFP = Corporate financial performance.

This study tests the quality and suitability of the model based on the calculation of the Warp–PLS applications (Table 3). Three main indicators are considered: the average path coefficient, average R^2, and the average block variance inflation factor. The results show that the quality of the model meets the required criteria.

Table 3. Goodness of fit and quality indices of the model

Model fit and quality indices
Average path coefficient (APC)=0.224, P=0.014
Average R-squared (ARS)=0.350, P=0.002
Average adjusted R-squared (AARS)=0.222, P=0.077
Average block VIF (AVIF)=1.209, acceptable if <= 5, ideally <= 3.3
Average full collinearity VIF (AFVIF)=2.068, acceptable if <= 5, ideally <= 3.3
Tenenhaus GoF (GoF)=0.387, small >= 0.1, medium >= 0.25, large >= 0.36
Sympson's paradox ratio (SPR)=1.000, acceptable if >= 0.7, ideally = 1
R-squared contribution ratio (RSCR)=1.000, acceptable if >= 0.9, ideally = 1
Statistical suppression ratio (SSR)=1.000, acceptable if >= 0.7

The value of the average path coefficient (0.224) is significant at the 5% level (p-value = 0.014) and average $R^2 = 0.350$; this means that the determinant coefficient is significant at the 5% level (p-value = 0.002). The value of the average block variance inflation factor is 1.209; acceptable values should be less than or equal to 5 and, ideally, less than or equal to 3.3. Similarly, the goodness of fit value is 0.387; acceptable values can be small ≥ 0.1, medium ≥ 0.25, or large ≥ 0.36. This result suggests that the proposed model is supported by relevant and reliable data.

Table 4 shows that the R^2 values of both of the endogenous latent variables of EM are 0.23 and of CFP are 0.57. This result suggests that the exogenous variables hypothesized herein have a positive correlation with the endogenous variables. The variance inflation factors indicate that the result of the free model testing for multicollinearity bias must be below 3.3 (Kock, 2011). Table 3 shows that each variable has a value below 3.3. Therefore, this research model is free from vertical, lateral, and common collinearity. In line with Q^2 testing procedures, it is useful to test the predictive validity and relevance of the predictor and criterion variables, with criteria that must be greater than 0. Table 5 shows that $Q^2 > 0$; in other words, all the model variables are valid.

Table 4. Latent variable coefficients

Latent variable coefficients	MO	IO	EM	CFP
R-squared coefficients			0.23	0.57
Adjusted R-squared coefficients			0.179	0.196
Full collinearity VIFs	2.856	2.870	1.242	1.303
Q-squared coefficients			0.229	0.259

Hypothesis Testing And Discussion

The hypothesis testing procedure comprises two stages (Hair *et al*., 2014):

1. Verify the direct effects of managerial ownership and institutional ownership on CFP and on earnings management.

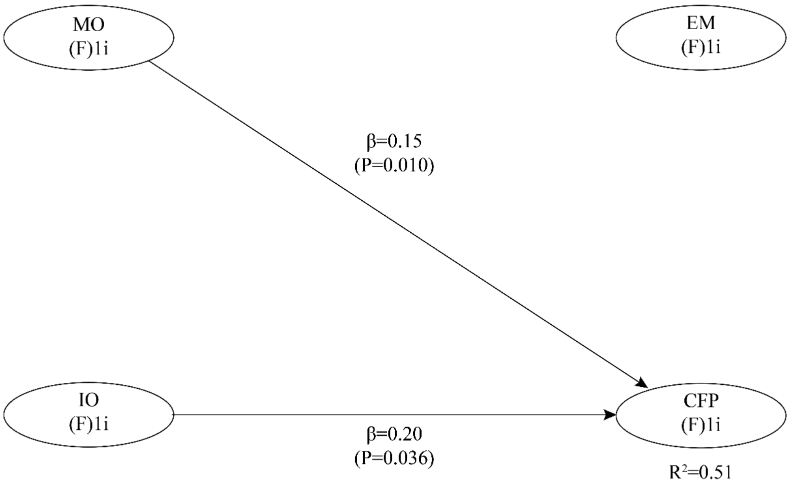

Figure 3. Direct effect of managerial and institutional ownership on CFP

Based on the results in Figure 3, the effect of managerial ownership on CFP is 0.15 (p-value = 0.01), while the impact of institutional ownership on CFP is 0.20 (p-value = 0.03). This result implies that both these variables have a positive and significant effect. Therefore, H_{1a} and H_{1b} are supported. These results confirm the findings of Abed, Al-Attar, and Suwaidan (2012), Ajinkya, Bhojraj, and Sengupta, (2005), Cornett, Marcus, and Tehranian (2008), Chung, Firth, and Kim (2002), and Koh (2003).

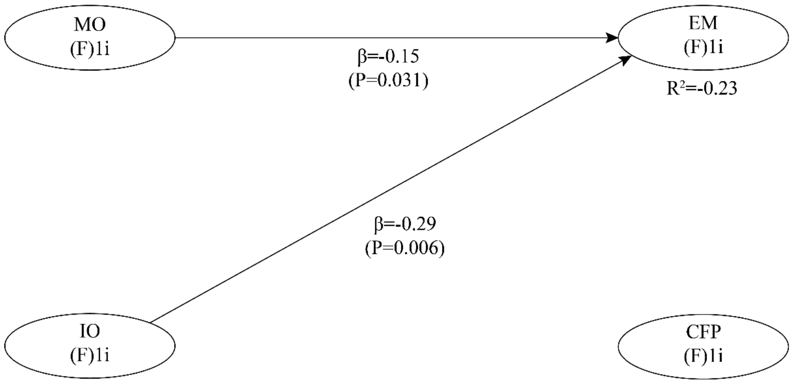

Figure 4. Direct effect of managerial and institutional ownership on earnings management

As Figure 4 shows, the effect of managerial ownership on earnings management is -0.15 (p-value = 0.031), while the impact of institutional ownership on earnings management is -0.29 (p-value = 0.006). This result shows that both the variables have a negative and significant influence on earnings management. This finding means that the larger managerial and institutional ownership, the lower is earnings management. Therefore, H_{2a} and H_{2b} are supported. These results also support the findings of Ajinkya, Bhojraj, and Sengupta (2005), Chung, Firth, and Kim (2002), and McConnell and Servaes (1990).

2. Verify the indirect effects considering the mediating effect of earnings management.

To test the indirect effect of managerial and institutional ownership on CFP through earnings management, we adopt a structural model. Figure 5 reports the results.

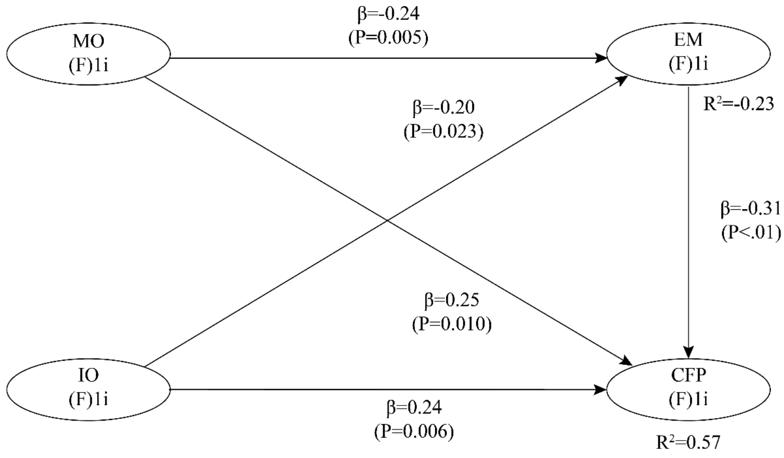

Figure 5. Estimation of the indirect effects: Structural model

Variance accounted for (VAF) measures the extent to which earnings management absorbs the direct influence of the exogenous variables on the endogenous variables. A VAF score above 80% indicates full mediation, 20–80% indicates partial mediation, and less than 20% indicates no mediation (Hair *et al.*, 2014).

Table 5. VAF results

Relationship variable	Calculation	Total	Category
MO→EM →CFP	MO→EM: -0,24	-0.55	
	EM →CFP: -0,31		
	Indirect effect = -0,24X-0,31	0,25	
	Direct Effect: 0,25		
	Total effect	-0,30 = -30 %	Partial mediation
IO →EM →CFP	IO→EM: -0,20	-0.51	
	EM → CFP: -0,31		
	Indirect effect = 0,26X0,14	0,24	
	Direct Effect: 0,24		
	Total effect	-0,27 = -27 %	Partial mediation

The VAF analysis shows that earnings management can act as a partial mediator between managerial ownership and CFP with the variance of the mediating effect equal to -0.30. The value of the mediating effect under institutional ownership is also negative. Hence, managerial and institutional ownership are considered to be proxies for good governance and can improve CFP by decreasing earnings management by 30% and 27%, respectively. This finding shows the importance of good governance in avoiding the occurrence of earnings management while improving company performance. This result is in line with that of Chung, Firth, and Kim (2002), who concluded that managers' ability to opportunistically exploit earnings management is limited by the effectiveness of external monitoring by institutional stakeholders or investors. Institutional investors have the opportunity, resources, and ability to monitor and influence managers and gather information, monitor management actions, and promote better performance. McConnell and Servaes (1990) also reported a statistically significant relationship between firm value and the percentage of institutional ownership.

CONCLUSION

In some circumstances, managers have an incentive to manipulate a company's reported gains by using discretionary accruals. This profit management practice benefits managers with little or no (or even negative) benefits to shareholders. Managerial share ownership, through bonuses, can reduce the manager's incentive to pursue earnings management. The greater managerial ownership, the more the potential for opportunistic actions by managers, through earnings management, is reduced. Similarly, institutional ownership helps monitor the accounting choices made by managers and could force changes if they are believed to be conducting opportunistic earnings management.

The results of this study provide new empirical evidence in the field of CG. First, our findings show that managers tend to carry out earnings management, by using discretionary accruals, for their benefit. Second, managers who own shares in a company are motivated to avoid or reduce the effects of earnings management to improve CFP without manipulating financial reporting. Third, institutional investors with a significant shareholding can prevent managers from using opportunistic discretionary accruals. In other words, managerial and institutional ownership play a strategic role in achieving good CG.

There are several limitations to this study. First, the analysis focuses on the mechanism of share ownership, both from the managerial and from the institutional points of view. Hence, it ignores any other variables or proxies that may contribute to good CG. Second, the sample includes only banking companies, and the peculiarities of financial institutions are not accounted for in measuring their performance. Third, the interpretation of the results is not supported by the personal experience of corporate managers, as the analysis only uses secondary data.

Future research should conduct similar analyses by using a longer and more recent observation period. Researchers should also consider using a sample of non-banking companies listed on the IDX and add qualitative reviews that address the personal experiences of corporate managers. In this way, the conclusions of the research could more easily be generalized.

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