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# Determinants of Earnings Management and Its Implications on the Integrity of the Financial Statements

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## Abstract

This study aims to estimate and analyze the effect of corporate governance, audit quality, firm size, and leverage towards earnings management and its implications on the integrity of the financial statements, either partially or simultaneously. The research method used is panel data regression analysis. By using purposive sampling method, there are six companies that consistently follow corporate governance perception index (CGPI) program from 2010 to 2015 and listed on the Indonesia Stock Exchange.The results show that, in the first model, CGPI partially has a significant negative effect, audit quality partially has a significant negative effect, firm size partially has a significant negative effect, leverage partially has a significant positive effect, on earnings management. CGPI, audit quality, firm size, and leverage simultaneously have significant effect on earnings management. In the second model, CGPI partially has a significant negative effect, audit quality has a significant negative effect, firm size has a significant negative effect, leverage has a significant positive effect, on earnings management. CGPI, audit quality, firm size, leverage, and earnings management simultaneously have significant effect on the integrity of the financial statements. According to these results, the company should maintain and improve corporate governance practices, uses the auditor services that have six quality factors (competence, independence, specialization, audit tenure, peer review, and affiliation), convey positive information related to the company and apply low debt ratio with good planning. The investor should choose to invest in the companies that implement good corporate governance, using qualified audit services, investment priorities in large companies, and companies with low leverage.

**Keywords:** corporate governance, audit quality, firm size, leverage, earnings management, integrity of the financial statements.

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## 1. Introduction

In the latest years, the business world surprised by legal case caused by manipulation or accounting scandal. Those events have resulted in a decline in public confidence, including the manipulation by Toshiba Corp in 2015, Olympus Corp in 2011, also in Britain in 2014 experienced by the largest supermarket named Tesco. In Indonesia, trading

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activities of PT Inovisi Infracom Tbk. (INVS) was suspended by the Indonesia Stock Exchange (IDX) in 2015 because of the number of mistakes in the financial statement.

In many accounting manipulation practices, engineering can generally be done because of the accrual basis that is applied in the preparation of financial statements, thus raising the desire of managers to display financial statements that are considered good by shareholders. This phenomenon can be viewed as the agency conflict (Jensen and Meckling, 1976). The agency relationship arises when the principal as the owner of the company delegates his authority to the agent to make the best decision for the principal in running the business. The agent is responsible for optimizing the owner's profit by providing large amount of profit so that they practice earnings management to meet the demand. Leuz et al. (2002) find empirical evidence that the companies in Indonesia was indicated to practice earnings management. Compared to other ASEAN countries, such as Malaysia, the Philippines, Thailand and Singapore, Indonesia even considered as the largest country of earnings management level. Further research by Ratmono (2010) also shows that the public companies in Indonesia actually do earnings management practices to avoid the reported annual loss. This is strengthened by Priharta (2017:235) who measure indication of real earnings management practices to 64 manufacturing companies in Indonesia, the conclusion is that 38 companies in the period 2013 and 43 companies in 2014 period, indicated to conduct earnings management practices.

The occurrence of earnings management practices have an impact on the integrity of the financial statements. The financial statements are said to be having integrity if they meet the quality of reliability (Hardiningsih, 2010: 65; Gayatri and Suputra, 2013: 346), and furthermore Martani, et al. (2012: 39) explains that information has reliable quality if it is free from misleading notions, material faults, and dependability as a faithful representation of what should be presented or reasonably expected to be presented. Indication of earnings management on 64 manufacturing companies in Indonesia has an impact on the integrity of the financial statements, as stated by Priharta (2017: 236) that only 34 of them in 2013 and 35 in 2014, companies whose financial statements are considered integrity.

Unhealthy practices that result in unintegrated financial statements are certainly a question of many parties related to corporate governance. In line with the implementation of corporate governance in Indonesia there is an institution called The Indonesian Institute of Corporate Governance (IICG) as an independent institution that disseminates and develops corporate governance. Since 2001, this institution has conducted a rating program known as Corporate Governance Perception Index (CGPI), a research program and rating of good corporate governance implementation to find out how far the companies in Indonesia apply the principles of good governance in which the participation of companies in this program is voluntary.

Based on the CGPI ranking for 2013-2014, there are six companies that consistently participate in the program. The six companies are PT. Aneka Tambang (Persero), Tbk., PT. Bank Mandiri (Persero), Tbk., PT. Bank BNI (Persero), Tbk., PT. Jasa Marga (Persero), Tbk., and PT. Timah (Persero), Tbk. Graph 1 shows that the six companies that consistently follow the CGPI ranking do indeed have a good commitment in the effort to improve good corporate governance practice, it is seen from the score which always increase when compared with the previous year. In addition, the "trusted" predicate was able to encourage the compilation of financial statements with integrity (with book to market proxy, value less than one assessed integrity), as presented in graph 2.

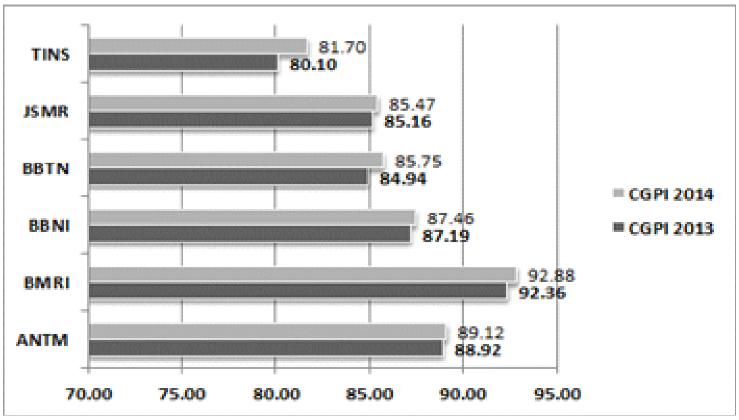


**Figure** 1: CGPI Rating of Six Companies "Trusted" and "Most Trusted"Period 2013-2014 (source: processed data).

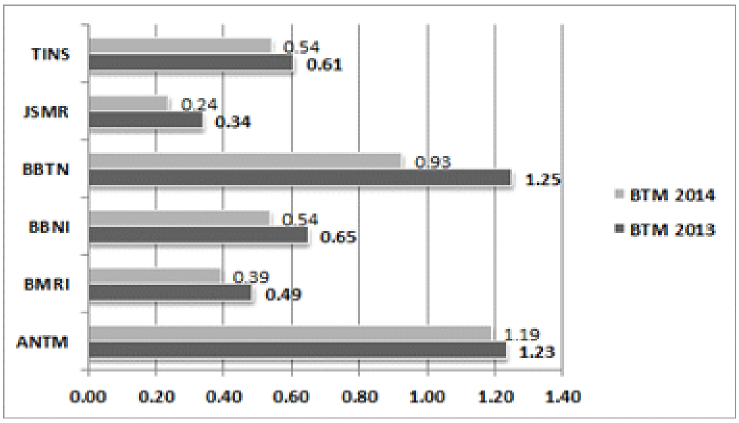


**Figure** 2: The Integrity of the Financial Statements of Six Companies"Trusted"and "Most Trusted" Period 2013-2014 (source: processed data).

Audit quality is also seen as a variable that affects earnings management and financial statement integrity. Audit qualityis seen as the ability to enhance the quality of financial reporting because high quality audits are expected to effectively play a role as a preventative earnings management. Another factor considered to affect earnings management practices is firm size. The size of the company shows the amount of information included in it, making it a public interest. Generally large companies get more attention than small companies, thus encouraging the management to be more careful in delivering financial statements that compiled. Another factor is leverage. Companies that have leverage will generally use those funds cautiously because there are limits to be followed and those funds are under the control of the lender. The greater the leverage the greater the risks facing the company in fulfilling its contractual obligations to the creditors associated with the debt ratio. Based on the above description it can be understood that the financial statements as a source of information in external decision making must be presented as it is in accordance with accounting principles and to encourage the preparation of reliable financial statements then there should be no profit management practices within the company. It is noteworthy that the implementation of corporate governance, audit quality, firm size, and leverage are factors affecting the practice of earnings management which implies the integrity of the financial statements.

# 2. Literature Review and Hypothesis

## 2.1. Grand Theory

### 2.1.1. Agency Theory

Agency theory essentially explains the relationship between two parties, namely the principal and the manager (agent). Jensen and Meckling (1976) argue that agency relations occur when the principal contracts and delegates authority to agents to act on behalf of the agent in decision making. According to this theory the separation between ownership and management will lead to agency problems. Such separation can encourage self-centered actions of managers who, when a conflict occurs, can not be maximized and the difference between the theoretical maximum value of the firm and the true value of the firm is given for agency costs (Palliam and Shalhoub, 2003).

### 2.1.2. Signaling Theory

This theory was proposed by Lintner (1956) for the first time, stating that the company's stock price will change when there is a change in the dividend payout. Further developed by Ross (1977), Pyle and Leland (1977) and Bhattacharya (1979). Signaling theory suggests that company management has better information (information asymmetry) and it is necessary to communicate it to investors in order to increase the company's stock value. Information asymmetry encourages managers to convey the information they have in the hope that the information will be responded by investors as a signal of certain events that can affect the value of the company.

### 2.1.3. Positive Accounting Theory

According to Watts and Zimmerman (1986) accounting theory aims to explain and predict the practice of accounting by describing why an accounting practice is conducted, which more specifically reveals the influence of economic variables on managerial motivation in choosing an accounting method. The notion of earnings management arises because managers expect a benefit from the actions taken in reverse manufacturing. There are three main hypotheses that form the basis for developing hypothesis testing to detect earnings management as follows: (1) bonus plan hypothesis, managers in companies with bonus plans tend to choose accounting procedures that can move earnings reports into future periods or known as income smoothing, (2) debt covenant hypothesis, corporate managers with large leverage ratios tend to choose accounting procedures with reported earnings changes from future periods to current periods, as it will give the company a small leverage ratio, and (3) political cost hypothesis, the greater the cost of corporate politics, managers tend to choose accounting procedures that postpone the earnings report from the current period to the future period.

## 2.2. Corporate Governance

Corporate governance can be defined as a set of rules that define the relationships between shareholders, managers, creditors, governments, employees, and other internal and external stakeholders in accordance with their rights and responsibilities (Nasution and Setiawan, 2007). While Sutedi (2012) defines it as a process and structure used by corporate organs (shareholders / owners of capital, commissioner / supervisory board and board of directors) to improve business success and corporate accountability in order to realize shareholder value in the long term by taking into account the interests of another stakeholders, based on legislation and ethical values. Corporate governance is an extension of the concept that governs the relationship between management and investors that allows the emergence of agency problems, a condition when managers of companies (managers) are not working optimallyin order to maximize the wealth of owners (investors). With this separation, company owners such as managing funds and making other corporate decisions for and on behalf of the owner. With this authority, the manager may not act best for the owner's interest because of the conflict of interest.

### 2.3. Corporate Governance Perception Index (CGPI)

Since 2001 an institute called The Indonesian Institute for Corporate Governance (IICG) in collaboration with SWA magazine has begun conducting research to assess the practice of corporate governance in Indonesia, which results in corporate governance perception index (CGPI). Participation of participants in CGPI is a voluntary option without being driven by mandatory impulse and considering internal company readiness (selective). CGPI program uses 3 (three) scopes of GCG implementation, namely compliance, conformance, and performance aspects.

### 2.4. Audit Quality

DeAngelo (1981) states that audit quality is defined as the competence and independence of auditors. While Bodie et al., (2008) describes the quality of audit as the ability of the accounting firm in understanding the client's business. Next Deis and Giroux (1992) stated that there are four things related to audit quality, namely tenure, number of clients, client's financial health, and review by third parties. In addition, DeAngelo (1981) also argues that audit quality is directly related to the size of audit firms or public accounting firms. The size of the accounting firm is proxied by Becker et al., (1998), Jordan et al., (2010), Herusetya (2012), and Indraswono (2016) with affiliated accounting firms, currently known as the big four. Based on various opinions on audit quality, it can generally be concluded that audit quality is related to the following six elements: first, auditor competence (DeAngelo, 1981); second, auditor independence (DeAngelo, 1981); third, the specialization of auditors (Elder et al., 2015); fourth, audit of tenure (Deis and Giroux, 1992); fifth, peer review (Deis and Giroux, 1992); and sixth, affiliated with the big four ( Jordan et al., 2010).

### 2.5. Firm Size

Firm size is a description of the size of the company that can be seen from the total assets, income, or market capitalization (Riyanti, 2012; Guna and Herawaty, 2010). Associated with the presentation of the integrity of the financial statements, Nuryaman (2009) argues that large companies will face high political costs and face greater demands from stakeholders related to the presentation of transparent financial statements. Nasution and Setiawan (2007) argue that the small size of firms do more profit management practices than large firms. The reason is that the larger the size of the company, generally the information available to investors more and more, in addition large companies get more attention from the community so it will be more careful in financial reporting. This is different from small companies that tend to want to show the performance of a company that always looks good for investors to invest in the company. Another opinion that company size as a proxy of political cost is considered very sensitive to earnings reporting behavior. Medium-sized and large companies have demands for financial performance in line with investor expectations, thus encouraging management to meet those expectations. Such behavior will in turn affect the practice of profit manipulation and smoothing (Watts and Zimmerman, 1978).

## 2.6. Leverage

Horne and Wachoviz (2009: 420) define leverage as the use of fixed costs to increase a company's profits. While Brealey et al., (2001) states that the leverage ratio measures how much corporate finance is based on debt to equity. Further, Ross et al. (2010: 65) and Brealey et al. (2001: 138) stated that the debt to equity ratio is the ratio comparing total debt to total equity of shareholders. Thus, debt to equity can also provide an overview of the capital structure owned by the company so that it can be seen the level of risk unpaid debt (Riyanti, 2012: 27).

## 2.7. Earnings Management

Soon (2011) defines earnings management as a management effort made through an external financial reporting process in order to gain personal gain. While Kieso et al., (2011) defines earnings management as the planned time of revenue, expenses, profits, and losses in order to make a surge in earnings. Next Fisher and Rosenzweig (1995) state that earnings management is the actions of managers to increase (decrease) the profit of the current period of a unit under its responsibility without causing the increase (decrease) of long-term economic benefits of the unit. There are various models to detect the occurrence of earnings management practices, including with the accrual working capital model. This model is considered the best in predicting accruals, in addition, if the data used is a data pool for each type of industry, the accuracy of the predictive model is better. In addition, the reason for the use of income or sales as a working capital accrator is that earnings management occurs mostly in revenue or sales accounts (Nelson et al., 2000).

### 2.8. Integrity of the Financial Statements

The financial statements are said to be of integrity if they meet the quality of reliability (Kieso et al., 2001), and according to Martani et al., (2012) information has quality reliability if free from misleading notions, material mistakes, and dependability as a sincere or honest presentation (faithful representation) from which it should be presented or reasonably expected to be presented. Mayangsari (2003) states that reliable financial statements or integrity can be assessed by the use of the principle of conservatism.

Accounting conservatism in financial reporting aims to recognize, measure, and report the value of low assets and income, as well as high liabilities and burdens ( Juran, 2008). While Baridwan (2002) states that if there is more than one alternative available then this conservative attitude tends to choose an alternative that will not make the assets and income too large. Watts (2003) defines conservatism as the concept of delaying recognition of future cash inflows. Based on the description it can be understood that conservatism is the attitude to choose a less favorable alternative.

There are several models in the measurement of conservatism, among them Beaver and Ryan (2000) models that use book to market proxy ratio (Hamdan et al., 2012; Saad and Jarboui, 2015) or by market to book ratio (Haque et al., 2016; Francis et al., 2013). This ratio reflects the investor's view of the company. Book-to-market (BTM) rate of less than one; or a ratio of market to book (MTB) that is greater than one, based on signaling theory indicates that investors believe in the presentation of financial statements or financial statements have integrity. This is stated by Savitri (2016) assuming that companies using conservatism will report lower net asset value and lower book to market ratio.

## 3. Research Methods

### 3.1. Object of Research

The population in this study isthe companies participating in the corporate governance perception index (CGPI) assessment conducted by The Indonesian Institute for Corporate Governance (IICG) in collaboration with SWA magazine, and the sample is selected

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using purposive sampling with the following criteria (1) The company consistently participate in the CGPI assessment from 2010 to 2015, (2) The Company has been a public company on the Indonesia Stock Exchange since 2010 and continues its listing until 2015, (3) The Company has complete and publicly available financial reporting data in accordance with the research variables. Pursuant to purposive sampling then obtained six companies as in Table 1 as follows:

TABLE 1: Research Sample Period 2010-2015.

| No. | Company Name | Code |
|---|---|---|
| 1 | PT. Aneka Tambang (Persero), Tbk. | ANTM |
| 2 | PT. Bank Mandiri (Persero), Tbk. | BMRI |
| 3 | PT. Bank Negara Indonesia (Persero), Tbk. | BBNI |
| 4 | PT. Bank Tabungan Negara (Persero), Tbk. | BBTN |
| 5 | PT. Jasa Marga (Persero), Tbk. | JSMR |
| 6 | PT. Timah (Persero), Tbk. | TINS |
| Source: Processed data | | |

## 3.2. Method of Data Analysis

This study uses quantitative methods in the form of regression analysis of panel data, ie data with structured characteristics of time series as well as cross section (Ariefianto, 2012). There are three models, namely common effect, fixed effect, and random effect, and by paired test will be determined the best model to estimate.The panel data regression model in this study can be formulated as follows:

**Model for Earnings Management:**

$$MALA_{it}= \alpha+ \beta_1 CGPI_{it}+ \beta_2 KLAUD_{it}+\beta_3 UKPER_{it}+\beta_4 LEV_{it}+ \varepsilon_{it}$$

**Model for Financial Statement Integrity:**

$$ILK_{it}= \alpha+ \beta_1 CGPI_{it}+ \beta_2 KLAUD_{it}+\beta_3 UKPER_{it}+\beta_4 LEV_{it}+\beta_5 MALA_{it}+ \varepsilon_{it}$$

i = 1,2,..., N; t = 1,2,..., T

where:

ILK =Integrity of the Financial Statements

CGPI =Corporate Governance Perception Index

KLAUD =Audit Quality

UKPER =Firm Size

LEV =Leverage

MALA =Earnings Management

E = Error

B = Slope

α = Intercept

N = Number of Observations

T = Number of Time

N x T = Number of Panel Data

## 3.3. Operationalizing Variables

### 3.3.1. Corporate Governance Perception Index(CGPI)

The CGPI ranking results using assessment norms based on the range of scores with categorization as follows: **55-69.99 "Fair Trusted", 70-84.99 "Trusted", and 85-100 "Most Trusted"**.

### 3.3.2. Audit Quality

Audit quality measurements employ scoring methods that include six audit quality measures from several previous studies, namely (1) Competence (DeAngelo, 1981), a statement that the audit is conducted under the audit standards established by the Indonesian Institute of Certified Public Accountants (IAPI). Competency is given a number 1 if it states it, (2) Independence (DeAngelo, 1981), a statement that the audit is conducted under the audit standards established by the Indonesian Institute of Certified Public Accountants (IAPI). Independence is numbered 1 if it states, (3) Auditor Specialization (Elder et al., 2015; Behn et al., 2008), measured by the same number of clients in one industry, in line with Behn et al., (2008) the auditor's specialization shall be numbered 1 if the client in the same industry is at least 10, (4) Tenure Audit (Deis and Giroux, 1992; Francis and Yu, 2009; Herusetya, 2012), following Francis and Yu (2009) and Herusetya), the assignment of the audit is considered sufficient to gain sufficient understanding of the client if the assignment period is within the interval of more than 3 years and less than 9 years. Tenure is assigned a number 1 if the assignment period is within that interval, (5) Peer Review (Deis and Giroux, 1992), testing and review activities undertaken by equivalent peers to gain reasonable assurance that the review organization is obedient the quality control system and the implementation of the audit activities are in accordance with the applicable audit standards, given the number 1 if the public accounting firm conducts peer review, and (6) Affiliated the big 4 (Jordan et al., 2010; Damayanti and Rochmi, 2014) KAP the big four are Price Water House Coopers (PWC), Deloitte, Klynveld Peat Marwick Goerdeler (KPMG) International, and Ernst and Young (Damayanti and Rochmi, 2014). Affiliates of the big 4 are numbered 1 if an audit is performed by an affiliated accountant one of them. Next will be done scoring audit quality with the following formula:

$$Audit\ Quality = \frac{Score\ obtained}{6}$$

### 3.3.3. Firm Size

Firm size is the size of the company that can be measured by market capitalization (Riyanti, 2012; Utami, 2006). The measurement is as follows:

$$SIZE_{it} = L_n\,(Market\ Capitalization)$$

### 3.3.4. Leverage

Leverage describes the amount of debt-funded assets. The calculations are as follows (Brealey et al., 2001):

$$LEV_{it} = \frac{Debt}{Equity}$$

### 3.3.5. Earnings Management

Earnings management in this study employs accrual specific model, namely accrual working capital measured as follows:

$$Earnings\ Management = \frac{Accrual\ Working\ Capital}{Income}$$

### 3.3.6. Integrity of the Financial Statement

The integrity of the financial statements was measured by the conservatism proportions of Beaver and Ryan (2000) used in Kootanaee et al. (2013), Hamdan et al. (2012), Reyad et al., (2012), as well as Lara et al., (2012) using the book to market (BTM) ratio as follows:

$$Conservatism = \frac{Book\ Value}{Market\ Value}$$

The application of conservative accounting if the BTM value is less than one, because the company records the book value lower than its market value.

### 3.4. Types and Data Sources

Secondary data is obtained through the website www.idx.co.id, Indonesian Capital Market Directory, and CGPI assessment through CGPI Research and Reporting Results published by IICG.

### 3.5. Framework of Thinking

Interrelationships between variables can be seen through the frame of thought as described in Figure 3.

### 3.6. Research Hypothesis

The hypothesis is a temporary answer to the formulation of the problem that needs to be verified. The hypotheses in this research are as follows.

$H_1$: CGPI has a negative effect on earnings management.

$H_2$: Audit quality has a negative effect on earnings management.

$H_3$: Firm size has a negative effect on earnings management.

$H_4$: Leverage has a positive effect on earnings management.

$H_5$: CGPI, audit quality, firm size, and leverage simultaneously have effecton earnings management.

$H_6$: CGPI has a positive effect on the integrity of the financial statements.

$H_7$: Audit quality has a positive effect on the integrity of the financial statements.

$H_8$: Firm size has a positive effect on the integrity of the financial statements.

$H_9$: Leverage has a negative effect on the integrity of the financial statements.

$H_{10}$: Earnings management has a negative effect on the integrity of the financial statements.

$H_{11}$: CGPI, audit quality, company size, leverage and earnings management simultaneouslyaffect the integrity of the financial statements.

## 4. Results

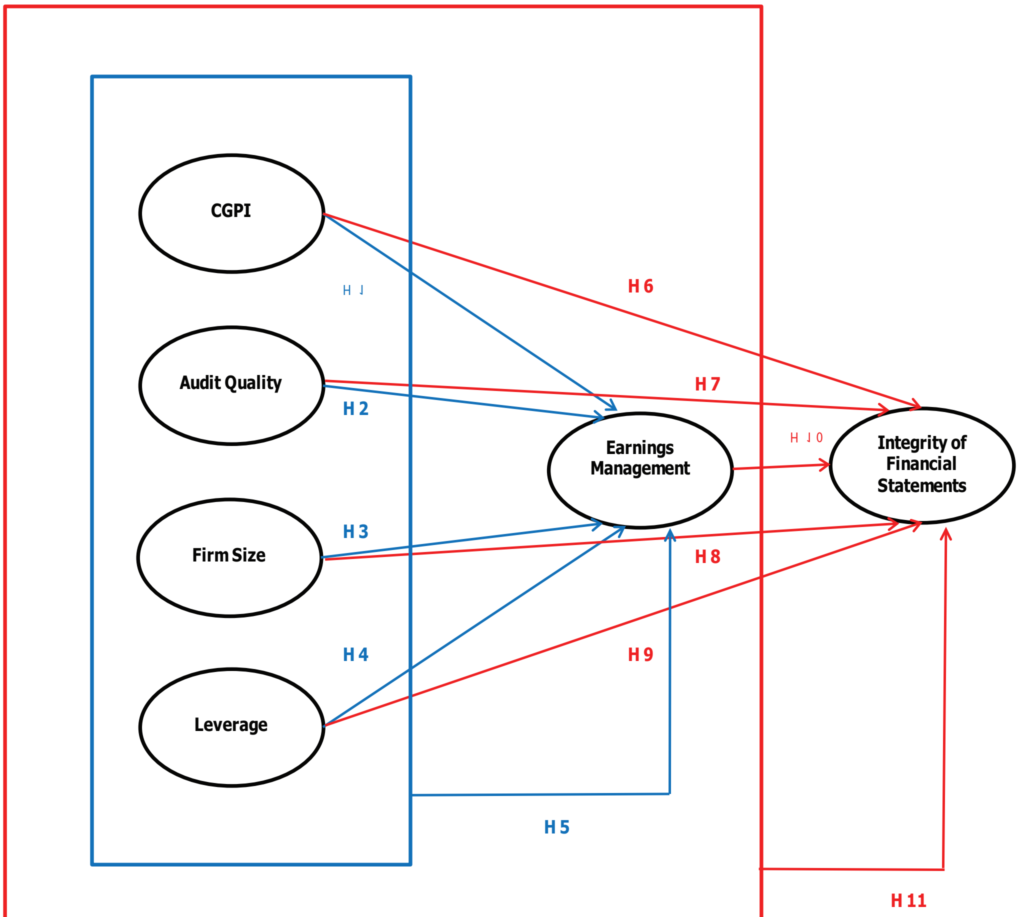


**Figure** 3: Framework of Thinking.

### 4.1. Analysis and Discussions

Based on the result of paired test to the three models (common effect, fixed effect, and random effect), for its influence both to earnings management and financial statement integrity, both yield best model is fixed effect. The fixed effect model used will eliminate the problem of heteroscedasticity by converting residuals by using white-heteroscedasticity. The results of panel data regression estimation for profit model majors can be seen through table 1, while the integrity of the financial statements can be seen through table 2. The results of the analysis are as follows:

1. CGPI negatively and significantly affects earnings management. This finding is **in line** with the research hypothesis which states that CGPI negatively affects earnings management on the companies that follow CGPI program for the period 2010-2015 (see Table 1).

2. Audit quality negatively and significantly affects earnings management. This result is **in line** with the research hypothesis which states that audit quality negatively affects earnings management on the companies that follow CGPI program for the period 2010-2015 (see Table 1).

3. Firm size negatively and significantly affects earnings management. This finding is **in line** with the research hypothesis which states that firm size negatively affects earnings management on the companies that follow CGPI program for the period 2010-2015 (see Table 1).

4. Leverage positively and significantly affects earnings management. This result is **in line** with the research hypothesis which states that leverage positively affects earnings management on the companies that follow CGPI program for the period 2010-2015 (see Table 1).

5. All independent variables (CGPI, audit quality, firm size, and leverage) simultaneously and significantly affects earnings management. This finding is **in line** with the research hypothesis which states that CGPI, audit quality, firm size, and leverage simultaneously affect earnings management on the companies that follow CGPI program for the period 2010-2015. The value of the coefficient of determination ($R^2$) of 0,688401 shows that all independent variables can explain the variation of earnings management of 68.84%, while the remainder of 31.16% explained by other factors not included in the model. Furthermore, compared to other independent variables in influencing earnings management, CGPI variable has **the most dominant effect** while firm size has **the smallest effect**. According to the estimation of each company, the result shows that PT. Aneka Tambang (Persero), Tbk (ANTM) has **the highest sensitivity of earnings management change**, while PT. Bank Tabungan Negara (Persero), Tbk (BBTN) has **the lowest sensitivity of earnings management change** (see Table 1).

6. CGPI positively affects the integrity of the financial statement but it is insignificant. This result is **inconsistent** which states that CGPI has a positive effect on the integrity of the financial statement on the companies that follow CGPI program for the period 2010-2015 (see Table 2).

7. Audit quality positively and significantly affects the integrity of the financial statements. This finding is **in line** with the research hypothesis which states that audit quality has a positive effect on the integrity of the financial statements on the companies that follow CGPI program for the period 2010-2015 (see Table 2).

8. Firm size negatively and significantly affects the integrity of the financial statements. This result is **inconsistent** with the research hypothesis which states that firm size has a positive effect on the integrity of the financial statements on the companies that follow CGPI program for the period 2010-2015 (see Table 2).

9. Leverage positively affects the integrity of the financial statements but it is insignificant. This finding is **inconsistent** with the research hypothesis which states that leverage has a negative effect on the integrity of the financial statements on the companies that follow CGPI program for the period 2010-2015 (see Table 2).

10. Earnings management negatively and significantly affects the integrity of the financial statements. This result is **in line** with the research hypothesis which states that earnings management has a negative effect on the integrity of the financial statements on the companies that follow CGPI program for the period 2010-2015 (see Table 2).

11. All independent variables (CGPI, audit quality, firm size, leverage, and earnings management) simultaneously and significantly affect the integrity of the financial statements. This finding is **in line** with the research hypothesis which states that CGPI, audit quality, firm size, leverage, and earnings management simultaneously affects the integrity of the financial statements on the companies that follow CGPI program for the period 2010-2015. The value of the coefficient of determination of 0.874129 shows that all independent variables can explain the variation of the integrity of the financial statements of 87.41%, while the remainder of 12.59% explained by other factors which is not included in the model. Furthermore, compared to the other independent variables in affecting the integrity of the financial statements, firm size has **the most dominant effect**, while audit quality has **the lowest effect**. Based on the estimation towards each company, the results show that PT. Bank Mandiri (Persero), Tbk (BMRI) has **the highest sensitivity of the change of the integrity of the financial statements**, while PT. Bank Tabungan Negara (Persero), Tbk (BBTN) has **the lowest sensitivity of the change of the integrity of the financial statements** (see Table 2).

## 5. Conclusion

The results of the first model show that CGPI partially has a significant negative effect, audit quality partially has a significant negative effect, firm size partially has a significant negative effect, leverage partially has a significant positive effect, on earnings management. CGPI, audit quality, firm size, and leverage simultaneously have significant effect on earnings management, with the value of the coefficient of determination ($R^2$) of 0.688401, show that all independent variables can explain the variation of earnings management of 68.84% while the rest of 31.16% explained by other factors not included in the model. In the second model, CGPI partially has a positive effect but insignificant, audit quality partially has a significant positive effect, firm size partially has a negative significant effect, leverage partially has a positive effect but insignificant, earnings management partially has a significant negative effect, on the integrity of the financial statements. CGPI, audit quality, firm size, leverage, and earnings management have significant effect on the integrity of the financial statements, with the value of the coefficient of determination ($R^2$) of 0.874129, indicating that all independent variables can explain the variation of the integrity of the financial statements of 87.41% while the rest of 12.59% explained by other factors not included in the model.

## 6. Managerial Implications

Based on the results of this study, the company should maintain and improve corporate governance practices, uses the qualified auditor services, convey positive information related to the company and apply low debt ratio with good planning. The investor should choose to invest in the companies that implement good corporate governance, uses qualified auditor services, investment priorities in large companies with low leverage.

## 7. Limitations and Research Suggestions

The independent variables used in this study are still limited, therefore it is necessary to add other independent variables, such as professional ethics, stock ownership concentration, company cash flows, company growth, financial distress, tax, etc. Furthermore, the measurement of earnings management can be calculated by real earnings management, and the integrity of the financial statements can be computed using Pennan and Zhang (2002), Givoly and Hayn (2000), Basu (1997) models.The research object consists of various industries, it is suggested that further research can be conducted in homogenous industry. Samples are limited to only six companies with six years of data for period 2010-2015, this is because CGPI is still voluntary. It is suggested that samples can be more with longer study periods with other corporate governance proxies.

# Appendices

Table 1: The Estimation of Factors Affecting Earnings Management *Fixed Effect White Cross-Sections Methods (No-Heteroscedasticity)*.

Dependent Variable: MALA?
Method: Pooled EGLS (Cross-section weights)
Date: 03/10/17 Time: 01:38
Sample: 2010 2015
Included observations: 6
Cross-sections included: 6
Total pool (balanced) observations: 36
Linear estimation after one-step weighting matrix
White cross-section standard errors & covariance (d.f. corrected)

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | 5.725414 | 1.068819 | 5.356764 | 0.0000 |
| CGPI? | -3.018742 | 0.542800 | -5.561423 | 0.0000 |
| KUALAUD? | -0.253762 | 0.117253 | -2.164220 | 0.0398 |
| UKPER? | -0.211646 | 0.044783 | -4.726072 | 0.0001 |
| LEV? | 0.235887 | 0.060397 | 3.905605 | 0.0006 |
| Fixed Effects (Cross) | | | | |
| ANTM--C | 0.520508 | | | |
| BMRI--C | 0.351924 | | | |
| BBNI--C | 0.174630 | | | |
| BBTN--C | -1.696404 | | | |
| _JSMR--C | 0.498792 | | | |
| TINS--C | 0.150551 | | | |

Effects Specification

Cross-section fixed (dummy variables)

Weighted Statistics

| | | | |
|---|---|---|---|
| R-squared | 0.688401 | Mean dependent var | 0.380630 |
| Adjusted R-squared | 0.580540 | S.D. dependent var | 0.319580 |
| S.E. of regression | 0.229191 | Sum squared resid | 1.365742 |
| F-statistic | 6.382297 | Durbin-Watson stat | 1.036709 |
| Prob(F-statistic) | 0.000094 | | |

Unweighted Statistics

| | | | |
|---|---|---|---|
| R-squared | 0.710422 | Mean dependent var | 0.367809 |
| Sum squared resid | 1.645919 | Durbin-Watson stat | 1.014646 |

Table 2: The Estimation of Factors Affecting the Integrity of the Financial Statements *Fixed Effect White Cross-Sections Methods (No-Heteroscedasticity)*.

Dependent Variable: ILK?
Method: Pooled EGLS (Cross-section weights)
Date: 03/10/17 Time: 02:03
Sample: 2010 2015
Included observations: 6
Cross-sections included: 6
Total pool (balanced) observations: 36
Linear estimation after one-step weighting matrix
White cross-section standard errors & covariance (d.f. corrected)

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | 11.42105 | 2.258325 | 5.057312 | 0.0000 |
| CGPI? | 0.522690 | 1.356578 | 0.385300 | 0.7033 |
| KUALAUD? | 0.354543 | 0.115553 | 3.068240 | 0.0051 |
| UKPER? | -0.678717 | 0.102730 | -6.606772 | 0.0000 |
| LEV? | 0.089738 | 0.062497 | 1.435883 | 0.1634 |
| MALA? | -0.525352 | 0.084824 | -6.193457 | 0.0000 |
| Fixed Effects (Cross) | | | | |
| _ANTM--C | 0.125496 | | | |
| BMRI--C | 0.949580 | | | |
| BBNI--C | 0.643863 | | | |
| _BBTN--C | -1.015492 | | | |
| _JSMR--C | -0.034331 | | | |
| TINS--C | -0.689116 | | | |

Effects Specification

Cross-section fixed (dummy variables)

Weighted Statistics

| | | | |
|---|---|---|---|
| R-squared | 0.874129 | Mean dependent var | 0.878932 |
| Adjusted R-squared | 0.823781 | S.D. dependent var | 0.605243 |
| S.E. of regression | 0.193478 | Sum squared resid | 0.935845 |
| F-statistic | 17.36167 | Durbin-Watson stat | 1.689889 |
| Prob(F-statistic) | 0.000000 | | |

Unweighted Statistics

| | | | |
|---|---|---|---|
| R-squared | 0.808302 | Mean dependent var | 0.661617 |
| Sum squared resid | 1.207694 | Durbin-Watson stat | 1.567421 |

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