

Research Article

Do Owners and Auditors Matter? Examining the Governance Drivers of Earnings Management

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Abstract

This study examines the effects of Managerial Ownership, Institutional Ownership, and the Number of Audit Committees on Earnings Management. Managerial ownership is measured as the percentage of management ownership, Institutional Ownership is measured as the percentage of institutional ownership, and the number of audit committees is measured by the number of audit committees in the company. This study uses a sample of manufacturing companies in all manufacturing sectors listed on the Indonesia Stock Exchange (IDX) during the 2013-2017 period. The sampling technique in this study was purposive, and a sample of 28 companies was selected. This study uses secondary data, namely company financial reports obtained from the official website of the Indonesian Stock Exchange (IDX). The results of the study indicate that Managerial Ownership, Institutional Ownership, and the Number of Audit Committees have a significant effect on Earnings Management. Managerial Implications The results of this study provide input for management and stakeholders that increasing managerial ownership, strengthening institutional ownership, and optimizing the number and function of audit committees can be an effective monitoring mechanism to suppress earnings management practices.

Keywords: Managerial Ownership, Institutional Ownership, Number of Audit Committees, Earnings Management

JEL Classification: G32, G34, M41

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1. Introduction

Earnings management remains one of the most widely scrutinized issues in corporate financial reporting due to its implications on transparency, credibility, and investor confidence. Prior studies show that managers often engage in discretionary accounting choices to meet performance targets, influence contractual outcomes, or shape market perceptions (Healy & Wahlen, 1999; Dechow, Ge, & Schrand, 2010). Earnings management practices may distort the reliability of financial reports and create information asymmetry between managers and stakeholders, making the phenomenon an important topic within corporate governance research. Recent empirical evidence indicates that the persistence of earnings management remains a global challenge, particularly in environments with weak monitoring structures (Garza-Gómez, 2020; Zang, 2012).

The relevance of ownership structure as a monitoring mechanism has been extensively examined in relation to financial reporting behavior. Managerial ownership, in particular, is believed to align managers' and shareholders' interests by giving managers a direct stake in the firm's residual claims (Jensen & Meckling, 1976; Alves, 2012). However, the actual impact of managerial ownership on earnings management remains inconclusive. Some studies argue that higher managerial ownership reduces opportunistic behavior due to alignment of interests (Mahariana & Ramantha, 2014), whereas others find that entrenched managers may use their authority to manipulate earnings for personal gain (Warfield, Wild, & Wild, 1995; Teshima, 2008). These conflicting findings indicate a research gap regarding how managerial ownership influences discretionary reporting practices.

Institutional ownership also plays a critical role in shaping monitoring intensity. Institutional investors typically possess greater analytical capabilities, resources, and incentives to assess managerial actions compared to individual shareholders (Cornett, Marcus & Tehrani, 2008). Prior research finds that institutional ownership can constrain opportunistic earnings management by strengthening monitoring quality and limiting discretionary behavior (Suryani, 2010; Chung, Firth & Kim, 2002). However, other evidence suggests that not all institutional investors are active monitors; some may pursue short-term gains and tolerate earnings manipulation to boost stock prices temporarily (Koh, 2007). This inconsistency in the literature highlights the need for further empirical investigation, particularly in emerging markets where ownership concentration tends to be high, and governance enforcement varies across firms.

The audit committee represents another critical governance structure designed to enhance the integrity of financial reporting. Effective audit committees typically signaled by appropriate size, independence, and financial expertise are expected to monitor internal controls and oversee the quality of financial audits (DeZoort, Hermanson, Archambeault & Reed, 2002). Empirical studies provide mixed results regarding their effectiveness. Some findings show that larger or more active audit committees are associated with lower levels of earnings management due to stronger oversight (Xie, Davidson & DaDalt, 2003), while others report no significant impact, suggesting that committee size alone may not reflect effectiveness (Bedard, Chtourou & Courteau, 2004). These inconsistencies reinforce the need for further examination of the audit committee's role within different firm environments.

Given the inconsistent empirical results across the dimensions of managerial ownership, institutional ownership, and audit committee characteristics, this study aims to provide

new evidence on the determinants of earnings management. A specific emphasis on manufacturing companies adds further relevance, as firms in this sector often have complex operational structures and substantial discretion in cost allocations and production estimates, increasing the risk of earnings manipulation (Gunny, 2010; Roychowdhury, 2006). Moreover, publicly listed firms in emerging markets, such as Indonesia, face heightened pressure to demonstrate financial stability amid market competition, thereby increasing incentives for earnings management. These factors justify the need for updated empirical analysis using recent methodological approaches and more comprehensive governance indicators.

This study addresses several research gaps observed in previous literature. First, the inconsistent relationship between managerial ownership and earnings management suggests the need to revisit theoretical assumptions regarding entrenchment versus alignment. Second, the mixed effects of institutional investors across jurisdictions underscore the importance of understanding monitoring behavior in contexts with high ownership concentration. Third, while the audit committee is formally mandated in Indonesia, its actual effectiveness may vary, requiring empirical testing. By examining these variables collectively, this study contributes to a more integrated understanding of the governance mechanisms that influence earnings management.

Accordingly, the objectives of this research are threefold: (1) to examine the effect of managerial ownership on earnings management, (2) to evaluate the influence of institutional ownership on earnings management, and (3) to assess whether the number of audit committee members mitigates or facilitates earnings management behavior. This study provides practical contributions to regulators, investors, and companies to strengthen governance mechanisms and ensure transparent financial reporting. Theoretically, this research extends the existing literature by offering empirical evidence from an emerging market context, where governance dynamics may differ from those in developed economies. The novelty of the study lies in its simultaneous evaluation of ownership structure and audit committee characteristics within a single empirical model, thereby offering a more holistic perspective on the effects of governance on earnings management.

2. Literature Review and Hypothesis

Literature Review

Earnings Management

Earnings management is the behavior of management in using accounting policies opportunistically to influence reported earnings (Healy & Wahlen, 1999). This practice can occur through accrual mechanisms or the manipulation of real activities, thereby affecting the quality of financial reports provided to stakeholders (Dechow, Ge, & Schrand, 2010). Earnings management is rooted in agency problems, where managers have incentives to maximize their personal interests through specific reporting techniques (Jensen & Meckling, 1976). Other studies show that earnings management is more common in companies with high market pressure or weak governance structures (Roychowdhury, 2006; Zang, 2012).

Managerial Ownership

Managerial ownership refers to the proportion of a company's shares held by its managers, directors, or commissioners. This structure is believed to align the interests of principals and agents because managers share the risk associated with the decisions they

make (Jensen & Meckling, 1976). Empirical research shows that managerial ownership can reduce incentives to engage in earnings management by increasing alignment of interests (Warfield, Wild, & Wild, 1995; Alves, 2012). However, several studies have found that when managerial ownership levels are too high, managers may engage in earnings manipulation due to the entrenchment effect (Teshima, 2008; Garza-Gómez, 2020). These findings suggest that the effect of managerial ownership on earnings management is not linear and depends on the corporate governance context.

Institutional Ownership

Institutional ownership refers to share ownership by professional institutions such as investment firms, pension funds, insurance companies, or other financial institutions. Institutional investors tend to have analytical capabilities, resources, and incentives to exercise closer oversight over management (Cornett, Marcus, & Tehrani, 2008). The literature suggests that institutional ownership can limit earnings management through strong monitoring mechanisms (Suryani, 2010; Chung, Firth, & Kim, 2002). However, other studies note that some institutions are "transient" and engage in earnings management to achieve short-term goals, such as maintaining the value of certain shares (Koh, 2007; Bushee, 1998). Therefore, the influence of institutional ownership on earnings management remains mixed in previous research.

Audit Committee

The audit committee is part of the corporate governance structure responsible for overseeing financial reporting and internal controls. The audit committee's role is considered crucial in improving audit quality and preventing financial statement manipulation (DeZoort et al., 2002). Research shows that larger, more independent audit committees with financial expertise are more effective in reducing earnings management (Xie, Davidson, & DaDalt, 2003; Bedard, Chtourou, & Courteau, 2004). However, several studies have found that audit committee size alone is not a sufficient indicator of effectiveness, as adequate quality and frequency of activities are required (Krishnan, 2003; Abbott, Parker & Peters, 2004). This is what makes the audit committee remain an important topic in corporate governance studies.

Hypothesis

Managerial Ownership and Earnings Management

Managerial ownership can reduce earnings management through the alignment-of-interests mechanism, as managers share the economic impact of the company's financial reporting decisions (Warfield et al., 1995). Several studies support the notion that higher managerial ownership reduces earnings manipulation (Alves, 2012; Mahariana & Ramantha, 2014). However, other studies show a nonlinear effect, in which managers may become more opportunistic at higher ownership levels (Teshima, 2008; Garza-Gómez, 2020). Nevertheless, most empirical research supports that managerial ownership tends to reduce opportunistic earnings management practices.

H1: Managerial ownership affects earnings management.

Institutional Ownership and Earnings Management

Institutional ownership is considered to improve monitoring quality because institutions have the incentive and ability to suppress management actions that harm shareholders (Cornett et al., 2008). Empirical research shows that institutional investors can suppress earnings management through strong monitoring activities (Chung et al., 2002; Suryani, 2010). However, some studies also suggest that certain types of institutional investors may

be inactive or even support manipulation practices for short-term goals (Koh, 2007; Bushee, 1998). Nevertheless, the majority of research supports a significant relationship between institutional ownership and control over earnings management.

H2: Institutional ownership influences earnings management.

Audit Committee and Earnings Management

The audit committee is tasked with overseeing the financial reporting process and reducing the potential for bias or manipulation of earnings reports (DeZoort et al., 2002). Previous research has found that larger and more active audit committees significantly reduce earnings management (Xie et al., 2003; Bedard et al., 2004). Additional studies have shown that audit committee size influences oversight effectiveness, as more members allow for more intensive task allocation and monitoring (Abbott et al., 2004; Krishnan, 2003). Thus, the size of the audit committee is an important indicator in detecting and preventing earnings management practices.

H3: The number of audit committee members influences earnings management.

Managerial Ownership, Institutional Ownership, Audit Committee (Simultaneous Effect)

The three governance variables managerial ownership, institutional ownership, and the audit committee are key components of a company's oversight mechanism. Previous studies have shown that strong governance can suppress opportunistic management behavior, including earnings management (Dechow et al., 2010; Xie et al., 2003). Studies such as Rahmaningtyas & Sarsiti (2017) and Aryanti et al. (2017) also demonstrate the simultaneous influence of governance mechanisms on earnings manipulation practices. Therefore, the simultaneous relationship among these three governance variables is expected to influence the level of corporate earnings management significantly.

H4: Managerial ownership, institutional ownership, and the size of the audit committee simultaneously influence earnings management.

3. Data and Method

Type of Research

The research method used in this study is quantitative. Quantitative research methods are systematic, planned, and clearly structured from the beginning through to the development of the research design. Quantitative research methods, as stated by Sugiyono (2014), are: "Research methods based on the philosophy of positivism are used to study specific populations or samples. Data collection uses research instruments, and data analysis is quantitative/statistical, with the aim of testing predetermined hypotheses." This type of data collection, use of research instruments, and data analysis is quantitative/statistical, with the aim of testing predetermined hypotheses.

Population and Sample

A population is the entire collection of elements that exhibit specific, defining characteristics that can be used to conclude. In conducting research, the population to be studied must be determined. As Sugiyono (2014) states, regarding population, "A population is a generalized area consisting of objects or subjects with a certain quantity and characteristics determined by the researcher to be studied and then conclusions drawn." The population in this study was manufacturing companies listed on the Indonesia Stock Exchange (BEI) from 2013 to 2017. Sampling is a step in determining the sample size for a study. Furthermore, it is important to note that the selected sample must reflect all population characteristics so that they are reflected in the selected sample. In other words, the sample must accurately reflect the population or be representative of it.

Data Collection Method

Data Types and Data Sources

Data can be obtained from two sources: primary and secondary. According to Sanusi (2011), data sources are divided into two categories: primary and secondary data. Primary data is data collected by the researcher himself, data that has not been previously collected, either by a specific method or over a specific time. Secondary data, on the other hand, is data collected by others, not by the researcher. This data usually comes from research conducted by institutions or organizations. The data source for this study is secondary data obtained from the official website of the Indonesia Stock Exchange (www.idx.co.id), specifically, company annual financial reports. The data taken from these financial reports include the percentage of management share ownership, the percentage of institutional share ownership, the number of audit committee members, and the company's total accruals.

Data Collection Technique

This study used documentation as a technique. As Sugiyono (2013) stated, documentation is a record of past events. Documents can be in the form of writings, drawings, or monumental works by a person. Documentation in this study involved collecting data from the financial reports of manufacturing companies listed on the IDX.

Data Analysis Method

This study used quantitative data analysis, where the data were processed after all required data had been collected. To test the hypotheses, multiple regression methods and descriptive statistics were used using Statistical Product and Service Solutions (SPSS) Version 25.

4. Results

Normality Test

According to Ghozali (2018), the normality test assesses whether the confounding variables or residuals in a regression model follow a normal distribution. As is known, the t- and F-tests assume that the residual values follow a normal distribution. If this assumption is violated, the statistical test becomes invalid for small sample sizes. The following is an illustration of a standard probability plot (P-Plot):

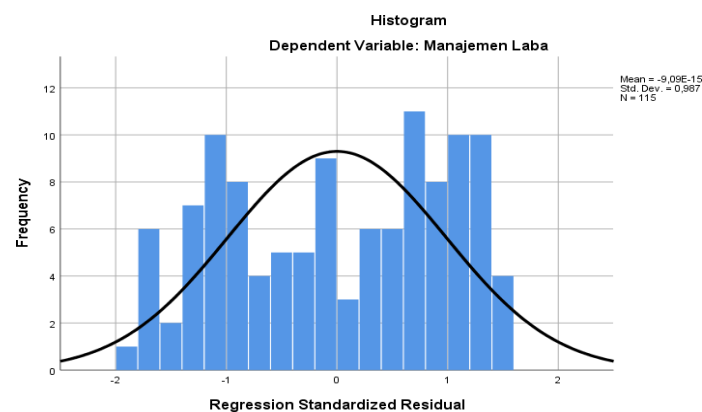


Figure 1. Normality Test

From the normal P-Plot, the histogram follows the diagonal line, indicating a normal distribution, and the dots are spread around it.

Multicollinearity Test

According to Ghazali (2018), this test assesses whether a correlation exists among the independent variables in the regression model. A good regression model should not correlate with the independent variables. If the independent variables are correlated, they are not orthogonal. The multicollinearity test is performed by examining the Tolerance Value and Variance Inflation Factor (VIF). The Tolerance Value limit is 0.10, and the VIF limit is 10. If the Tolerance Value is below 0.10 or the VIF value is above 10, multicollinearity occurs. The results of the multicollinearity test can be seen in Table 1 below:

Table 1. Results of the Multicollinearity Test Coefficient

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
1 (Constant)	2,532	,044		57,526	,000		
Managerial Ownership	-,037	,001	-,800	-26,778	,000	,841	1,189
Institutional Ownership	-,131	,005	-,785	-26,394	,000	,850	1,177
Number of Audit Committee Members	-,241	,012	-,579	-20,604	,000	,950	1,052

Source: Processed results (2018)

The analysis results show that the Tolerance values indicate no independent variable has a tolerance less than 0.10, meaning there is no correlation between the independent variables with a value greater than 95%. The calculation of the Variance Inflation Factor (VIF) also shows the same thing; no independent variable has a VIF value greater than 10. Therefore, it can be concluded that there is no multicollinearity among the independent variables in the regression model.

Heteroscedasticity Test

According to Ghazali (2018), the Heteroscedasticity Test assesses whether the variance of the residuals differs across observations in the regression model. A good regression model exhibits homoscedasticity, or no heteroscedasticity. These results can be seen in Figure 2 below:

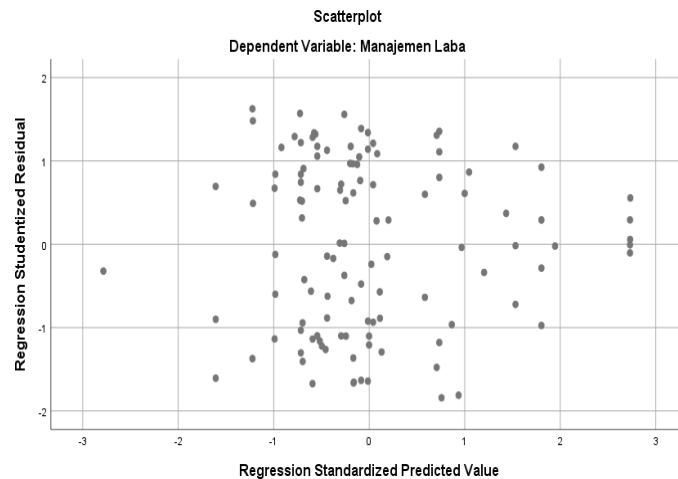


Figure 2. Heteroscedasticity Test Results – Scatterplot Graph

Heteroscedasticity was tested using a scatterplot. The scatterplot graph shows that the points are randomly distributed both above and below zero on the Y-axis. This indicates that there is no heteroscedasticity in the regression model, making it suitable for predicting the effects of managerial ownership, institutional ownership, and the number of audit committees on earnings management.

Autocorrelation Test

According to Ghozali (2018), the autocorrelation test aims to determine whether there is a correlation between the nuisance error in period t and the nuisance error in period $t-1$ (the previous period). If a correlation occurs, an autocorrelation problem is identified. Autocorrelation arises when consecutive observations are related to each other. This problem arises because the residuals (nuisance errors) are not independent from one observation to the next. A good regression model is free of autocorrelation. In this study, the autocorrelation test was tested using a Run Test. More details regarding the results of the research autocorrelation test can be seen in Table 2 below:

Table 2. Results of the Autocorrelation Test Runs

Test Value ^a	,00033
Cases < Test Value	57
Cases $\geq$ Test Value	58
Total Cases	115
Number of Runs	63
Z	,844
Asymp. Sig. (2-tailed)	,399

Source: Processed results (2018)

Table 2 above shows that the Asymp. Sig. (2-tailed) is 0.399, indicating a value greater than 0.05, meaning H_0 is accepted. Therefore, it is concluded that the residuals are random, meaning there is no autocorrelation between the residual values.

Partial Test Results (t-Statistic Test)

To determine the relationship between each independent variable (namely, managerial ownership, institutional ownership, and the number of audit committees) and earnings management, a t-test was used to test the regression coefficients. Based on SPSS version 25.0 calculations, as shown in Table 3, the probability values for each independent variable

on the dependent variable are determined. If the probability value is >0.05 , H_0 is rejected; if the probability value is <0.05 , H_a is accepted. Table 3 below shows that:

Table 3. Partial Test Results

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2,532	,044		57,526	,000
	Managerial Ownership	-,037	,001	-,800	-26,778	,000
	Institutional Ownership	-,131	,005	-,785	-26,394	,000
	Number of Audit Committee Members	-,241	,012	-,579	-20,604	,000

Source: Processed results (2018)

Partial test results indicate that all independent variables managerial ownership, institutional ownership, and the number of audit committee members significantly affect earnings management. All three variables have very low significance values and negative coefficients, indicating that improvements in each corporate governance mechanism tend to reduce earnings management practices. This confirms that a strong ownership structure and an effective audit committee are important components in reducing the likelihood of management engaging in earnings manipulation.

Coefficient of Determination (R²) Test

The coefficient of determination (Goodness of Fit), denoted by R^2 , is an important measure in regression because it can indicate the goodness of fit of the estimated regression model. In other words, this number measures how closely the estimated regression line fits the actual data. In this case, R^2 is used to determine the extent of the independent variables' influence on the dependent variable. The results of the coefficient (R^2) test can be seen in Table 4 below:

Table 4. Coefficient of Determination (R²) Test

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	,957 ^a	,917	,914	,03334

Source: Processed results (2018)

The R^2 value from the SPSS 25.0 analysis was 91.7%. Therefore, the influence of the variables KM, KI, and the number of audit committees on earnings management is 91.7%. In comparison, the remaining 8.3% is influenced by other factors not examined in this study.

5. Discussion

The Influence of Managerial Ownership on Earnings Management

The results of this study indicate that managerial ownership significantly influences earnings management practices. These findings indicate that when managers own a shareholding in a company, their interests tend to be more aligned with those of shareholders. This alignment minimizes managers' incentives to manipulate earnings, thereby reducing the risk of harming the company's long-term performance. This finding aligns with agency theory, which holds that greater managerial ownership can reduce

agency conflicts because managers bear the economic consequences of financial reporting decisions. These results are supported by Warfield, Wild, and Wild (1995), who found that increasing managerial ownership can reduce the tendency to engage in earnings management. Alves (2012) also showed that managerial ownership contributes to improved financial reporting quality, while Mahariana and Ramantha (2014) demonstrated that managers tend to be more cautious in reporting when they also act as owners. Overall, the results of this study are consistent with the majority of previous studies, which confirm that managerial ownership is an effective governance mechanism in suppressing earnings management practices.

The Influence of Institutional Ownership on Earnings Management

Institutional ownership was found to influence earnings management, suggesting that institutional investors can strengthen a company's monitoring function. With greater analytical capabilities and resources, professional institutions can exercise more stringent oversight of management actions, including financial reporting. This finding suggests that institutional investors play a crucial role as an external control mechanism in reducing the likelihood of earnings manipulation. These results are consistent with those of Chung, Firth, and Kim (2002), who demonstrated that institutional investors are effective at curbing opportunistic earnings management. Suryani (2010) also found that increasing institutional ownership increases pressure on management to present more transparent financial reports. Cornett, Marcus, and Tehrani (2008) showed that institutions tend to encourage more conservative corporate management practices to maintain the reputation of their investments. Therefore, the results of this study reinforce the conclusion that institutional ownership is a crucial factor in improving corporate governance quality.

The Influence of the Audit Committee on Earnings Management

The findings of this study indicate that the number of audit committee members influences the level of earnings management. The interpretation is that a stronger audit committee provides more effective monitoring of the financial reporting process. A larger audit committee facilitates diverse expertise, division of duties, and greater oversight intensity, thus limiting management's ability to manipulate earnings reports. These results align with a study by Xie, Davidson, and DaDalt (2003), which confirmed that an active and competent audit committee can reduce earnings management. Bedard, Chtourou, and Courteau (2004) also showed that an audit committee with an adequate structure has a better capacity to oversee a company's accounting policies. Research by Abbott, Parker, and Peters (2004) found that a strong audit committee correlates with a lower risk of financial statement restatements, an indicator of effective oversight. Therefore, these results strengthen the argument that the audit committee is a key pillar in maintaining the integrity of a company's financial reporting.

The Simultaneous Effect of Managerial Ownership, Institutional Ownership, and the Audit Committee on Earnings Management

The results also show that these three governance variables simultaneously contribute significantly to controlling earnings management. This finding indicates that strong governance relies not on a single mechanism, but on a combination of various oversight instruments. When managerial ownership, institutional ownership, and audit committee effectiveness operate synergistically, companies have a more robust control structure that minimizes opportunistic management behavior. This finding aligns with research by Dechow, Ge, and Schrand (2010), which emphasized that financial reporting quality

improves when various governance mechanisms operate simultaneously. Rahmaningtyas and Sarsiti (2017) also found that a combination of several governance components provides a more substantial control effect on earnings management practices. Furthermore, Aryanti, Kristanti, and Hendranto (2017) demonstrated that comprehensive governance mechanisms can suppress manipulative behavior more effectively than a single variable. These findings emphasize the importance of a multidimensional approach in designing effective corporate governance.

6. Conclusion

The research results indicate that corporate governance mechanisms, consisting of managerial ownership, institutional ownership, and the audit committee, play a crucial role in controlling earnings management practices. Managerial ownership aligns management and shareholder interests, reducing the potential for opportunistic behavior, while institutional ownership strengthens external monitoring through the analytical capacity of institutional investors. Furthermore, the presence of an adequate audit committee has been shown to increase the effectiveness of oversight of the financial reporting process. Overall, the combination of these three governance mechanisms demonstrates that controlling earnings management relies not on a single instrument, but on the synergy of various oversight tools working simultaneously to ensure the integrity of financial reporting.

The managerial implications of these findings are that companies need to strengthen their governance structures by increasing managers' involvement as shareholders, optimizing the role of institutional investors in monitoring, and ensuring adequate audit committee composition and capacity. Management needs to design internal policies that support transparent reporting, enhance oversight quality, and prioritize the independence and competence of audit committee members. For stakeholders, including regulators and investors, these results emphasize the importance of promoting comprehensive governance practices to create a more accountable financial reporting environment, minimize manipulation, and orient towards sustainable corporate performance.

Recommendation

Companies need to improve governance effectiveness by increasing managerial ownership proportionally, encouraging active monitoring by institutional investors, and ensuring that audit committees have adequate membership, competence, and independence. Regulators are advised to tighten reporting standards and regular evaluations of audit committee effectiveness. Investors should consider governance indicators as part of their risk analysis. Further research is recommended to incorporate audit quality, company size, or industry factors to broaden the understanding of the determinants of earnings management.

Limitations and avenues for future research

This study is limited by its focus on a single sector and reliance on secondary financial data, which may not fully capture qualitative governance dynamics. The analytical design also uses a cross-sectional approach, restricting the ability to observe changes in earnings management over time. Future research could incorporate longitudinal data, expand the sample across multiple industries, or integrate additional governance variables, such as audit quality, board diversity, or ownership concentration. Mixed-method designs or experimental approaches may also provide deeper insight into managerial decision-making and into the effectiveness of monitoring.

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