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# The Role of Good Corporate Governance in Profit Management

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**ABSTRACT**

*Profit management is the manipulation of transactions within the financial statement based on certain decisions by managers. This can mislead stakeholders who want to know the company's economic performance. Therefore companies need to their economic performance in the long term and minimize profit management through a good corporate governance system in order to control, manage, and supervise the company's operational mechanisms. This study aims to identify the role of Good Corporate Governance on profit management. Data collection followed the procedure of library research. The results of the analysis showed that Good Corporate Governance played a role in profit management by providing supervision by a permanent audit committee for a period. Effective supervision of managerial behavior can reduce profit management practices, aligning the interests of managers and shareholders, in accordance with agency theory, which explains that proper governance helps mitigate conflicts of interest and opportunistic behavior by management.*

## INTRODUCTION

The increasingly competitive business world requires companies to show their good performance. One of the performance indicators is profit. Company management manages company profits and this action is called profit management. Profits can be managed opportunistically or efficiently which will reflect the company's performance. Efficient profit management refers to increasing profit to provide informative information, while opportunistic profit management focuses on managing profit to increase profits in accordance with the d interests of certain parties (Widyaningsih, 2017).

Profit management occurs due to the conflict between shareholders (principals) and managers (agents). Company management is the party that plays an important role in generating and managing a company's profits. It is also responsible for maximizing the interests of the owner (Roychowdhury, 2006). However, management also has an interest in improving their welfare. This difference encourages management to carry out profit management. Implementing opportunistic profit management and manipulating financial statements can show the company's achievements. This aims for personal gain. Therefore, managers can practice profit management based on flexibility in selecting existing accounting policies (Ningsih, 2017).

The practice of earnings management is closely linked to agency theory, which explains the conflict of interest between managers (agents) and shareholders (principals). In response to this, companies are expected to implement Good Corporate Governance (GCG) mechanisms that can supervise and limit managers' opportunistic behavior. GCG, through mechanisms such as audit

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committees, managerial ownership, and independent commissioners, is believed to play a role in minimizing earnings management practices by aligning the interests of management with those of the stakeholders.

Some previous studies reveal different results regarding profit management. (Rahmawati, 2013) found that good corporate governance (audit committee, managerial ownership, institutional ownership along with an independent board of commissioners) played a role in profit management. (Abdillah et al., 2016) stated that good corporate governance (audit committee, independent commissioners, and institutional ownership) did not play a role in profit management. Meanwhile, good corporate governance (managerial ownership) had a role in profit management. (Widyaningsih, 2017) revealed that good corporate governance (managerial ownership) played a role in profit management. However, (Alfiano, 2017) found that only the independent board of commissioners had a role in profit management. These varying findings indicate the presence of a research gap, suggesting that there is no definitive consensus on the effectiveness of each GCG mechanism in curbing earnings management.

In practice, this inconsistency is reflected in the ongoing phenomenon of earnings management despite the formal implementation of GCG principles by many companies. Several financial reporting manipulation cases involving major corporations—with established audit committees, independent boards, and institutional ownership—raise questions about the real effectiveness of these mechanisms. This phenomenon brings into doubt the extent to which GCG implementation can genuinely restrain managers' opportunistic behavior. Therefore, further research is needed to re-examine the actual role of GCG mechanisms in limiting earnings management, especially considering the inconsistent findings in prior studies and the practical challenges faced by companies.

Therefore, companies need a good corporate system to minimize profit management practices, fraud, and corruption (Siagian et al., 2013). The Forum for Corporate Governance in Indonesia (FCGI) characterizes good corporate governance (GCG) as a collection of guidelines that manage the interactions among shareholders, managers (administrators), creditors, government, employees, and various internal and external stakeholders concerning their rights and responsibilities. In other terms, it is a mechanism for overseeing the company (Halim et al., 2012).

GCG mechanisms are realized by the existence of internal and external mechanisms, executive compensation, the level of debt financing, board of directors, audit committee, audit quality, and institutional ownership and managerial ownership (Firdausi, 2010). In addition to managerial ownership, institutional ownership, and the board of directors, the audit committee needs to play a role to further improve the quality of information in the company's financial statement in order to achieve good corporate governance (Jensen et al., 1976). To maintain company performance in the long term and minimize profit management practices, good corporate governance is needed in order to control, manage, and supervise the company's operational mechanisms (Setiawati et al., 2000). The existence of corporate governance is expected to monitor work within the company and stakeholders can carry out work according to their respective rights and obligations (Barnhart et al., 1998); (Midiastuty et al., 2003); and Bachtiar, 2004 in Syaiful, 2007).

This study offers novelty compared to previous research by not only examining the effect of Good Corporate Governance (GCG) mechanisms on earnings management individually, but also by addressing the inconsistencies of prior findings and the real-world context of GCG implementation in Indonesian companies. Moreover, this study evaluates the combined impact of various GCG components (audit committee, institutional ownership, managerial ownership, and independent commissioners), which were often tested separately in earlier studies. Through this approach, the research aims to provide a more comprehensive understanding of the actual effectiveness of GCG in limiting earnings management practices.

This study consists of four parts. The first part is the introduction which contains the background related to good corporate governance and profit management, the literature as the basis for this study, namely agency theory, good corporate governance, and profit management, factors affecting profit management, namely the bonus plan hypothesis, debt covenant hypothesis, and political cost hypothesis (Komite Nasional, 2006). The second part contains an explanation of the method used in this study, namely library research. The third part is a discussion of the role of good corporate governance in profit management and is associated with interpersonal communication theories to provide valid and relevant answers to the problem. The last part is the conclusion which summarizes the entire contents of the article regarding good corporate governance in realizing profit management (Purwaningtyas, 2011).

## MATERIALS AND METHODS

The research approach used in this study is descriptive qualitative with a library research method, as proposed by (Zang, 2006), which includes the process of collecting data from relevant scientific articles and books. The keywords used in the article search process were profit management and good corporate governance. The researcher relied on accredited national and international journals as the primary data sources. The data analysis technique was carried out in several stages. First, the researcher identified and selected literature based on topic relevance. Second, the data was categorized according to key themes, such as managerial incentives, GCG mechanisms, and earnings management practices. Third, the researcher applied content analysis by understanding and interpreting the literature. Then, synthesis was conducted to draw conclusions from various theoretical perspectives and previous research findings. This study also refers to the library research method applied in previous works by (Danandjaja, 2014), (Khatibah, 2011), and (Sugiyono, 2014) making this approach reliable in addressing the research problem formulation and drawing comprehensive conclusions.

## RESULTS AND DISCUSSION

### The Role of Good Corporate Governance in Realizing Profit Management

Shareholders (principals) who have authority in company management, both as creditors and members of the board of commissioners, are referred to as managerial ownership (Scott, 2000). Managerial ownership will result in the supervision of the policies taken by company management. Managerial ownership can also be interpreted as the percentage of shares owned by company managers and directors at the end of the year for each observation period. The interests of shareholders (principals) can be aligned with the interests of managers by increasing managerial ownership (Triatmojo, 2010). However, a high level of managerial ownership in a company can have a negative impact on the company as managers have high voting rights in making company decisions so managers have a strong position to control the company. Therefore, this can create difficulties for external shareholders to control managers' actions.

Institutional ownership is share ownership by other institutions, namely ownership by companies or other institutions outside the company concerned. Ownership divided among multiple entities in the form of institutions like insurance firms, banks, investment firms, pension funds, and various other institutional proprietorships (Dechow, 1995). Institutional ownership serves as a mechanism for companies to minimize agency conflicts. Institutional ownership can influence management via a strong oversight system. A significant degree of institutional ownership will lead to increased oversight from institutional investors. This initiative aims to deter opportunistic actions by managers and reduce the incidence of fraud by company leadership, which leads to a decline in company value (Dechow et al., 1995).

The audit committee is an additional party needed by the company to implement good corporate governance. The audit committee is formed by the board of commissioners to carry out examinations or research considered necessary for the implementation of the directors' functions in carrying out company management duties and tasks related to the financial reporting system (Astuti, 2010). (Sulistiyanto, 2008) in (Wahyuni, 2010) explain that audit committees are required to act independently in carrying out their duties and making decisions. This is necessary because the audit committee is the party that bridges the supervisory function of the board of commissioners and the internal auditor.

Regulation number 73/POJK.05/2016 from the Financial Services Authority defines independent commissioners as Board of Commissioners members who do not have affiliations with shareholders or similar members of the Board of Directors, nor with other Board of Commissioners members, and/or sharia supervisory board members, who possess no financial ties, management roles, share ownership, and/or familial connections with shareholders or equivalent individuals, Board of Directors members, other Board of Commissioners members, and/or sharia supervisory board members, nor any associations that could compromise their ability to operate independently (Committee, 1992). The Financial Services Authority Circular Letter Number 13/SEOJK.03/2017 stipulates that the board of commissioners must consist of a minimum of 3 (three) individuals and cannot have more members than the board of directors, with at least 1 (one) member residing in Indonesia, and at least 50% (fifty percent) of the total board members being independent commissioners (Syafa'ah, 2017). Thus, a minimum of fifty percent of the commissioners' board is independent (Graham et al., 2005). The presence of independent commissioners is anticipated to be impartial regarding all policies established by the board of directors. The behavior of participating in corporate governance, influenced by various internal and external factors, dictates the effectiveness of good corporate governance practices.

Some previous studies on profit management with various variables produced different findings. (Abdillah et al., 2016) and (Geraldina, 2013) used accrual profit management as a dependent variable and found that managerial ownership could realize profit management. Meanwhile, the audit committee, independent board of commissioners, and institutional ownership could not realize earnings management. Another study by (Alfiano, 2017) revealed that only an independent board of commissioners could realize accrual profit management. (Kusumawati, 2015) found that audit committees and managerial and institutional ownership could realize real profit management but independent boards of commissioners could not. However, (Hidayanti et al., 2014) found that only managerial ownership could realize profit management.

Thus, it can be said that Corporate Governance, namely the audit committee, cannot realize accrual and real profit management due to changes of position, replacement, reduction, or addition of audit committee members in the middle of a period causing inefficient performance of the audit committee (Rahardi et al., 2014). The audit committee's busyness with other tasks also causes a lack of supervision from the audit committee. Meanwhile, corporate governance, namely an independent board of commissioners, can realize accrual and real profit management because decisions regarding the company's daily operational activities are taken by management in addition to less supervision by the independent board of commissioners (Suwardjono, 2008). Thus, the independent board of commissioners can reduce agency theory for accrual and real profit management. Corporate governance, namely managerial ownership, cannot realize accrual and real profit management as management tends to carry out profit management. Corporate Governance, namely institutional ownership, cannot realize accrual and real profit management due to the lack of shares owned by institutions causing minimal supervision of financial reporting by parties outside the company. This can lead to increased profit management practices.

## CONCLUSIONS AND SUGGESTION

This study concludes that not all elements of good corporate governance affect profit management practices. Specifically, the audit committee, managerial ownership, and institutional ownership were found to be ineffective in reducing both accrual and real earnings management. This may be due to weak external oversight, conflicts of interest, or low share ownership by external parties. In contrast, the presence of independent commissioners was found to play a significant role in mitigating earnings management due to their neutral and independent role in decision-making and supervision.

This study is limited by its conceptual, library-based approach without empirical testing using real company data. As a result, the findings cannot be broadly generalized. For future research, it is suggested to use a quantitative approach by collecting data from the financial reports of listed companies, and to consider additional variables such as external audit quality, firm size, and regulatory compliance level. This is anticipated to offer a more thorough and accurate understanding of the effectiveness of corporate governance in reducing earnings management.

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