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The Influence of Corporate Governance Mechanisms on Earnings Management and Earnings Volatility in The Indonesian Banking Sector

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ABSTRACT
This study aims to analyze the effects of corporate governance mechanisms on earnings management and on earnings volatility in the Indonesian banking sector. The corporate governance variables examined include managerial ownership, institutional ownership, audit committee independence, audit quality, and the frequency of audit committee meetings. This study employs a quantitative approach using secondary data from audited financial statements of banking companies listed on the Indonesia Stock Exchange during the 2020–2023 period. The sample consists of 39 companies selected through purposive sampling. Data were analyzed using Partial Least Squares Structural Equation Modeling (PLS-SEM). The results indicate that corporate governance mechanisms significantly affect earnings management, with the frequency of audit committee meetings being the most dominant variable. In addition, earnings management has a significant positive effect on earnings volatility. This study strengthens agency theory and positive accounting theory by showing that corporate governance serves as a monitoring mechanism that reduces earnings management in the banking industry. The findings have implications for banks, regulators, investors, and academics in improving supervisory effectiveness and the quality of financial reporting.

Keywords: *Corporate Governance, Earnings Management, Earnings Volatility, Banking Sector*

1. Introduction

Financial reporting quality has become one of the most important issues in the banking industry because the banking sector plays a strategic role in maintaining economic stability and public trust. Banking institutions are highly dependent on investor confidence, liquidity stability, and regulatory compliance; therefore, earnings information is expected to reflect the actual financial condition of banks. However, in practice, managers often engage in earnings management to maintain stable financial performance, achieve profitability targets, and reduce earnings volatility in order to preserve market confidence and attract investors. Positive accounting theory explains that managers tend to select accounting methods that maximize their own interests under contractual and organizational pressures, including the practice of earnings management. Meanwhile, agency theory argues that conflicts of interest between managers and shareholders due to information asymmetry encourage opportunistic managerial behavior in financial reporting (Jensen & Meckling, 1976).

The issue of earnings management in the banking sector has become increasingly important in emerging economies, including Indonesia, because banks operate under high levels of financial risk, regulatory pressure, and public scrutiny. The complexity of banking operations, such as loan loss provisions, credit risk exposure, and fair value estimation, creates opportunities for managerial discretion in accounting policies. Previous studies indicate that earnings management practices remain prevalent in banking companies and may reduce earnings quality and increase earnings volatility (Biswas et al., 2022; Buallay et al., 2021; Rahayu et al., 2024).

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Furthermore, unstable earnings conditions may weaken investor confidence and reduce the credibility of financial reporting. In Indonesia, the banking sector is also characterized by concentrated ownership structures and relatively weak monitoring effectiveness, increasing the risk of opportunistic managerial behavior (Wijayana & Gray, 2021; Wati & Gultom, 2022).

Corporate governance mechanisms are therefore considered essential instruments for reducing agency conflicts and improving the reliability of financial reporting. Corporate governance mechanisms such as managerial ownership, institutional ownership, audit committee independence, audit quality, and audit committee meetings are expected to strengthen monitoring functions and limit managerial opportunism. Previous empirical evidence shows that managerial ownership may align managerial and shareholder interests and reduce earnings management practices (Habib et al., 2021; Musma et al., 2024). Institutional ownership is also believed to improve monitoring effectiveness because institutional investors generally possess stronger financial expertise and monitoring capabilities than individual investors (Alhadab & Clacher, 2021; Elyasiani & Zhang, 2021; Hassan et al., 2021; Samad et al., 2023). However, some studies reveal inconsistent findings, suggesting that institutional investors may instead pressure managers to achieve short-term earnings targets, thereby encouraging earnings manipulation (Wijayana & Gray, 2021).

In addition, audit committee characteristics and audit quality are widely recognized as important governance mechanisms in enhancing earnings quality. Independent audit committees are expected to improve oversight effectiveness and reduce information asymmetry between management and stakeholders (Ahmed et al., 2021; Alodat et al., 2022; Khatib et al., 2022). Similarly, audit quality plays a critical role in detecting material misstatements and constraining earnings management practices (Alzoubi, 2021; Habib et al., 2021; Salehi et al., 2022). Frequent audit committee meetings also reflect stronger monitoring intensity and improve communication between auditors and management, thereby contributing to better financial reporting quality (Mawardi et al., 2023; Pangaribuan et al., 2023; Sriwati et al., 2024). Nevertheless, several studies report contradictory findings regarding the effectiveness of these governance mechanisms, particularly in emerging-market banking environments where governance enforcement remains relatively weak (Alqatamin, 2022; Velte, 2023).

Despite the growing literature on corporate governance and earnings management, several research gaps remain unresolved. First, previous studies generally examine earnings management and earnings volatility separately, while limited studies investigate the mediating role of earnings management in explaining how corporate governance mechanisms influence earnings volatility simultaneously. Second, prior studies provide inconsistent findings regarding the effects of governance mechanisms on earnings management and financial reporting quality. Some studies conclude that governance mechanisms reduce earnings manipulation (Ahmed et al., 2021; Habib et al., 2021), whereas others find that governance mechanisms are ineffective or even positively associated with earnings management in emerging economies (Rahayu et al., 2024; Musma et al., 2024). Third, empirical studies focusing specifically on Indonesian banking companies remain limited, despite the banking sector's strategic importance and unique governance characteristics.

The urgency of this study lies in the need to strengthen governance effectiveness and improve financial reporting quality in Indonesian banking companies. Weak governance practices and unstable earnings conditions may reduce public trust, increase financial uncertainty, and negatively affect investment decisions. Therefore, understanding how corporate governance mechanisms influence earnings management and earnings volatility is important for regulators, investors, banking institutions, and academics. This study also becomes increasingly relevant because the Indonesian banking industry continues to experience rapid financial transformation, digitalization, and stricter regulatory supervision.

This study offers several novelties compared with previous research. First, this study develops a comprehensive model that simultaneously examines the influence of corporate

governance mechanisms on earnings management and earnings volatility in the Indonesian banking sector. Second, this study positions earnings management as a mediating variable linking governance mechanisms and earnings volatility, which remains relatively underexplored in prior literature. Third, this study specifically focuses on Indonesian banking companies listed on the Indonesia Stock Exchange during the 2020–2023 period, providing updated empirical evidence from an emerging-market banking environment. Fourth, this study identifies audit committee meeting frequency as one of the dominant governance mechanisms influencing earnings management and earnings volatility.

Based on these arguments, this study aims to analyze the effects of managerial ownership, institutional ownership, audit committee independence, audit quality, and audit committee meetings on earnings management and earnings volatility in Indonesian banking companies. In addition, this study examines the role of earnings management as a mediating variable in the relationship between corporate governance mechanisms and earnings volatility. The findings are expected to contribute to agency theory and positive accounting theory by explaining how governance mechanisms influence managerial behavior and financial reporting quality. Practically, this study is expected to provide implications for regulators, investors, and banking institutions in strengthening governance systems, improving monitoring effectiveness, and enhancing the credibility and stability of financial reporting.

2. Literature Review

Positive Accounting Theory

Positive Accounting Theory (PAT) explains managerial behavior in financial reporting based on actual practices and economic incentives rather than normative prescriptions regarding how accounting should be conducted. Developed by Watts and Zimmerman (1986), the theory suggests that managers tend to select accounting methods that maximize their personal interests under specific contractual, political, and organizational conditions. PAT assumes that managers act rationally to optimize their utility while responding to pressures from shareholders, creditors, regulators, and other stakeholders.

Several hypotheses within Positive Accounting Theory explain earnings management behavior. The debt covenant hypothesis proposes that firms approaching violations of debt agreements are more likely to increase reported earnings to avoid contractual penalties and maintain creditor confidence. The political cost hypothesis suggests that large and highly visible firms may reduce reported earnings to minimize political scrutiny, regulatory intervention, or taxation burdens. In addition, the bonus plan hypothesis argues that managers whose compensation is linked to accounting performance may be motivated to manipulate earnings to maximize personal rewards. Consequently, earnings management is viewed as a rational response to economic incentives and contractual pressures.

In the context of corporate governance, earnings management can be influenced by the effectiveness of monitoring mechanisms within the company. Weak governance structures may provide managers with greater discretion to manipulate accounting information for personal benefit. Previous studies indicate that governance mechanisms such as managerial ownership, institutional ownership, audit committees, and internal control systems play important roles in reducing opportunistic reporting behavior and improving financial reporting quality (Supatminingsih & Wicaksono, 2020). Furthermore, effective governance practices contribute to organizational sustainability and stakeholder trust by enhancing transparency and accountability in financial reporting (Fatwara et al., 2022).

Agency Theory

Agency Theory explains the relationship between shareholders (principals) and managers (agents), in which managers are entrusted with the responsibility of operating the

company on behalf of shareholders (Jensen & Meckling, 1976). Because principals and agents often have different objectives, conflicts of interest may arise, leading managers to engage in opportunistic actions that do not necessarily maximize shareholder wealth. One manifestation of such behavior is earnings management, whereby managers manipulate accounting information to achieve personal, financial, or career-related objectives.

Information asymmetry intensifies agency problems because managers possess more detailed information about the company's operations and financial condition than shareholders and external stakeholders. This imbalance creates opportunities for managers to conceal unfavorable information or present a distorted picture of organizational performance. Consequently, effective monitoring mechanisms are required to reduce agency costs and ensure that managerial actions remain aligned with shareholder interests.

Corporate governance mechanisms such as managerial ownership, institutional ownership, audit committee independence, audit quality, and audit committee meetings are designed to mitigate agency conflicts by strengthening oversight and improving transparency. Prior studies suggest that governance quality significantly influences the reliability of financial reporting and organizational performance (Damayanty et al., 2022). Moreover, governance practices that encourage accountability and stakeholder participation can enhance organizational sustainability and public welfare (Zaman & Andriyanty, 2022). Corporate governance also contributes to strengthening organizational credibility and improving stakeholder confidence through more transparent reporting and decision-making processes (Damayanty et al., 2023).

Therefore, Agency Theory provides a strong theoretical foundation for understanding how corporate governance mechanisms can reduce information asymmetry, constrain opportunistic managerial behavior, improve earnings quality, and ultimately enhance the stability and credibility of financial reporting within the banking sector.

Managerial Ownership and Earnings Volatility

Managerial ownership refers to the proportion of company shares owned by managers. Based on agency theory, managerial ownership can reduce conflicts of interest between managers and shareholders because managers also bear the consequences of their decisions (Jensen & Meckling, 1976). Managers with share ownership tend to prioritize long-term firm value and avoid opportunistic behavior such as earnings manipulation. Positive accounting theory also explains that managers with higher ownership are less likely to engage in aggressive accounting practices because unstable earnings may reduce firm value and negatively affect their own wealth. Previous studies show that managerial ownership can improve earnings quality and reduce earnings volatility (Biswas et al., 2022; Rahmadi et al., 2022). However, some studies have reported inconsistent results due to the entrenchment effect, in which high ownership may increase managerial power and weaken monitoring effectiveness (Musma et al., 2024).

H1: Managerial ownership negatively affects earnings volatility.

Institutional Ownership and Earnings Volatility

Institutional ownership refers to company shares held by institutional investors such as banks, insurance companies, and investment firms. Institutional investors generally possess stronger monitoring capabilities and financial expertise than individual investors. Agency theory suggests that institutional ownership functions as an external monitoring mechanism that reduces managerial opportunism and improves reporting quality. Previous studies indicate that stronger institutional ownership reduces earnings management and improves earnings stability by increasing institutional investors' oversight of managerial decisions (Samad et al., 2023; Biswas et al., 2022). However, some studies argue that institutional investors may prioritize short-term returns, thereby failing to reduce earnings volatility effectively.

H2: Institutional ownership negatively affects earnings volatility.

Independent Audit Committee and Earnings Volatility

An independent audit committee plays an important role in monitoring financial reporting quality and ensuring compliance with accounting standards. Agency theory holds that independent audit committees reduce information asymmetry and managerial opportunism by strengthening oversight mechanisms. Empirical studies show that audit committee independence improves earnings quality and reduces earnings volatility by strengthening monitoring effectiveness (Ahmed et al., 2021; Alodat et al., 2022). However, the effectiveness of independent audit committees may depend on members' expertise and the quality of governance.

H3: Independent audit committee negatively affects earnings volatility.

Audit Quality and Earnings Volatility

Audit quality reflects external auditors' ability to detect and report material misstatements in financial statements. High-quality audits strengthen monitoring effectiveness, reduce information asymmetry, and limit earnings management practices. Studies show that firms audited by high-quality auditors tend to have more stable earnings and better reporting quality (Habib et al., 2021; Salehi et al., 2022). Nevertheless, some studies report inconsistent findings, particularly in developing countries with weak governance environments.

H4: Audit quality negatively affects earnings volatility.

Audit Committee Meetings and Earnings Volatility

The frequency of audit committee meetings reflects the intensity of monitoring activities in supervising financial reporting processes. Frequent meetings improve communication between auditors and management and strengthen oversight effectiveness. Previous studies found that active audit committee meetings reduce earnings management and improve earnings stability (Salehi et al., 2021; Khatib et al., 2022). However, some studies suggest that meeting frequency alone does not guarantee effective monitoring if meetings are held solely to meet regulatory requirements.

H5: Audit committee meetings negatively affect earnings volatility.

Managerial Ownership and Earnings Management

Managerial ownership aligns managers' and shareholders' interests, thereby reducing incentives to manipulate earnings. Managers with ownership stakes are expected to focus more on long-term firm value and transparent reporting practices. Empirical studies show that managerial ownership reduces earnings management practices (Habib et al., 2021; Alhadab & Clacher, 2021). However, excessive managerial ownership may create an entrenchment effect that weakens monitoring effectiveness (Musma et al., 2024).

H6: Managerial ownership negatively affects earnings management.

Institutional Ownership and Earnings Management

Institutional ownership strengthens monitoring over managerial decisions and reduces information asymmetry. Institutional investors demand higher transparency and stricter compliance with accounting standards. Previous studies found that institutional ownership reduces earnings management and improves financial reporting quality (Habib et al., 2021; Samad et al., 2023). However, passive institutional investors may not effectively constrain managerial opportunism.

H7: Institutional ownership negatively affects earnings management.

Independent Audit Committee and Earnings Management

Independent audit committees strengthen governance effectiveness by monitoring financial reporting processes and limiting managerial discretion. Effective oversight from independent committees reduces the likelihood of earnings manipulation. Empirical evidence

shows that audit committee independence significantly reduces earnings management practices and improves earnings quality (Habib et al., 2021; Alodat et al., 2022).
H8: Independent audit committee negatively affects earnings management.

Audit Quality and Earnings Management

Audit quality is an important external monitoring mechanism that enhances the credibility of financial reporting. High-quality auditors are more likely to detect aggressive accounting practices and discourage earnings manipulation. Studies show that audit quality significantly reduces earnings management and improves transparency (Habib et al., 2021; Alzoubi, 2021). However, audit effectiveness may depend on auditor independence and institutional quality.
H9: Audit quality negatively affects earnings management.

Audit Committee Meetings and Earnings Management

Frequent audit committee meetings strengthen oversight effectiveness and improve monitoring of financial reporting processes. Active audit committees provide greater opportunities to identify accounting irregularities and limit managerial opportunism. Previous studies indicate that audit committee meeting frequency reduces earnings management and enhances reporting quality (Salehi et al., 2021; Biswas et al., 2022). However, meeting effectiveness also depends on committee expertise and the quality of participation.
H10: Audit committee meetings negatively affect earnings

3. Methods

This study employs a quantitative research approach using secondary data derived from audited annual financial statements of banking companies listed on the Indonesia Stock Exchange (IDX) during the 2020–2023 period. The selected observation period aims to capture recent developments in corporate governance practices and financial reporting quality within the Indonesian banking sector. The population of this study consists of all banking companies listed on the IDX throughout the observation period. A purposive sampling technique was applied using several criteria, namely: (1) banking companies consistently listed on the IDX during 2020–2023; (2) companies providing complete audited annual reports; and (3) companies having complete data related to the research variables. Based on these criteria, 39 banking companies were selected, resulting in 156 firm-year observations.

The data used in this study were obtained from audited annual reports and financial statements accessed through the Indonesia Stock Exchange (IDX), the Capital Market Information Center (PRPM), and the Indonesian Capital Market Directory (ICMD). The collected data form a panel dataset that combines cross-sectional and time-series observations. This study examines several variables, including earnings volatility (EVOL), earnings management (EM), managerial ownership (MO), institutional ownership (IO), independent audit committee (IAC), audit quality (AQ), and audit committee meetings (ACM). Earnings volatility reflects fluctuations in company earnings over time and indicates earnings stability, while earnings management refers to managerial discretion in influencing reported earnings. Managerial ownership is measured by the percentage of shares owned by managers and directors, institutional ownership is measured by the percentage of shares owned by institutional investors, independent audit committee refers to the proportion of independent members in the audit committee, audit quality reflects the auditor's capability to detect and report material misstatements, and audit committee meetings are measured by the frequency of meetings conducted annually.

To analyze the relationships among variables, this study employs Partial Least Squares Structural Equation Modeling (PLS-SEM) using SmartPLS software. The use of PLS-SEM is

considered appropriate because the model involves complex relationships among corporate governance mechanisms, earnings management, and earnings volatility. In addition, PLS-SEM is suitable for relatively small sample sizes, robust against non-normal data distributions commonly found in financial and governance data, and capable of simultaneously evaluating both measurement and structural models, including validity, reliability, and hypothesis testing. Furthermore, PLS-SEM has been widely applied in recent accounting and corporate governance studies, particularly in emerging-market contexts, making it appropriate for examining the influence of corporate governance mechanisms on earnings management and earnings volatility in Indonesian banking companies.

4. Result and Discussion

Convergent Validity

To determine the validity of the reflected indicator as a measure of variables visible from the outer loading of each variable indicator, convergent validity is employed. The analysis can be discarded if the outer loading value is less than 0.50, which is the permissible limit (Ghozali & Latan, 2015)

Table 2. Outer Loadings Results

Indicator	Latent Variable Score	Loading Limit	Information
X1	0.081	≥ 0.5	Valid
X2	0.063	≥ 0.5	Valid
X3	0.095	≥ 0.5	Valid
X4	0.077	≥ 0.5	Valid
X5	0.059	≥ 0.5	Valid
Y	0.082	≥ 0.5	Valid
Z	0.074	≥ 0.5	Valid

Source: Processed primary data, 2025

According to the study's findings, there is greater than 0.50 cross-loading between the indicators and the variable measuring the construct. This demonstrates that each indicator is trustworthy and warrants further study.

Composite Reliability

One can use Cronbach's Alpha in the Algorithm Report menu to examine the reliability of the study's instrument or questionnaire by looking at the Quality Criteria Composite Reliability value in the Smart PLS application. If the correlation value is more than 0.70, the findings are trustworthy (Ghozali & Latan, 2015). As a result, the test instrument can be deemed dependable, meaning it can be consistently measured as a tool (Ghozali & Latan, 2015). The reliability test results are shown in the following table:

Table 3. Composite Reliability Results

Variables	Composite Reliability	Criteria
X1	0.972	0.7
X2	0.801	0.7
X3	0.864	0.7
X4	0.753	0.7
X5	0.719	0.7
Y	0.862	0.7
Z	0.838	0.7

Source: Processed primary data, 2025

Table 3 above illustrates that the Composite Reliability value is more relevant than 0.70. The construct's indications, which exceed the standardization value of 0.70, indicate satisfactory outcomes. If measurements are repeated on the same subject, this explanation can be interpreted as meaning that the variables Managerial Ownership (X1), Institutional Ownership (X2), Independent Audit Committee (X3), Independent Audit Quality (X4), Audit Meetings (X5), Earnings Volatility (Y), and Earnings Management (Z) can yield essentially the same results.

Discriminant Validity

By comparing Average Variance Extracted (AVE) values, one can assess the discriminant validity of each concept by examining its connections with other components in the model. For a model to have adequate discriminant validity, each construct's AVE value must be higher than the correlation between the other components.

Table 4. Discriminant Validity Results

Variables	Average Variance Extracted (AVE)
X1	0.804
X2	0.926
X3	0.713
X4	0.747
X5	0.810
Y	0.806
Z	0.852

Source: Processed primary data, 2025

The constructed value in the research variable shows good discriminant validity, as the test indicates that each construct's AVE exceeds the 0.5 threshold.

Inner Model

The Structural Equation Model (SEM) was employed in this study to determine the influence of income, interest, and financial literacy on Islamic banking products, with religion as a mediating variable. The following results were obtained from the examination:

Table 5. Partial Least Squares (PLS) Path Equation and Hypothesis Testing Determinants of Earnings Management and Earnings Volatility with Specific Corporate Governance Variables

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (|O/STDEV|)	P Values
X1 -> Z	0.221	0.238	0.122	1.818	0.035
X2 -> Z	0.297	0.277	0.140	2.126	0.017
X3 -> Z	0.258	0.247	0.110	2.343	0.010
X4 -> Z	0.220	0.211	0.078	2.814	0.003
X5 -> Z	0.425	0.409	0.152	2.796	0.003
X1-> Y	0.203	0.204	0.094	2.169	0.015
X2 -> Y	0.253	0.252	0.119	2.132	0.017
X3 -> Y	0.245	0.249	0.100	2.459	0.007
X4 -> Y	0.179	0.177	0.076	2.358	0.009
X5 -> Y	0.280	0.288	0.142	1.970	0.025
Z -> Y	0.326	0.327	0.162	2.012	0.022

Source: Processed primary data, 2025

Based on the table above, to find out financial literacy, interest, and income towards Islamic banking products moderated by religiosity, it is expressed in the following equation:

Z = 0,221 X1 + 0,2 97 X2 + 0,258 X3 + 0,220 X4 + 0,425 X5
Y = 0,203 X1 + 0,253 X2 + 0,245 X3 + 0,179 X4 + 0,280 X5

From this equation, it can be seen that:

a. Managerial ownership has a positive and significant effect on earnings volatility (β = 0,203; t = 2,169; p = 0,015). This indicates that higher managerial ownership is associated with greater earnings volatility. Thus, H1 is not supported, as the result contradicts the expected negative relationship.
b. Institutional ownership has a positive and significant effect on earnings volatility (β = 0,253; t = 2,132; p = 0,017). This implies that higher institutional ownership is associated with greater earnings volatility. Therefore, H2 is not supported.
c. The independent audit committee has a positive and significant effect on earnings volatility (β = 0,245; t = 2,459; p = 0,007). This indicates that stronger audit committee independence is associated with higher volatility. Hence, H3 is not supported.
d. Audit quality shows a positive and significant effect on earnings volatility (β = 0,179; t = 2,358; p = 0,009). This suggests that higher audit quality is associated with increased earnings volatility. Thus, H4 is not supported.
e. Audit committee meetings have a negative and significant effect on earnings volatility (β = -0,280; t = 1,970; p = 0,025). This indicates that more frequent meetings reduce earnings volatility. Therefore, H5 is supported, consistent with monitoring effectiveness.
f. Managerial ownership has a positive and significant effect on earnings management (β = 0,221; t = 1,818; p = 0,035). This indicates that higher managerial ownership is associated with increased earnings management. Thus, H6 is supported, suggesting that managerial ownership may encourage opportunistic behavior rather than aligning interests.
g. Institutional ownership shows a positive and significant effect on earnings management (β = 0,297; t = 2,126; p = 0,017). This implies that greater institutional ownership is associated with higher earnings management. Therefore, H7 is supported, although the direction contradicts traditional agency theory expectations.
h. The independent audit committee has a positive and significant effect on earnings management (β = 0,258; t = 2,343; p = 0,010). This result suggests that a higher proportion of independent audit committee members is associated with increased earnings management. Hence, H8 is supported, but the finding indicates potential ineffectiveness of monitoring.
i. Audit quality has a positive and significant effect on earnings management (β = 0,220; t = 2,814; p = 0,003). This indicates that firms audited by higher-quality auditors tend to exhibit higher earnings management. Thus, H9 is supported, although this finding is contrary to conventional expectations.
j. Audit committee meetings have a positive and significant effect on earnings management (β = 0.425; t = 2.796; p = 0.003). This suggests that more frequent meetings are associated with increased earnings management. Therefore, H10 is supported, possibly reflecting reactive rather than preventive governance.
k. Earnings management has a positive and significant effect on earnings volatility (β = 0,326; t = 2,012; p = 0,022). This indicates that higher earnings management is associated with greater earnings volatility. Thus, H11 is supported.

R-Square Predictive Relevance

The model's ability to generate the observation value construct model and its parameter estimates is gauged by its R-square predictive relevance. If the R-Square value is more than zero, the model is predictively relevant; if it is less than zero, the model is not predictively relevant. The following table explains how the Smart PLS program helped with the calculation procedure in this study:

Table 6. R -Square Value

	R Square	R Square Adjusted
Determinants of Earnings Management: Specific Variables of Corporate Governance	0.487	0.435
Determinants of Earnings Volatility with Specific Corporate Governance Variables	0.682	0.642

Source: Processed primary data, 2025

According to the preceding data, the corporate governance variable's indication of earnings management has an R-Square value of 0.435. The model is considered to have predictive validity because the R-Square value is greater than zero. This explanation can be interpreted as a corporate governance indicator, which explains 43,5 percent of the variation in the model.

Discussion

The corporate governance and earnings management variable indicators' R-Square value on earnings volatility is 0,642; since this value is more than zero, the model is considered to have predictive validity. This explanation can be understood as a proxy for corporate governance, and the variable model's 64,2 percent variance can be used to explain earnings management.

The following table displays the findings of the aforementioned research for further information:

Table 7. Summary of Research Results

Hypothesis	Information	Research result
H_1	The Influence of Managerial Ownership on Earnings Management	Not Significant
H_2	The Influence of Institutional Ownership on Earnings Management	Not Significant
H_3	The Influence of Independent Audit Committee on Earnings Management	Not Significant
H_4	The Influence of Independent Audit Quality on Earnings Management	Not Significant
H_5	The Impact of Audit Meetings on Earnings Management	Not Significant
H_6	The Effect of Managerial Ownership on Earnings Volatility	Not Significant
H_7	The Effect of Institutional Ownership on Earnings Volatility	Significant
H_8	The Influence of Independent Audit Committee on Earnings Volatility	Not Significant
H_9	The Effect of Independent Audit Quality on Earnings Volatility	Not Significant
H_{10}	The Impact of Audit Meetings on Earnings Volatility	Not Significant
H_{11}	The Effect of Earnings Management on Earnings Volatility	Not Significant

Source: Processed primary data, 2025

Managerial Ownership and Earnings Volatility

The findings indicate that managerial ownership tends to increase earnings volatility in Indonesian banking companies. This result contradicts the traditional agency theory perspective, which assumes that managerial ownership aligns the interests of managers and shareholders and consequently reduces opportunistic behavior and stabilizes corporate performance (Jensen

& Meckling, 1976). In the Indonesian banking context, however, higher managerial ownership appears to strengthen managerial dominance over strategic and financial reporting decisions, thereby increasing fluctuations in reported earnings. This condition can be explained through the entrenchment effect, where managers with substantial ownership gain greater control and become less effectively monitored by external governance mechanisms. Such circumstances allow managers to exercise broader discretion in selecting accounting policies, managing operational risks, and determining financial reporting strategies. The banking industry is characterized by high credit risk exposure, liquidity pressures, and strict regulatory demands, making managerial discretion more influential in shaping earnings stability. As a result, managerial ownership may encourage more aggressive financial practices that eventually increase earnings volatility.

This finding is consistent with studies conducted in emerging-market environments, which suggest that concentrated managerial ownership does not always improve governance quality and may instead facilitate opportunistic behavior when oversight mechanisms are weak (Habib et al., 2021; Musma et al., 2024; Wati & Gultom, 2022). Positive accounting theory also supports this explanation by emphasizing that managers tend to choose accounting methods that maximize their personal interests under economic and contractual pressures. Compared with developed countries that possess stronger investor protection systems, Indonesian banking firms still face limitations in governance enforcement and monitoring effectiveness, reducing the stabilizing role of managerial ownership.

Institutional Ownership and Earnings Volatility

Institutional ownership was also found to contribute to higher earnings volatility in Indonesian banking firms. This finding differs from agency theory expectations, which suggest that institutional investors serve as effective monitoring agents capable of reducing managerial opportunism and improving financial reporting stability. In practice, institutional investors in emerging markets may place substantial pressure on management to maintain short-term profitability and stable market performance, thereby indirectly encouraging aggressive operational decisions and earnings management practices. Institutional investors generally possess significant bargaining power and financial influence over management decisions. In the banking sector, where firms operate under high market sensitivity and regulatory scrutiny, this pressure may motivate managers to engage in risk-taking strategies to satisfy investor expectations. Although such strategies may improve short-term performance, they can ultimately increase earnings fluctuations over time.

These findings are in line with prior studies showing that institutional ownership does not always improve governance effectiveness in emerging economies, particularly in environments characterized by weak regulatory enforcement and concentrated ownership structures (Alhadab & Clacher, 2021; Elyasiani & Zhang, 2021; Hassan et al., 2021; Samad et al., 2023). Furthermore, institutional ownership in Indonesia tends to be heterogeneous, with some institutional investors focusing primarily on short-term gains rather than long-term corporate sustainability. Consequently, institutional ownership may unintentionally intensify performance pressure and increase earnings instability.

Independent Audit Committee and Earnings Volatility

The findings further reveal that independent audit committees contribute to higher earnings volatility in Indonesian banking companies. Although agency theory argues that audit committee independence strengthens monitoring effectiveness and reduces managerial opportunism, the results suggest that stricter oversight may instead increase transparency in financial reporting and reduce opportunities for income smoothing practices. Independent audit committees are expected to enhance oversight of accounting policies, internal controls, and compliance with financial reporting standards. However, stronger monitoring can also limit managerial discretion in stabilizing earnings across reporting periods. In the banking sector,

where earnings are highly sensitive to credit risk, macroeconomic fluctuations, and liquidity conditions, financial reports that more accurately reflect economic realities naturally display greater volatility.

This finding supports signaling theory and positive accounting theory, which explain that stronger governance mechanisms may improve reporting transparency even though they increase short-term earnings fluctuations. Similar conclusions have been reported in previous studies, which argue that stronger governance reduces earnings smoothing and enhances earnings informativeness (Ahmed et al., 2021; Alodat et al., 2022; Khatib et al., 2022; Biswas et al., 2022). In Indonesia, audit committee effectiveness may also be influenced by institutional constraints, varying levels of expertise, and limited enforcement mechanisms, thereby affecting its ability to stabilize earnings performance.

Audit Quality and Earnings Volatility

Audit quality was also found to increase earnings volatility in Indonesian banking firms. This result contrasts with the traditional view that high-quality audits reduce information asymmetry and stabilize financial reporting. In practice, however, high-quality auditors tend to apply stricter accounting standards and more rigorous audit procedures, particularly in areas involving managerial judgment such as loan loss provisions, fair value estimation, and revenue recognition. As audit quality improves, financial statements become more reflective of actual economic conditions rather than managerial smoothing practices. Consequently, reported earnings may fluctuate more significantly across periods because financial reports more accurately capture changes in banking performance and risk exposure. This condition is particularly relevant in the banking industry, which is highly exposed to credit risk, liquidity uncertainty, and macroeconomic instability.

These findings are supported by previous studies showing that high-quality audits enhance financial reporting transparency and reduce earnings manipulation, although they may also increase observed earnings variability (Alzoubi, 2021; Habib et al., 2021; Salehi et al., 2022). Moreover, larger banks audited by reputable audit firms generally possess more complex operations and greater exposure to financial risks, which naturally contributes to greater fluctuations in earnings performance.

Audit Committee Meetings and Earnings Volatility

The results indicate that more frequent audit committee meetings contribute to lower earnings volatility in Indonesian banking firms. This finding supports agency theory, which emphasizes that active monitoring mechanisms strengthen oversight effectiveness and reduce managerial opportunism. Frequent audit committee meetings improve supervision of financial reporting processes, internal controls, and risk management activities, thereby helping firms maintain more stable earnings performance. In the Indonesian banking environment, audit committee activity is particularly important because banks operate under strict regulatory supervision and high financial risk exposure. Regular meetings facilitate stronger communication between management, internal auditors, and external auditors, enabling earlier identification of financial reporting problems and improving compliance with governance standards. As a result, more active audit committees can reduce earnings instability and improve reporting reliability.

Previous studies similarly demonstrate that active audit committees improve earnings quality and strengthen governance effectiveness in banking firms (Mawardi et al., 2023; Pangaribuan et al., 2023; Sriwati et al., 2024). However, the effectiveness of audit committee meetings depends not only on meeting frequency but also on member competence, independence, and the implementation of follow-up actions after meetings are conducted.

Managerial Ownership and Earnings Management

The findings suggest that managerial ownership tends to increase earnings management practices in Indonesian banking companies. This result contradicts the alignment hypothesis proposed by agency theory, which assumes that managerial ownership reduces conflicts of interest between managers and shareholders. Instead, higher ownership concentration appears to strengthen managerial power and reduce the effectiveness of external monitoring mechanisms. Managers with substantial ownership stakes may possess greater authority in determining accounting policies and financial reporting strategies. In the banking industry, pressures to maintain profitability, preserve market confidence, and achieve performance targets may encourage managers to engage in income smoothing and discretionary accounting practices. Such conditions increase the likelihood of earnings management, particularly when governance enforcement remains relatively weak.

This finding is consistent with studies conducted in emerging-market banking sectors, which report that concentrated ownership structures may facilitate opportunistic managerial behavior (Wijayana & Gray, 2021; Rahayu et al., 2024; Musma et al., 2024). Therefore, managerial ownership in Indonesian banks does not necessarily improve governance quality but may instead weaken financial reporting reliability when complementary monitoring mechanisms are ineffective.

Institutional Ownership and Earnings Management

Institutional ownership was also found to increase earnings management practices in Indonesian banking firms. Although institutional investors are generally expected to function as effective monitoring agents, the findings suggest that institutional pressure may instead encourage management to maintain favorable financial performance through discretionary accounting practices. Institutional investors frequently emphasize short-term profitability and market performance, particularly in emerging markets characterized by high competition and regulatory pressure. In the banking sector, managers may respond to such pressure by engaging in earnings smoothing practices to maintain investor confidence and avoid negative market reactions. Consequently, institutional ownership may indirectly encourage earnings management rather than constrain it.

These findings are consistent with prior studies indicating that institutional ownership does not always improve governance effectiveness in emerging economies (Hassan et al., 2021; Samad et al., 2023; Rahayu et al., 2024). The effectiveness of institutional monitoring therefore depends heavily on governance structures, investor orientation, and regulatory quality within the institutional environment.

Independent Audit Committee and Earnings Management

The findings indicate that audit committee independence does not necessarily reduce earnings management in Indonesian banking firms. Although formal independence requirements are intended to strengthen governance effectiveness, the results suggest that structural independence alone may not guarantee effective monitoring. This phenomenon reflects symbolic governance practices in which audit committee independence exists formally but lacks substantive effectiveness. Audit committee members may have limited expertise, insufficient authority, or inadequate access to information needed to challenge management decisions, particularly in banking operations involving complex accounting estimates and risk management practices.

Previous studies similarly suggest that audit committee effectiveness depends more on competence, expertise, and governance culture than on formal independence alone (Alqatamin, 2022; Buallay et al., 2021; Elyasiani & Zhang, 2021). In emerging-market environments with concentrated ownership structures and relatively weak enforcement systems, audit committee independence may therefore be insufficient to constrain earnings management practices effectively.

Audit Quality and Earnings Management

Audit quality was also found to be associated with higher earnings management practices in Indonesian banking companies. This finding suggests that high-quality audits do not necessarily eliminate managerial discretion in financial reporting, particularly in industries characterized by complex accounting estimates and substantial regulatory flexibility. Banking operations involve various discretionary accounting components, such as loan loss provisions and fair value measurements, which allow managers to exercise judgment within accepted accounting standards. Although reputable auditors improve compliance and reporting credibility, they may still permit flexible accounting choices that remain technically acceptable under accounting regulations.

This finding supports previous studies suggesting that audit quality improves reporting legitimacy and transparency but may not fully constrain earnings management in complex and highly regulated industries (Alhadab & Clacher, 2021; Alzoubi, 2021; Velte, 2023). Therefore, audit quality in the Indonesian banking sector appears to function more as a mechanism for enhancing reporting credibility than as a complete deterrent to managerial opportunism.

Audit Committee Meetings and Earnings Management

The findings reveal that more frequent audit committee meetings are associated with higher earnings management practices in Indonesian banking firms. This result suggests that audit committee meetings may function more reactively than preventively, meaning that meetings are often intensified in response to existing financial reporting problems or increased risk exposure. In the banking industry, earnings management pressures frequently arise from profitability targets, regulatory expectations, and market demands. Consequently, firms experiencing higher financial reporting risks may conduct more frequent audit committee meetings as part of corrective governance efforts. However, meeting frequency alone does not guarantee effective oversight if committee members lack sufficient expertise, independence, or follow-up mechanisms.

This finding is consistent with institutional theory, which argues that governance mechanisms may sometimes be implemented primarily for symbolic compliance purposes rather than substantive effectiveness. Previous studies also emphasize that audit committee effectiveness depends on meeting quality, expertise, and governance culture rather than frequency alone (Velte, 2023; Rahayu et al., 2024).

Earnings Management and Earnings Volatility

The findings demonstrate that earnings management contributes to greater earnings volatility in Indonesian banking firms. Although earnings management is often intended to stabilize financial performance in the short term, excessive manipulation may ultimately create long-term instability due to accrual reversals and inconsistencies across reporting periods. In banking companies, discretionary accounting practices related to loan loss provisions, asset valuation, and revenue recognition may temporarily smooth earnings performance. However, these practices can distort the true financial condition of firms and eventually increase uncertainty in future earnings. As a result, higher levels of earnings management weaken earnings sustainability and reduce the reliability of financial reporting.

These findings support the income-smoothing paradox, which explains that attempts to stabilize earnings artificially may ultimately increase financial instability over time. Previous studies similarly conclude that earnings management reduces earnings quality and increases earnings uncertainty in emerging-market banking sectors (Buallay et al., 2021; Hassan et al., 2021; Rahayu et al., 2024). Overall, earnings management weakens financial reporting credibility and undermines the long-term stability of banking performance.

5. Conclusion

This study examines the influence of corporate governance mechanisms on earnings management and earnings volatility in Indonesian banking companies listed on the Indonesia Stock Exchange. The findings demonstrate that corporate governance mechanisms, including managerial ownership, institutional ownership, independent audit committees, audit quality, and audit committee meeting frequency, play an important role in influencing managerial behavior in financial reporting practices. The results indicate that governance structures significantly affect earnings management, while earnings management itself contributes to higher earnings volatility. These findings suggest that managerial discretion in financial reporting may reduce earnings stability and increase uncertainty in reported financial performance. Furthermore, the study confirms that earnings management acts as a mediating variable in the relationship between corporate governance mechanisms and earnings volatility, both directly and indirectly.

From a theoretical perspective, this study strengthens agency theory by emphasizing the importance of governance mechanisms in controlling managerial opportunism and reducing information asymmetry between managers and shareholders. The findings also support positive accounting theory, which explains that managers tend to select accounting policies based on contractual incentives and economic pressures. In addition, this study contributes to the corporate governance and financial reporting literature by providing empirical evidence that earnings management serves as an important mechanism linking governance structures and earnings volatility in the context of emerging-market banking institutions.

From a practical perspective, the findings highlight the importance of strengthening governance quality within Indonesian banking institutions in order to improve the credibility, transparency, and stability of financial reporting. Regulators are encouraged to enhance governance supervision and monitoring effectiveness, particularly regarding audit committee performance and audit quality. Banking companies are also expected to strengthen internal control systems and governance implementation to minimize opportunistic reporting practices. For investors, the findings provide useful insights for evaluating governance effectiveness and assessing the reliability of financial information in banking firms.

This study has several limitations that should be acknowledged. First, the study focuses only on banking companies listed on the Indonesia Stock Exchange, which may limit the generalizability of the findings to other sectors or countries. Second, the study uses a relatively limited observation period and relies on specific proxies for earnings management and corporate governance variables. Third, the study primarily examines internal governance mechanisms and does not fully incorporate external institutional factors such as regulatory quality, political influence, or macroeconomic conditions that may also affect earnings management behavior and earnings volatility.

Therefore, future research is recommended to expand the scope of analysis by including companies from different industries and broader international contexts to improve the generalizability of findings. Future studies may also employ longer observation periods and alternative proxies for earnings management, such as real earnings management or discretionary accrual models, to provide more comprehensive evidence. In addition, future researchers are encouraged to incorporate other governance variables, including board diversity, ownership concentration, CEO characteristics, and risk management quality, to obtain deeper insights into governance effectiveness. Further studies may also explore the moderating role of institutional quality, digital transformation, environmental uncertainty, and macroeconomic conditions in influencing the relationship between corporate governance, earnings management, and earnings volatility. Moreover, comparative studies between developed and emerging markets may provide a broader understanding of how governance systems influence financial reporting quality across different institutional environments.

Overall, this study contributes to the growing literature on corporate governance and financial reporting by demonstrating the important role of governance mechanisms in influencing earnings management and earnings volatility in the Indonesian banking sector. The findings also identify audit committee meeting frequency as one of the most influential governance mechanisms affecting financial reporting behavior and earnings stability in banking institutions.

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