

THE DETERMINANTS OF FIRM VALUE: THE ROLE OF EARNINGS MANAGEMENT AND GOOD CORPORATE GOVERNANCE

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Abstract

The conflict of interest between managers (agents) and the owner (principals) occurs all the time, although the level of the conflict is not always similar. This is because there are separation roles or a difference of interests. In many Indonesian banks, the implementation of Good Corporate Governance (GCG) is mandatory. But, in manufacturing companies in Indonesia, GCG is still not a must. So, what is the role of GCG in conjunction with firm value in manufacturing companies? In addition, many manufacturing companies use earnings management as a benchmark of firm value. It is clear that earnings management can be placed as an antecedent of firm value. The purpose of this research is to analyze the determinants of firm value in relation to earnings management and the mechanism of GCG as a moderating variable. The GCG is not viewed as an antecedent variable. The research sample is 46 companies in the entire industry of consumer goods of manufacturing companies in the Indonesia Stock Exchange. By specific considerations, the number of the sample is reduced to 39 out of 46 companies. The method used is a moderated regression analysis (MRA). The results show that the earnings management and the mechanism of GCG have an impact on the firm value. The dimension of GCG, namely, independent commissioner, managerial ownership, and audit quality can be placed as moderating variables and as determinants of firm value. In order to increase the firm value, it is advisable that this industry should strictly apply the mechanism of GCG as mandatory. However, the issue of GCG as an independent or moderating variable still remains debatable.

Keywords: Firm Value, Earnings Management, Good Corporate Governance (GCG)

1. INTRODUCTION

Approaches to measuring the firm value are not always the same in each company due to varying purposes of doing business. However, a company's profit tends to be a tool to measure the firm value. Furthermore, GCG serves as a good benchmark for, at least, showing society including customers that the company is well managed. Nevertheless, many companies, including manufacturing companies in Indonesia, do not use GCG as a variable which is used to operate the business.

As an antecedent of a firm value, earnings management needs to be done properly. Nevertheless, the implementation of earnings management may result in an accounting scandal caused by the conflict of interest between an agent and the principal. Role separation between the agent and the principal and information asymmetry lead to weak decision-making (Siallagan and Machfoedz, 2006).

Agency theory provides a view that management problems, in particular, the issue of earnings management, can be eradicated by supervisory mechanisms of GCG. Barnhart and Rosenstein (1998) state that some mechanisms of GCG are expected to address the problem of the agency.

Several studies related to earnings management and GCG mechanism show that some GCG mechanisms and earnings management have a negative effect on company performance (Midiastuty and Machfoedz, 2003; Meutia, 2004; Wedari, 2004; Suranta and Midiastuty, 2004; Ujijantho and Pramuka, 2007 and Herawaty, 2008) whereas other GCG mechanisms, namely managerial ownership, board of commissioners, the proportion of independent commissioners and the number of the board of directors and earnings management, have a positive impact on the firm value (Suranta and Midiastuty, 2004 and Ujijantho and Pramuka, 2007). In the aforementioned research, GCG was regarded as an antecedent.

The novelty of this research lies in viewing the GCG mechanism as a moderating variable which makes GCG optional. The aim of this research is to analyze the trigger impact of GCG and earnings management on firm value of manufacturing companies in Indonesia, with GCG as a moderating variable.

2. STUDY OF LITERATURE

The main purpose of a company is to maximize prosperity for shareholders (principals). Management, including workers as agents who are appointed by the shareholders, is working in a

company for some benefits of shareholders. In some cases, role difference between agents and principles creates a conflict. The conflict occurs due to several reasons. Eisenhard (1989) in Sabeni (2005) argue that the conflict is grounded by three basic assumptions: (1) assumption about human nature, (2) organizational assumption, and (3) assumption about information.

Beaudoin, Cianci and Tsakumis (2015) inform that incentive conflict and ethics management (EM) interact to determine CFOs' discretionary accruals such that (a) in the presence of incentive conflict, CFOs with low (high) EM-Ethics tend to give in to (resist) the personal incentive by booking higher (lower) expense accruals; and (b) in the absence of an incentive conflict, CFOs with low (high) EM-Ethics tend to give in to (resist) the corporate incentive by booking lower (higher) expense accruals. We also find support for a mediated-moderation model in which CFOs' level of EM-Ethics influences their moral disengagement tendencies which, in turn, differentially affect their discretionary accruals, depending on the presence or absence of incentive conflict.

Both principals and agents have bargaining positions. Principals, being the owners of the capital, have access rights to the company's internal information, while agents, who run the company, have real and thorough information about the operation and performance of the company. At the same time, agents do not have absolute authority over decision making, particularly over strategic and long-term decisions. It is the latter decisions that allow the principal authority remain the owner of the company.

The position, function, interests, and background of principals and agents are different and mutually contradictory, but both parties need each other. The contradictory nature of agent-principal relationship causes conflict in practice. The role asymmetry gives rise to difficulties of monitoring and controlling the agent's actions. Jensen and Meckling (1976) state that problem is about moral hazard and adverse selection.

Agency concept is expected to serve as a tool to give confidence that (1) the manager will give an advantage to investors, (2) investors will not be embezzled by investing into projects that do not create a benefit, and (3) the investor can control managers (Shleifer and Vishny, 1997 and Herawaty, 2008). A GCG problem appears due to an agency conflict. In other words, it is necessary to reduce some problems of the GCG agency.

There exists no certain definition of GCG. The concept of GCG can be seen based on the Shareholding Theory (Monks and Minow (1995), Sabeni (2005)). While the World Bank defines the GCG as a collection of laws, regulations and norms that must be met, which may encourage the performance of company resources for functioning efficiently generating economic long-term sustainable value for shareholders as well as the surrounding communities as a whole.

FCGI (Forum for GCG in Indonesia) in 2000, described GCG as that including transparency, disclosure, independence, accountability, responsibility, and fairness. According to the Cadbury Report (1992), the main principles of GCG are transparency, integrity, and accountability.

Meanwhile, the Organization for the Economic Corporation and Development (OECD), mentions that basic principles of GCG include fairness, accountability, transparency, and corporate responsibility.

These principles are expected to be a point of reference for government in building a framework for GCG implementation. Businessmen and capital market principals can take them as a guideline in implementing the best practices for increasing value and sustainability of the company.

Boediono (2005) informs that GCG mechanism is a system which is able to control, direct and execute some activities of the company as well as the parties that are involved in it. Thus, it can be used to suppress the occurrence of agency problems. In addition, Shleifer and Vishny (1997), Ujyantho and Pramuka (2007) state that the mechanism of GCG is required in order to reduce agency problem that takes place between the owners and the managers.

Research on GCG has produced a variety of mechanisms that aim to ensure managers' actions aligned with the interests of the stakeholders. According to Barnhart and Rosenstein (1998) mechanisms of the GCG may be divided into two perspectives: (1) internal mechanisms, like composition of board of directors/commissioners, managerial ownership and executive compensation, and (2) external mechanisms, such as controlling the quality of auditing and the level of debt financing by the market.

Some researchers provide different definitions of earnings management. Fisher and Rosenzweig (1995), Heally & Wahlen (1999), Sugiri (1998), and Scott (1997), mention that earnings management is the management of intentional efforts to manipulate financial statement, in the limits allowed by the accounting principles, with the aim to provide misleading information to the users. The normative objective of financial decision is to maximize the firm value which can be measured using Tobin's Q Ratio (1967). This ratio can explain many phenomena in the activities of the company such as the occurrence of cross-sectional differences in the decision-making of investment and diversification, as well as the relationship between share ownership and corporate value management (Sukamulja, 2004).

This ratio is a concept which suggests that the current financial market can be estimated by the value of the returns of investment (Herawaty, 2008). A greater value of Tobin's Q ratio shows that the company has good growth prospects. According to Brealy and Myers (2000) in the Sukamulja (2004), companies with a high Tobin's Q ratio usually have a strong brand image of companies. On the contrary, companies that have low Tobin's Q ratio are generally involved in a very competitive industry or an industry that begins to shrink.

Sloan Research (1996) in Herawaty (2008) shows that the performance of profits derived from components of accrual earnings management activities has a persistence of being lower than its cash flow. Whereas, in relation to the mechanism of GCG, Klapper and Love (2002) in Herawaty (2008) find a positive relationship between the mechanism of GCG and company performance as measured by Return on Assets (ROA) and Tobin's Q ratio. Moreover, it is said that the implementation of GCG

makes more sense in developing countries than in developed countries. It shows that companies which have implemented GCG will gain greater benefit in emerging countries.

In conjunction with this research, Midiastuty and Machfoedz (2003) conclude that: (1) managerial and institutional ownership is associated with negative income, whereas, the number of BOD is associated with positive earnings management; (2) managerial and institutional ownership is positively associated with the quality of earnings, but the number of BOD has no effect on the quality of earnings. Furthermore, the managerial and institutional ownership is associated with negative earnings, while the size of BOD correlates with positive earnings. Managerial and institutional ownership also has a positive correlation with the quality of earnings.

Meutia (2004) mentions that (1) the higher quality of auditing will have lower earnings management, (2) non-audit services have impact on the quality of auditing through increasing absolute discretionary accruals at the time the company received non-audit services, and (3) the longer-term auditor in a workplace will improve audit quality.

Christensen, Kent, Routledge and Stewart (2015) state that formation of an audit committee is significantly associated with improved earnings quality for small and large companies. However, compliance with other governance recommendations is not systematically associated with improved performance or earnings quality.

Wedari (2004) shows that (1) the proportion of BOD and the audit committee have a significantly negative effect on earnings management, (2) the interaction between the BOD and the audit committee is not effective in reducing the earnings management activities, (3) managerial and institutional ownership do not have an apparent influence on earnings management activities, and (4) the quality of an auditor has a negative influence on earnings management activities.

Kothari, Mizik and Roychowdhury (2016) state that earnings management is most consistently and predictably linked with post-seasoned equity offering stock market underperformance when it is driven by real activities manipulation. Demerjian, Lewis-Western and McVay (2015) show that intentional smoothing by high-ability managers is not associated with declines in future operating performance.

Boediono (2005) mentions that managerial ownership and the composition of the board of commissioners have an impact on earnings management. Midiastuty and Suranta (2004) show that audit committee and the institutional ownership have a weak effect on implementing the mechanisms of GCG. Meanwhile, independent commissioners, size of BOD, and the managerial ownership play a limitation role in implementing the GCG.

Siallagan and Machfoedz (2006) conclude that the mechanism of GCG has an impact on firm value. In addition, Herawaty (2008) shows that earnings management has an effect on firm value and implementation of GCG, which is represented through institutional ownership, managerial ownership, quality of auditing. Besides, independent commissioners also have an effect on firm value.

Black, Kim, Jang and Park (2015) conclude that large firms, whose controllers have incentive to tunnel, earn strong positive returns, relative to mid-sized firms. Authors also show that better governance moderates the negative effect of related-party transactions on value and increases the sensitivity of firm profitability to industry profitability.

The outlined concept and some of the above-mentioned research give us the following research model.

2.1. Model 1

$$Q_{it} = \alpha_0 + \alpha_1 EM_{it} + \alpha_2 LEV_{it} + \alpha_3 SIZE_{it} + e \quad (1)$$

2.2. Model 2

$$Q_{it} = \alpha_0 + \alpha_1 IO_{it} + \alpha_2 MO_{it} + \alpha_3 IC_{it} + \alpha_4 QA_{it} + \alpha_5 LEV_{it} + \alpha_6 SIZE_{it} + e \quad (2)$$

2.3. Model 3

$$Q_{it} = \alpha_0 + \alpha_1 EM_{it} + \alpha_2 IO_{it} + \alpha_3 MO_{it} + \alpha_4 IC_{it} + \alpha_5 QA_{it} + \alpha_6 |EM_{it} - IO_{it}| + \alpha_7 |EM_{it} - MO_{it}| + \alpha_8 |EM_{it} - IC_{it}| + \alpha_9 |EM_{it} - QA_{it}| + \alpha_{10} LEV_{it} + \alpha_{11} SIZE_{it} + e \quad (3)$$

Where Q_{it} = Tobin's Q ratio = proxy of company value in year t ; α_0 = constant; $\alpha_1, \dots, \alpha_{11}$ = regression coefficient of each variable; EM_{it} = earnings management in year t ; IO_{it} = institutional ownership percentage in year t ; MO_{it} = percentage of managerial ownership in year t ; IC_{it} = percentage of the total independent commissioners in year t ; QA_{it} = quality of audit = dummy variable; LEV_{it} = leverage company in year t , the ratio is between total debt and total assets; $SIZE_{it}$ = size of company proxy with value of natural logarithm of company's equity markets at the end of the year, the number of shares at the end of the year, and the stock market price; e = error term.

3. RESEARCH METHODS

The method of this research is *ex post facto*. The approach used is the moderated regression analysis (MRA) which considers the mechanism of GCG as a moderating variable. The sample of this research is the entire industry of consumer goods manufacturing companies that are listed on the Indonesia stock exchange (IDX), that is, 46 companies. Criteria which are used to calculate the sample include: (1) companies in sub-groups of consumer goods manufacturing, (2) listed companies, (3) companies that publish financial reports, (4) companies that published financial statements on 31 December, and (5) companies which have the completeness of data and information regarding institutional, managerial ownership, independent commissioner and public accountant. From the obtained sample criteria, the sample of this research is 39 companies.

The mechanisms of GCG that are used in this research are the internal mechanisms, namely, the institutional ownership, managerial ownership, independent commissioners, and the external mechanism of the quality of auditing. The firm value is seen in terms of financial ratios and changes in

stock prices. The firm value is measured using Tobin's Q ratio, which compares the value of the market value of assets and the book value of assets (Sukamulja, 2004). The market value of equity is derived from the value of market capitalization. The book value of assets is obtained from the total assets. The book value of the equity is acquired from shareholder equity. The greater value of Tobin's Q ratio shows that the company has good growth prospects.

Earnings management is measured by proxy of the discretionary accruals. The value of discretionary accruals is calculated with the modified model by Jones (Dechow *et al.*, 1995 in Midiastuty and Machfoedz, 2003). This model uses the total accrual which is classified into discretionary and non-discretionary components. Institutional ownership is measured through the number of share ownership by the institution such as insurance companies, banks, investment companies, asset management and ownership of other institutions. Indicators which are used to measure institutional ownership are the percentage of shares, owned by the institution.

Managerial ownership is measured through the number of share in ownership. The ownership, in this study, is placed as a dummy variable. The independent commissioner is measured based on a number of the board of commissioners who are not affiliated with management, free from any business or other relationships that can affect their ability to act independently or acting solely in the interest of the company. The composition of independent commissioners is calculated based on the total number of independent commissioners in the board of commissioners divided by the total number of commissioners.

The quality of auditing is a systematic review process, based on certain quality standards and is conducted by a professional auditor. The audit quality is measured by classifying the audit conducted by a public accountant. Control variables are the leverage and the size of the company. The leverage is measured by the ratio of total debt to total assets, while the size is measured by using a natural logarithm of total assets (Midiastuty and Machfoedz, 2003).

The data of the research is pool data from Indonesia stock Exchange (IDX), Indonesian Capital Market Directory (ICMD), and JSX Statistics. Data processing techniques are descriptive statistical, causality relationship, and moderated regression analysis.

4. RESULTS AND DISCUSSION

Model I shows that the value of adjusted R² is 0,091 and the regression equation is:

$$\text{InverseQ}_{it} = -1.627 + 0.047 \text{InversePM}_{it} + 63.464 \text{InverseLEV}_{it} + 0.067 \text{InverseSIZE}_{it} \quad (4)$$

t	-3.4	3.563	4.971	1.429
sig.	0.001	0.000	.0000	0.154

From this equation, it can be concluded that there are two variables that significantly affect the firm value (Q_{it}), namely, earnings management (PM_{it}) and leverage (LEV_{it}). However, the control variable

that is size of company (SIZE_{it}) does not significantly influence the firm value (Q_{it}).

In regression model II, the value adjusted R² is 0,128, and regression equation is:

$$\text{InverseQ}_{it} = -0,079 - 0,654 \text{IO}_{it} + 0,154 \text{MO}_{it} - 0,295 \text{IC}_{it} - 0,163 \text{QA}_{it} - 51,430 \text{InverseLEV}_{it} - 0,173 \text{InverseSIZE}_{it} \quad (5)$$

Based on model II, it can be concluded that there are four variables that significantly influence the firm value variables (Q_{it}), i.e., three independent variables and one control variable. The variables are as follows: (1) managerial ownership (PM_{it}), (2) the independent commissioner (IO_{it}), (3) the quality of auditing (QA_{it}), and (4) leverage (LEV_{it}). Meanwhile, the control variables that are institutional ownership (IO_{it}) and size (SIZE_{it}) do not significantly influence the firm value (Q_{it}).

Regression Model III shows that adjusted R square is 0,256. The equation of model III is shown as follows.

$$\text{Q}_{it} = -575 + 258 \text{PM}_{it} + 0.24 \text{IO}_{it} + 98 \text{MO}_{it} - 0.063 \text{IC}_{it} - 0.056 \text{QA}_{it} - 210 \text{PM}_{it} - \text{IO}_{it} - 111 \text{PM}_{it} - \text{MO}_{it} - 0.077 \text{PM}_{it} - \text{IC}_{it} - 100 \text{PM}_{it} - \text{QA}_{it} + 45.584 \text{LEV}_{it} + 107 \text{SIZE}_{it} + e \quad (6)$$

Based on the equation model III, it can be concluded that the quality of auditing is not significant as a moderating variable whereas institutional ownership, managerial ownership, and independent commissioners are significant as moderating variables. Moreover, those three variables decrease an effect of earnings management on firm value. These variables as manifest variables of latent variable, that is GCG do not increase the influence of earnings management on firm value. It indicates that there is a conflict of interest between an agent and a principal. In addition, the size of a company and institutional ownership do not affect firm value. Based on the value of R square, the biggest number of R square is model number III. Thus, this model is more appropriate to measure firm value.

The research result shows that improvement in earnings management will improve the firm value. This result is in compliance with research result of Sloan (1996) in Herawaty (2008) that earnings management, in a short period of time, has the capability to improve the firm value. Does the mechanism of GCG influence the firm value? This research informs that institutional ownership does not have an effect on firm value. This result is not in compliance with the research result of Herawaty (2008). A high percentage of institutional ownership in Indonesian public companies, enable institutional investors to intervene with management process and composition of financial reports.

The research result also shows that the mechanism of GCG which is represented by managerial ownership has a negative effect on firm value. This result is not in compliance with the research result conducted by Jensen and Meckling (1976). However, this research is in compliance with Herawati (2008). This result indicates that the proportion of managerial ownership can reduce the firm value. It means that many Indonesian companies in this sample have a significant number

of shares. Thus, they have enough votes to control management activities.

In addition, the mechanism of GCG, which is represented by an independent commissioner, has a positive effect on firm value. This result is similar to Herawaty's (2008) and Midiastuty and Machfoedz's (2003) research results. It means that the presence of independent commissioners can influence earnings management activities, such as reducing moral hazard, and the firm value.

Moreover, the mechanism of GCG, which is represented by the quality of the audit, has a positive impact on the firm value. It means that the firm value will increase when the company is audited by a public accountant. This result is in compliance with Meutia's (2004) research result.

Additionally, the mechanism of GCG, with proxy by institutional ownership, independent commissioner, and the quality of auditing, simultaneously, has a positive impact on firm value. This result is in consistence with Herawati's (2008) research result.

Furthermore, the mechanism of GCG with proxy by institutional ownership, managerial ownership, an independent commissioner, and the quality of auditing simultaneously has a negative effect on firm value. It means that those manifest variables have the capability to reduce the cost of the agency by controlling the conflict of interest between the principal and the agent. This way the firm value can be improved.

5. CONCLUSIONS AND RECOMMENDATIONS

Based on the research results, it can be concluded that: (1) earnings management has a positive impact on firm value, (2) institutional ownership does not have an impact on firm value, (3) managerial ownership has a negative effect on firm value, (4) an independent commissioner has a positive effect on the firm value, (5) the quality of auditing has a positive effect on firm value, (6) leverage of a company as a control variable, has a positive and significant effect on firm value (7) company's size as a control variable has a negative but not a significant effect on firm value, (8) the mechanism of GCG with proxy by (a) institutional ownership; (b) managerial ownership; (c) an independent commissioner; and (d) the quality of auditing has a positive and significant effect on firm value, and these manifest variables of GCG as a latent variable can be placed as a moderating variable on the effect of earnings management on firm value. Theoretically, earnings management has a positive impact on firm value. However, firm value can be manipulated through financial statements.

In this research, manifest variables which are used to measure the mechanism of GCG as a latent variable are only four manifest variables. Managerial ownership cannot be used due to inability to measure the amount of shares. The quality of auditing is only measured by using one measurement, whether it is audited or not audited by a public accountant.

The low coefficient of adjusted R^2 on all models of regression, in this research, shows that there are still many other variables that can affect the relationship between earnings management and firm value. In model III, there is no "multicollinearity"

result, so there is no correlation between independent variables.

This research suggests that the effect of earnings management on firm value is just a temporary situation. A company should consider many aspects in the long period of time. It is not only financial aspects but also all strategic aspects. The mechanism of GCG is able to reduce the effect of earnings management on firm value. Therefore, it is predicted that earnings management activities still evoke the conflict of interest between the principal and the agent. However, it is highly suggested that the mechanism of GCG can be applied as a moderating variable, and this variable can also be a mandatory variable to convince the public that a company is well governed. However, GCG can be considered as an independent or moderating variable in the future research.

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