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Earnings Management and Managerial Ownership Moderate the Influence of Profitability on Firm Value

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Abstract

This research was aims to get an empirical evidence about the ability of earnings management and managerial ownership in moderating the influence of profitability on firm value. The firm value in this research was measured using the Tobin's Q model developed by Prof. James Tobin (1967). Earnings management in this study is real earnings management which is proxied by cash flow operation, production cost and discretionary expenses; managerial ownership is measured by the percentage of share ownership owned by directors and commissioners, and profitability is measured by ROE (return on equity), which is the ratio of net income and equity of common stock. The sample in this research is 51 companies that conducted in manufacturing companies listed on the Indonesia Stock Exchange. Observation period during 2014 until 2016. The method of determining the sample has using purposive sampling. The technique of analysis was used Moderated Regression Analysis (MRA). The results showed that earnings management cannot be able to weakness the influence of profitability on firm value and managerial ownership cannot be able to strengthen the effect of profitability on firm value.

Keywords: Firm Value; Earnings Management; Managerial Ownership; Profitability.

1. Introduction

The development of technology and information currently makes it easy for everyone to get all types of information needed, not least for shareholders to get information about the companies that are the target of their business. This information is usually about the company's financial condition and company performance.

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One of the strategies taken by the company's management is through the publication of financial statements and hopes to increase the firm value through its share price. The stock price of a company can be used as a benchmark of the firm value due to the expectations of investors regarding the future of the company is in the development of stock prices, so that the high stock market prices also means like a high firm value [1].

In regard to the agency relationship, firm value is the responsibility of management and that responsibility is the reflection of its agreement with contractual shareholders. The actual information contained in the financial statements presented by management is needed. This information will be used by those who have an interest in decision making, which is for both investment or company operational decisions.

One of the information that could responded by market quickly is a profit. The changes of company's profit value are responded positively by the market which will have a direct impact on stock prices and of course the firm value. The information about earnings can be known through profitability ratios. According to Analisa [2] research the firm value can be influenced by the size of the profitability generated by the company. Profitability is one of the financial ratios that can be used to see the ability of a company to earn profits during a certain period. The company's ability to generate profits will be able to attract investors to invest their funds to expand their business, whereas a low level of profitability will cause investors to withdraw their funds. For the company itself, profitability is used as an evaluation tool for the effectiveness of managing the company's operational activities.

Profitability in this study is measured by ROE which shows how much profit the company can get to guarantee the return of shareholders' equity. Nurmayasari [3] stated that the profitability variable as measured by ROE shows a positive and significant influence on firm value. Increased profitability shows that management performance is increasing in managing operational financing resources effectively to generate net income. ROE as a measure of the profitability of equity owned by the company can affect the firm value [4].

Research conducted by Yunita [5], Analisa [2], Nurmayasari [3] and Prasetyorini [6] states that profitability shows that the variable profitability as measured by Return on Equity (ROE) has a positive and significant effect on firm value. While research conducted by Indrajaya [27] shows that profitability has a negative influence on firm value. Sari [7], Mulyawati [8], Ardimas [9] and Ratih [10] find that the results of profitability do not affect the firm value.

The inconsistency of research results regarding the effect of profitability on the value of this company indicates that there are other factors that moderate the relationship. Earnings management and managerial ownership are indicated as moderating variables that can affect the relationship between profitability and firm value. Profitability provides information on a company's earnings and this inconsistency is related to earnings quality. Earnings quality can be said to be good if the manager as a financial report maker has able to convey real information without manipulation. Profit quality has said to be bad if the manager does not convey information actually even manipulates. According to Ulfah [11] managers are internal parties of the company who know the state of the company well, so that they have a great opportunity to manipulate earnings. Profit manipulation is caused by the separation of responsibilities in running business activities where the manager is not the owner of

the company but as an agent who carries out the principal's wishes. Agency theory explains that this separation of responsibilities creates a conflict of interest that encourages managers to make earnings management to meet the expectations of principals and increase the firm value through stock prices. This shows that earnings management can moderate the effect of profitability on the up and down of firm value.

This statement has evidenced by one of go public company list is PT Bumi Resources Tbk's. Before the information from the Directorate General of Taxes that was issued regarding alleged engineering of financial reporting if this company, the stock price were at 6,000 rupiah. After it was proven that the company did engineering in the financial statements, stock prices skyrocketed down to 910 rupiah [28]. Earnings management actions carried out by company managers can affect the quality of earnings reflected in the value of profitability. Although the profits of the company are high, but there is an element of earnings management in them, the market will react not to choose the company's shares. This will have an impact on the decline in the firm value as in the case example.

Earnings quality indicates that quality can be evaluated in relation to any decision that depends on the financial performance information. The potential for conflict between the manager and the principal makes the company's financial information irrelevant and reliable. The existence of information asymmetry owned by managers can trigger manipulation to influence earnings quality, so that this will affect profitability. High profitability with low earnings quality will be responded negatively by the market and can reduce the firm value. Conversely, high profitability with good earnings quality will be positively responded by the market and can increase the firm value.

Agency theory can explain the emergence of earnings management practices. The manager as an agent is morally responsible for optimizing the prosperity of the shareholders (principal) and in return will receive compensation in accordance with the contract. Earnings management behavior that is often carried out by management today is real earnings management. Manipulating through real activities is another alternative to achieving the desired profit target, because it can be done within the company's operating period. Real earnings management can be done by manipulating sales (sales manipulation), decreasing reduction of discretionary expenditures and over production [12].

The manufacturing industry is used in this research because it is very vulnerable to international economic development and has a strong business competition. This industry also has the potential to develop its products faster by innovating and tends to have a wider market expansion than other types of industries.

Managerial ownership is a condition where managers take part in the company's capital structure and play a dual role as managers and shareholders in the company. Managerial ownership can be a mechanism to reduce agency problems that arise between the agent and the principal so that the possibility of managerial opportunistic behavior will decrease [13]. Managerial ownership will align management interests by shareholders (outsider ownership) so that they will benefit directly from the decisions taken and bear losses as a consequence of wrong decisions. One way to reduce agency costs is to increase share ownership by management. Supported by research from Sujoko [14] and Rachmawati [15] found that managerial ownership has a positive effect on firm

value. In addition, research conducted by Sadia [16] and Ratih [17] found that managerial ownership in manufacturing companies has a negative effect on firm value.

The inconsistency of research results regarding the effect of profitability on the firm value above, this is allegedly due to the existence of other variables that influence it. In this study using earnings management variables as measured by real earnings management and managerial ownership. So that by making earnings management and managerial ownership variables as moderations able to become information related to the determinants of firm value.

2. Theoretical review

Agency Theory. Agency theory describes the agency relationship as a contract that occurs between the owner (principal) and the agent (agent) assigned to carry out certain tasks according to the agreed work contract. This theory assume that every individual motivated by their own self thus causing a conflict of interest between principal and agent.

2.1. Signaling Theory

Signaling theory is a theory about how a company should give a signal to users of financial statements in the form of information about what company management has done to realize the wishes of the owners of the company and other information that shows that the company is better than other companies [18]. According to signaling theory, company could show bad or good signal for investor. Profitability becomes a signal for investors when they will choose the company's shares. If the profitability shows good signal, investors will respond it is good and vice versa.

2.2. Earning Quality Theory

The quality of earnings is a measure to match whether the results are the same as those previously planned. The quality of earnings will be higher if it exceeds the target of the initial plan. Low earnings quality if profits are presented not in accordance with actual profits so that information obtained from earnings reports becomes biased and can mislead investors in making decisions [19].

2.3. Firm Value

The Firm Value is a market value that is reflected in the stock price and a measure of the company's success in past operations and future prospects to convince shareholders. Company value is measured using Tobin's Q developed by James Tobin (1967). Tobin's Q is a replacement cost of the costs needed to obtain assets that are exactly the same as the assets owned by the company.

2.4. Real Earnings Management

Deviations from the company's normal operating activities that are motivated by management's desire to give stakeholders a wrong understanding that certain financial reporting objectives have been achieved through the company's normal operating activities [12]. Real earnings management can be done in three ways, namely

manipulation of sales, decrease in discretionary expenses and excessive production.

2.5. Profitability

Profitability is the company's ability to generate profits in the future and is an indicator of successful of company's operations [29]. Profitability can be measured by Return on Equity to measure how much profit is the right of the owner of the capital itself with the assets used.

2.6. Managerial Ownership

Managerial ownership is the shareholders which also means in this case as the owner of the company from the management who actively participates in the decision making of the company concerned. Agency conflict could solved by increasing the number of managerial ownership. The way to increase the number of managerial ownership is to compensate based on the equity to manager. By providing compensation for equity ownership in management, it is expected that the company's performance will increase and earnings management can be reduced.

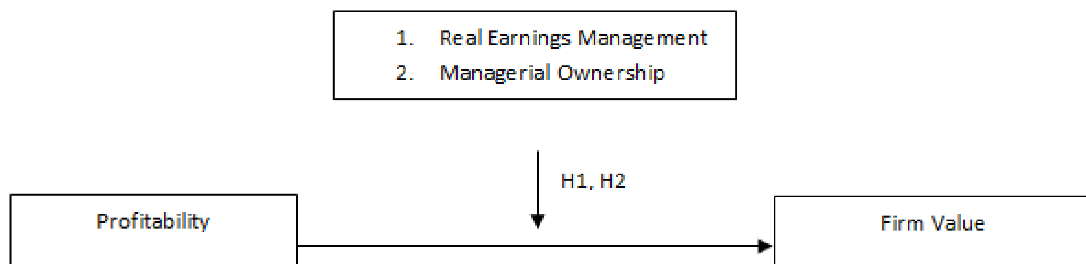

Figure 1: Theoretical Framework

3. Research Hypothesis

Based on the framework, the hypothesis proposed in this study as follows:

H_1: Real earnings management weakens the positive influence of profitability on firm value.

H_2: Managerial ownership strengthens the positive influence of profitability on firm value.

4. Research methods

The population in this study are all manufacture sector companies in Indonesia during 2014-2016. The reason researchers use manufacturing companies due to manufacture companies consist of various industrial sub-sectors that can reflect the overall capital market reaction, and have more potential to develop their products faster by innovating and tend to have wider market expansion than other types of industries. Research data is accessed and downloaded by researchers through the IDX website on the page www.idx.co.id and ICMD (Indonesia Capital Market Directory). Share price data is obtained from the finance.yahoo.com site. Sample

selection method used is purposive sampling method, with the following sample criteria: (1) The sample company must have information that can be traced and accessed on the page www.idx.co.id related to the annual financial statements in 2014-2016; (2) The company that will become the sample must have a book closing date as of December 31 of each report; (3) The company has compete data relating to the variables used in this study; (4) The company should reports a monetary information in rupiah. The dependent variable in this study is the firm value (NP). The independent variables in this study is profitability (PROF) and moderating variables are real earnings management (MLR) and managerial ownership (KM). The method used to analyze the effect between variables is Moderated Regression Analysis.

5. Result and discussions

Testing data in this study using Moderate Regression Analysis (MRA) presented in the following equation:

$$NP_{it} = \alpha + b_1MLR + b_2KM + b_3PROF + b_4MLR*PROF + b_5KM*PROF + \ldots \quad (1)$$

The results of the regression analysis are described in Table 1 as follows:

Table 1: The result of Moderate Regression Analysis

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	,573	,086		6,685	,000
PROF	-,005	,002	-3,289	-2,838	,005
MLR	,001	,000	,277	4,008	,000
KM	,327	,229	,099	1,429	,155
PROF_MLR	1,195E-5	,000	4,095	3,797	,000
PROF_KM	-,020	,005	-,760	-3,739	,000

Dependent variable: Firm Value

Based on Table 1, the regression equation can be described as follows:

1. The regression coefficient value on the interaction between real earnings management and profitability is 0,000 with a significance level of 0,000. This means that if the interaction between real earnings management and profitability increases by 1 unit, then the firm value will increase by 0,000 assuming other variables are constant (p value = 0,000 $<\alpha = 0.05$).
2. The regression coefficient value on the interaction between managerial ownership and profitability is -0.020 with a significance level of 0.000. This means that if the interaction between managerial ownership and profitability increases by 1 unit, then the firm value will decrease by 0.020 assuming other variables are constant (p value = 0.000 $<\alpha = 0.05$).

5.1. Real Earnings Management Strengthens the Effect of Profitability on Firm Values

The results of this study indicate that real earnings management strengthens the positive influence of profitability on firm value. This means that the higher level of profitability of the company, higher effect to the firm value. The influence of moderation variable in real earnings management strengthens that relationship, thus the behavior of real earnings management by managers can further increase the firm value. In the sample of manufacture companies studied, managers managed to trick investors through real earnings management by giving excessive discounts, reducing discretionary expenses such as research and development expenses, advertising expenses, sales expenses and administrative and general expenses. So that the company's performance reported through the company's financial statements could reflect good performance in investors review and could attract investors to want to buy as much as the company's shares.

The strategy carried out by managers through real earnings management cannot be detected by investors, so investors are fooled by earnings information that is reflected in the level of profitability. In addition, investors in Indonesia tend to be naïve, because they only pay attention to profit levels. Investors in Indonesia in this study have not been able to detect real earnings management, pay less attention to company fundamentals and not pay attention to the level of profitability generated by comparing detailed information from the level of operating cash flows, total sales and discretionary costs of the company, so that the tendency of real earnings management behavior is not detected. The results of this study are consistent with the research of Herawaty [20], Vajriyanti [21], Lestari [22] and Ningsih [23] which state that earnings management is able to strengthen the effect of profitability on firm value.

Agency theory supports the results of this study which states that there is a conflict of interest between management and principals, causing managers to try to maximize personal interests as well as principals through earnings management which in this study is real earnings management. The results of this study also support earnings quality theory that the ability of earnings in explaining the information contained in it, which can help decision makers by decision makers [24]. Low earnings quality could happened if profits are presented not in accordance with actual profits so that information obtained from earnings reports becomes biased and can mislead investors in making decisions. Low quality earnings information contained at the level of profitability is captured as a negative signal by investors when choosing stocks, so that the high level of profitability is not able to increase the firm value.

5.2. Managerial Ownership Weakens the Effect of Profitability on Firm Values

The results of this study indicate that managerial ownership weakens the positive influence of profitability on firm value. This means that the higher the percentage of managerial ownership will decrease the firm value. This condition can occur because the managerial ownership of the sample companies tends to be unstable where there is an increase and decrease in percentage of ownership. Significantly managerial ownership can influence the effect of profitability on the firm value and is able to be a control and monitor of conflicts in the company. However, the higher managerial ownership does not increase the value of this company due to managerial ownership in manufacturing companies from 2013-2016 is still unstable, there are companies that have high or low managerial ownership.

Descriptive statistics show that the average value of managerial ownership is lower than the maximum value, meaning that the sample managerial ownership of the company is still relatively low or not more than the maximum value. Agency theory states that managerial ownership can be a control for company management in order to create good performance so that the firm value can increase. However, this study rejects this statement where managerial ownership cannot be a control for improving the company's performance in order to increase the firm value. Investors judge that the level of managerial ownership that fluctuates cannot effectively improve the company's performance in accordance with the principal's expectations.

The results of this study are supported by the research of Suastini [25] and Sugiarto [26] who found that managerial ownership has a negative effect on firm value. Unstable managerial ownership can affect the firm value. The control function that is expected to improve company performance so that it can increase the firm value cannot be effectively implemented if the director and commissioner still have low share ownership. This is because the biggest decision is still owned by the highest shareholders. Based on the results of this study, managerial ownership is able to become a control function if the ownership percentage is more than 100%. So that directors and commissioners have greater rights in decision making.

6. Conclusion and recommendation

Based on the results of the regression test moderation of earnings management and managerial ownership on the effect of profitability on the firm value concluded that: (1) earnings management is not able to weaken the positive influence of profitability on the firm value. The influence of real earnings management can actually increase the firm value because managers succeed in tricking investors through information on the financial statements they make. So that the information reflected in the level of profitability is captured by investors as a positive signal. Investors in Indonesia tend to be naïve because they only pay attention to the profit level without paying more attention to the company's fundamentals. In addition, real earnings management is more difficult to detect by investors, as evidenced by the company's value continues to increase despite the tendency of earnings management. Real earnings management is done through discounts (discounts), reduction of discretionary expenses such as advertising costs and excessive production. These proxies that are difficult to detect are elements of earnings management in them; (2) Managerial ownership cannot strengthen the positive influence of profitability on company value. Profitability is captured as a negative signal for investors. There are some percentage of managerial ownership of sample companies is constant and there are some that are unstable where they have decreased and increased, so that the higher the level of profitability will actually reduce the firm value. This is evidenced by the company's value that has not increased.

Based on the results of the discussion and the conclusions, some suggestions may be given: (1) Investors are expected to pay more attention to supporting factors such as the level of cash flow, sales, production and discretionary costs in the company in detail every year. In addition, conducting an analysis of the company's fundamentals is also important before finally choosing the company's shares, because the quality of the information contained in the financial statements through the level of profitability is important to know; (2) Further research can examine in more detail the effect of each real earnings management proxy, namely operating cash flow, production costs and discretionary costs. More detailed testing can prove how each of these

proxies influences company value, company performance and stock prices.

7. Limitations

The limitations of this study are that the sample of this study is still relatively small because only take three period of years and using manufacture sector as a population. For researchers on further research can increase the number of samples by expand another sectors and periods of research. Furthermore, further research could make a researches about the effect of real earnings management on firm value by doing more detailed research with the proxies.

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