The Effect of Earnings Management on Firm Value with Corporate Governance as a Moderating Variable

Jevri Afrizal[1)], Rindu Rika Gamayuni [2)], Usep Syaipudin[3)]

[1]Faculty of Economics and Business, University of Lampung, Indonesia,
+6281366199291.jevriafrizal1991@gmail.com

[2]Faculty of Economics and Business, University of Lampung, Indonesia

[3]Faculty of Economics and Business, University of Lampung, Indonesia

Accounting Department, Faculty of Economics and Business, Lampung University.

ABSTRACT

This study aims to provide a conceptual study of the effect of earnings management on firm value by including corporate governance. as a moderating variable. This paper is a conceptual paper that discusses issues related to earnings management on firm value and the role of corporate governance in minimizing earnings management practices so as to increase firm value. Previous theoretical studies have shown that earnings management is effectively controlled by the corporate governance system and performance. In addition, the results of previous studies found empirical evidence that there is a positive relationship between earnings management and firm value. From the theoretical discussion and previous research, it is concluded that earnings management practices have a positive effect on firm value as moderated by corporate governance.

Keywords: Earnings management; firm value; corporate governance; independent commissioner; managerial ownership; institutional ownership

INTRODUCTION

Earnings management is a management intervention to influence earnings, usually for opportunistic reasons (Subramanyam and Wild, 2009). Gill *et al.* (2013) define earnings management as the practice of managerial actions reflected in the company's financial statements to either give the impression of periodic or annual smooth earnings, this is to show high profits in a certain year. The phenomenon of earnings management has occurred a lot in Indonesia in recent years, especially in companies listed on the Indonesia Stock Exchange (IDX), where the company's financial statements must be published to the public.

The issue of earnings management is often associated with *corporate governance* because according to the viewpoint of agency theory, the problem of earnings management can be reduced by implementing a monitoring mechanism for *good corporate governance* (Subanidja *et al*., 2016). In Indonesia, *corporate governance has* become important after the 1998 crisis. Many people say that the long process of improvement in Indonesia is due to the weak implementation of *corporate governance* in companies. Since then, both the government and investors began to pay significant attention to practices of *corporate*

governance. Several previous studies have discussed earnings management and firm value. However, this study tries to include the corporate governance variable as a moderating variable and examines the non-financial state-owned companies listed on the IDX. Where BUMN companies should not be allowed to commit such violations because most of the shares of BUMN companies are owned by the state, which of course the losses incurred are also stated losses.

RESEARCH ISSUE

Several cases of earnings management have occurred in Indonesia, such as PT Indofarma (Persero) Tbk, PT Kimia Farma (Persero) Tbk PT Timah (Persero) Tbk, PT Sekawan Intipratama Tbk, PT Cakra Mineral Tbk, and PT Bank Bukopin Tbk. It can be seen that state-owned companies can also carry out earnings management which should not be done by companies that are mostly owned by the state. Furthermore, the case that recently occurred was PT Garuda Indonesia, Tbk, wherein the 2018 financial statements, Garuda recorded a net profit of US $ 809.85 thousand or the equivalent of Rp. 11.33 billion (exchange rate of Rp. 14,000). Among other things, this profit was supported by the cooperation between Garuda and PT Mahata Aero Teknologi. The cooperation is valued at US $ 239.94 million or around Rp 2.98 trillion, of which the US $ 28 million is part of the profit-sharing obtained from PT Sriwijaya Air. The funds are still receivable but have been recognized as income. So that it made the previous company lose money then made a profit. These cases show that earnings management occurs in many companies in Indonesia, especially public companies where they have a responsibility to the public for the performance of their companies. This is also associated with weak corporate governance oversight, where corporate governance mechanisms are very important in a company. Kang and Kim (2011) prove that real activity-based earnings management is effectively controlled by the corporate governance system and has a relationship between corporate governance and performance. However, Darwis (2012) states that earnings management has no effect on firm value. This is not in line with the research of Gill *et al*. (2013) who found a negative influence between earnings management and firm value. Thus, this research contributes to filling the theoretical gap.

LITERATURE REVIEW

Agency Theory

Based on the agency theory that agency relations can create a conflict of interest between the owner (investor) and the manager (agent). The contract is made with the hope of minimizing the conflict of interest. The earnings management actions taken will not give a favorable reaction which will have an impact on increasing company value. This agency theory perspective is the basis for understanding the issue of corporate governance and earnings management. The separation of ownership by the principal and control by agents in an organization tends to cause agency conflicts between the principal and the agent. Jensen and Meckling (1976), Watts & Zimmerman (1986), and Gunarianto *et al.* (2012) stated that financial statements made with accounting figures are expected to minimize conflicts between interested parties. With the financial statements reported by the agent as the responsibility for its performance, the principal can assess, measure, and monitor the extent to which the agent works to improve his welfare and as a basis for providing compensation to the agent.

Earnings Management

Scott (2009) defines earnings management as an act of management to select accounting policies from a certain standard, for example by changing the declining balance method, straight-line, and other methods than which one has a higher cost to reduce corporate profits so that the company can reduce expenses. tax. Earnings management is also a manager's action to increase (reduce) the currently reported profit of a business unit for which the manager is responsible, without causing an increase (decrease) in the long-term economic profitability of the business unit (Hwihanus & Qurba, 2009). Several previous researchers have created models as a measure of earnings management, such as the Healy (1985), DeAngelo (1986), Jones (1991) model, the Industry Model (Dechow and Sloan, 1991), the Modified Jones (Dechow *et al*., 1995), Dechow-Dichev (2002), Kothari (2005), Stubben (2010) and New Approach Models (Dechow *et al*., 2011). The earnings management variable in this study is measured by identifying or measuring *discretionary accruals* using the Modified Jones Model because this model is considered the best model for detecting earnings management compared to other models and provides the strongest results (Dechow *et al*. 1995).

Corporate Governance

According to the Forum for Corporate Governance in Indonesia (FCGI, 2001), corporate governance is a set of regulations governing the relationship between shareholders, company management, creditors, government, employees, and other internal and external stakeholders. with their rights and obligations, or in other words, a system that regulates and controls the company. Meanwhile, according to the OECD (Organization for Economic Cooperation and Development), Good Corporate Governance is a system to direct and control companies.

Independent Commissioner

According to Agoes and Ardana (2014), Independent commissioners and directors are those who are appointed to represent independent shareholders (minority shareholders) and the appointed party is not in the capacity to represent any party and is solely appointed based on background knowledge. experience, and professional expertise they have to fully carry out their duties for the benefit of the company.

Managerial Ownership Managerial

ownership is the number of shares owned by management, namely the board of directors and commissioners of the company. Jensen and Meckling (1976) stated that in order to reduce the conflict of interest between the principal and agent, it can be done by increasing managerial ownership in a company. By increasing share ownership by managers, it is expected that managers will act in accordance with the wishes of the principals because managers will be motivated to improve performance (Siallagan and Machfoedz, 2006).

Institutional Ownership Institutional

ownership is the percentage of total shares at the end of the accounting period that is owned by external parties, such as institutions, companies, insurance, banks, or other institutions (Beiner *et al*., 2004). The existence of ownership by institutions will encourage an increase in more optimal supervision of

management performance because share ownership represents a source of power that can be used to support or vice versa to the existence of management.

Company Value Firm

value is a description of certain conditions that the company wants to achieve as a form of public trust in the company for all activities carried out by the company which is used by investors as a perception in carrying out investment activities related to stock prices because increasing company value shows that the company has performance good for the welfare of company stakeholders (Darmawan *et al*., 2019).

Effect of Earnings Management on Firm Value

The asymmetry between management and owners provides an opportunity for managers to carry out earnings management in order to increase firm value at a certain time. At first, the company value did increase in a certain period, but in fact earnings management could decrease the company value in the future. Tang and Chang (2015) also explain that *discretionary accruals* (DAs) and *discretionary current accruals* (DCA) have a significant negative effect on asset returns and Tobin's Q for companies with weak governance. This implies that managers in companies that are governed by weaker firms are more likely to violate accounting policies than in strongly regulated firms, leading to decreased firm performance.

H1: Earnings management has a positive effect on firm value.

Corporate Governance Moderating the influence of Earnings Management on Firm Value

Corporate governance is a system that regulates and controls the company which is expected to provide and increase company value to shareholders. Thus, the implementation of good corporate governance is believed to increase company value. Lei and Song (2012) revealed that companies can increase their value by increasing their corporate governance standards and that board reorganization can be an effective way to increase corporate and corporate value.

H2: Independent Commissioners moderate the effect of earnings management on firm value

H3: Managerial ownership moderates the effect of earnings management on firm value

H4: Institutional ownership moderates the effect of earnings management on firm value

DISCUSSION

Kang and Kim (2011) prove that real activity-based earnings management is controlled effectively by the corporate governance system and has a link between corporate governance and performance. Gill *et al*. (2013) found a negative influence between earnings management and firm value. In the Indian context, investors tend to impose sanctions on companies whose management carries out intensive earnings management. Lin (2011) states that earnings management can increase firm value. Suffian *et al*. (2015) also found that there is a relationship between each Real Earnings Management (REM) activity and firm value. Susanto and Christiawan's research (2016) found a positive and significant influence between earnings management and firm value. Yorke *et al*. (2016) show that earnings management has a negative relationship with firm value. Yung and Root (2019) show a relationship between policy uncertainty and

earnings management, where companies increase/decrease earnings management when policy uncertainty is high/low.

The findings of Bae *et al*. (2012) corporate governance has a positive relationship with East Asian and Latin American companies during the post-crisis recovery period. Then, Black *et al*. (2015) suggest that better governance moderates negative effects on value and increases the sensitivity of firm profitability to industry profitability (consistent with less tunneling). Subanidja *et al*. (2016) found that the GCG mechanism which is proxied by institutional ownership, managerial ownership, independent commissioners, and audit quality has a positive and significant effect on firm value. Men's Research (2014); Siagian *et al*. (2013); Arora and Sharma (2016); and Siddiqui (2015) also found that GCG is positively related to firm value. The findings of Latif *et al*. (2017) show that corporate governance effectively improves the quality and value of corporate earnings.

CONCLUSION

Previous research discusses how earnings management affects firm value described in agency theory (Kang and Kim, 2011; Gill *et al*., 2013; Lin, 2011; Suffian *et al*., 2015; Susanto and Christiawan, 2016; Yorke *et al*., 2016; Yung and Root; 2019). Based on the results of previous research, it is concluded that earnings management can increase firm value because management tends to make the company look good to investors. However, when including the corporate governance variable as a moderating variable, it will weaken the relationship between earnings management and firm value. Because corporate governance is a system that regulates and controls the company so that it can reduce managers' actions in manipulating earnings (Lei and Song, 2012; Bae *et al*, 2012; Black *et al*, 2015, Suriawinata and Correia, 2019; Darwis, 2009; Lee and Chen, 2011).

REFERENCES

Agoes, S. & Ardana, I. C. (2014). Etika Bisnis Dan Profesi Edisi Revisi. Salemba Empat: Jakarta.

Arora, A., & Sharma, C. (2016). Corporate governance and firm performance in developing countries: evidence from India. Corporate governance, 16(2), 420-436.

Bae, K. H., Baek, J. S., Kang, J. K., & Liu, W. L. (2012). Do controlling shareholders' expropriation incentives imply a link between corporate governance and firm value? Theory and evidence. Journal of financial Economics, 105(2), 412-435.

Beiner, S., Drobetz, W., Schmid, F., & Zimmermann, H. (2004). Is board size an independent corporate governance mechanism?. Kyklos, 57(3), 327-356.

Black Bernard, S., Kim, W., Jang, H., & Park, K. S. (2010). How Corporate Governance Affects Firm Value: Evidence on Channels from Korea. Journal of Corporate Finance, USA, 1-48.

Darmawan, I. P. E., Sutrisno, T., & Mardiati, E. (2019). Accrual Earnings Management and Real Earnings Management: Increase or Destroy Firm Value?. International Journal of Multicultural and Multireligious Understanding, 6(2), 8-19.

Darwis, H. (2012). Manajemen laba terhadap nilai perusahaan dengan corporate governance sebagai pemoderasi. Jurnal keuangan dan Perbankan, 16(1).

Dechow, P. M., Sloan, R. G., & Sweeney, A. P. (1995). Detecting earnings management. Accounting review, 193-225.

Forum for Corporate Governance in Indonesia (FCGI). (2001). *Corporate Governance*. Seri Tata Kelola Perusahaan (Corporate Governance) Jilid I Edisi ke-3. Jakarta: Citra Graha.

Gill, A., Biger, N., Mand, H. S., & Mathur, N. (2013). Earnings management, firm performance, and the value of Indian manufacturing firms. International Research Journal of Finance and Economics, 116(1), 121-131.

Gunarianto, Marjani AT., Endah PS. (2012). Analisis Earnings Management Serta Penerapannya Dalam Penyusunan Laporan Keuangan (Studi Pada Perusahaan Manufaktur Yang Go Publik Di Bursa Efek Indonesia). Hibah Penelitian Fundamental Dirjen Dikti, 30-90.

Hwihanus, & Qurba, H. (2009). Faktor-faktor yang Mempengaruhi Manajemen Laba pada Perusahaan Industri yang Terdaftar di BEI. JAAI, 13(2), 167-188.

Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. Journal of financial economics, 3(4), 305-360.

Kang, S. A., & Kim, Y. S. (2011). Does earnings management amplify the association between corporate governance and firm performance?: Evidence from Korea. International Business & Economics Research Journal (IBER), 10(2).

Latif, K., Bhatti, A. A., & Raheman, A. (2017). Earnings quality: A missing link between corporate governance and firm value. Business & Economic Review, 9(2), 255-280.

Lee, S. P., & Chen, H. J. (2011). Corporate governance and firm value as determinants of CEO compensation in Taiwan. Management research review, 34(3), 252-265.

Lei, A. C., & Song, F. M. (2012). Board structure, corporate governance and firm value: evidence from Hong Kong. Applied Financial Economics, 22(15), 1289-1303.

Lin, F. L. (2011). Is earnings management opportunistic or beneficial in Taiwan? Application of panel smooth transition regression model. International Journal of Economics and Finance, 3(1), 133-142.

Putra, A., & Simanungkalit, R. M. (2014). The impact of implementation good corporate governance to firm value (evidence from Indonesia public banking sector). Review of Integrative Business & Economic Research, 4(1), 95-102.

Rachmawati, A., & Triatmoko, H. (2007). Analisis faktor-faktor yang mempengaruhi kualitas laba dan nilai perusahaan. Simposium Nasional Akuntansi X, 10(16), 1-26.

Scott, R. (2009). Financial Accounting Theory, 5nd. New Jersey: Prentice-Hall.

Siagian, F., Siregar, S. V., & Rahadian, Y. (2013). Corporate governance, reporting quality, and firm value: evidence from Indonesia. Journal of accounting in emerging economies, 3(1), 4-20..

Siallagan, H., & Machfoedz, M. U. (2006). Mekanisme corporate governance, kualitas laba dan nilai perusahaan. Simposium Nasional Akuntansi IX. Padang, 23-26.

Siddiqui, S. S. (2015). The association between corporate governance and firm performance–a meta-analysis. International Journal of Accounting and Information Management, 23(3), 218-237.

Subanidja, S., Rajasa, A., Suharto, E., & Atmanto, J. D. (2016). The determinants of firm value: The role

of earnings management and good corporate governance. Corporate Ownership and Control, 13(4), 609-615.

Subramanyam, Wild. (2009). Analisis Laporan Keuangan. Edisi 8. Jakarta : Salemba Empat.

Suffian, M. T. M., & Sanusi, Z. M. (2015). Real earnings management and firm value: Empirical evidence from Malaysia. Management & Accounting Review (MAR), 14(1), 25-47.

Susanto, S dan Christiawan, Y.J. (2016). Pengaruh Earnings Management terhadap Firm Value. Business Accounting Review, 4 (1) : 205-216.

Tang, H. W., & Chang, C. C. (2015). Does corporate governance affect the relationship between earnings management and firm performance? An endogenous switching regression model. Review of Quantitative Finance and Accounting, 45(1), 33-58.

Watts R. and J.L. Zimmerman. (1986). Positive Accounting Theory. New York: Prentice Hall.

Yung, K., & Root, A. (2019). Policy uncertainty and earnings management: International evidence. Journal of Business Research, 100, 255-267.