Jurnal Politeknik Caltex Riau
https://jurnal.pcr.ac.id/index.php/jakb/
| e- ISSN : 2476-9460 (Online) | p- ISSN : 2085-0751 (Print)

Analysis of Corporate Governance Mechanisms, Financial Performance on Firm Value with Earnings Quality as Moderating Variable

Ika Neni Kristanti

Universitas Putra Bangsa, Accounting Department, email: ikanenikristanti@gmail.com

Abstract

This study aims to analyze the effect of corporate governance mechanisms, financial performance on firm value with earnings quality as a moderating variable. This study uses purposive sampling which obtained 48 samples of companies listed on the Jakarta Islamic Index for the period 2017 – 2019. The test results in the Inmek research prove that institutional ownership has no effect on firm value, managerial ownership does not affect firm value, independent commissioners affect firm value , financial performance has no effect on firm value, earnings quality is not able to moderate the relationship between institutional ownership, managerial ownership, independent commissioners and financial performance on firm value.

Keywords: *corporate governance mechanism, financial performance, firm value, earnings quality*

1. Introduction

Since the 1997 economic crisis, the implementation of good corporate governance or better known as Good Corporate Governance (GCG) has become a very prominent issue in Indonesia. As a result of poor governance and corporate governance in Indonesia at that time, the Indonesian economy slumped. This is marked by the lack of transparency in the management of the company so that public control becomes very weak and the concentration of large shareholders in several families causes the intervention of the majority shareholder in the company's management to be felt and creates a conflict of interest that deviates greatly from the norms of good corporate governance [5].

The company is seen as a set of contracts between company managers and shareholders. The appointment of managers by shareholders to manage the company in reality often faces problems because the company's goals conflict with the personal goals of the manager. With the authority they have, managers can act only for their own benefit and at the expense of the interests of shareholders. This may be due to differences in the information held by the two. This difference in information is referred to as asymmetric information.

The presence of good corporate governance in crisis recovery in Indonesia is absolutely necessary, considering that good corporate governance requires good management in an organization [4]. The owner can limit the divergence of interests by providing a reasonable level

Dokumen diterima pada Kamis 24 Juni, 2021
Dipublikasikan pada Selasa 30 November, 2021

of incentive to managers and must be willing to incur monitoring costs to prevent hazard from managers. These costs as agency costs or agency costs. Corporate governance is a mechanism that can be used to ensure that financial suppliers, such as shareholders and bondholders, from the company get a return from the activities carried out by managers, or in other words how the company's financial suppliers exercise control over managers.

According to Jang *et al.* [6] quality accounting earnings are accounting profits that have a little perceived noise in it, and can reflect the company's real financial performance. That is, profit as part of the financial statements must present the actual facts about the economic condition of the company, so that the quality can be justified and does not mislead the users of financial statements. Quality profits usually occur because in running the company's business, management is not the owner of the company. This separation of ownership will lead to conflicts in the control and implementation of company management which causes managers to act against the wishes of the owners.

Based on agency theory, these problems can be overcome by good corporate governance. The corporate governance mechanism has control capabilities that can align the differences in interests between principals and agents, so as to produce an earnings report that contains quality earnings information [2]. Corporate governance which contains five important elements, namely transparency, accountability, responsibility, independence, and fairness, is expected to be a way to reduce agency conflicts and the value of the company will be well assessed by investors. Corporate governance is one of the key elements in improving economic efficiency, which includes a series of relationships between company management, the board of commissioners, shareholders, and other stakeholders that can create added value for all interested parties (stakeholders). The added value in question is the effective protection of investors in getting their investment back fairly and with high value. There are several mechanisms that are often used in various studies on good corporate governance, including institutional ownership, managerial ownership, the proportion of independent commissioners, and audit committees.

Several studies support, Warfield *et al.,* [7] found that managerial ownership is negatively related to earnings management as a proxy for earnings quality. Chan *et al.* [8] found evidence that there is a negative relationship between accruals and future stock prices. Morck *et al.* [9] found evidence that Tobin's Q (firm value) increased and then decreased in the direction of increasing managerial ownership. Midiastuty & Machfoedz [10] found that there is an effect of good corporate governance mechanisms, namely managerial ownership and institutional ownership on the decline in earnings management which will ultimately improve the quality of reported earnings. However, it is different from the research conducted by Siregar and Bachtiar [11] and Darmawati *et al.* [3]. This study aims to analyze whether the corporate governance mechanism, which consists of institutional ownership, managerial ownership, and independent commissioners and financial performance has an effect on firm value. As well as analyzing whether earnings quality is a variable that can moderate the relationship between corporate governance mechanisms and financial performance on firm value.

2. Literature Review

2.1 Agency Theory

Agency theory suggests the relationship between the principal (owner) and agent (manager) in terms of managing the company, where the principal is an entity that delegates the authority to manage the company to the agent (management). According to Jensen Meckling [1], agency theory explains the contractual relationship between the party who delegates certain decisions (principal/owner/shareholder) and the party who receives the delegation (agent/management).

There is a conflict of interest between the owner and the agent due to the possibility of acting not in accordance with the interests of the principal, thus triggering agency costs. As agents, managers are morally responsible for optimizing the profits of the owners (principals) by obtaining compensation in accordance with the contract. Thus, there are two different interests in the company where each party seeks to achieve or maintain the desired level of prosperity [12]. Larasati [13] uses three assumptions of basic human nature to explain agency theory, namely: (a) humans are generally self-interested; (b) humans have limited thinking power regarding the perception of the future (bounded rationality); (c) humans always avoid risk (risk averse).

2.2 Firm Value

Firm value is a value that can measure how big the level of interest of a company in which investors are. Firm value is the perception of investors towards the company which is often associated with stock prices. High stock prices make the value of the company also high, stock prices are usually indicated by the value of the company (Tobin'q). High company value will make the market believe in the company's future prospects. High corporate value will be followed by high shareholder prosperity [14].

2.3 Earnings Quality

Earnings quality is something that is central and important in the world of accounting because based on the quality of earnings, the accounting profession is at stake. Investors, creditors and other stakeholders make decisions, one of which is based on the financial statements, if the quality of the earnings presented is not reliable then the stakeholders can no longer trust the accounting profession. Therefore, various efforts and studies continue to be carried out in order to be able to compile financial reports with high earnings quality.

2.4 Good Corporate Governance

Corporate Governance is a system used in directing and controlling the company's business activities. This corporate governance also contains an understanding of the rules regarding the division of tasks and responsibilities among the parties who participate and have different interests in the company.

2.5 Institutional Ownership

Institutional ownership is the proportion of share ownership by institutions, in this case the founding institutions of the company, not public shareholders, as measured by the percentage of shares owned by internal institutional investors. The Cadbury report expects institutional shareholding in its role as a shareholder to assume the role of a majority shareholder.

2.6 Managerial Ownership

Managerial ownership, namely the total share ownership by the management of the entire share capital of the company [2]. The indicator to measure managerial ownership is the percentage of the number of shares owned by the management of the total outstanding share capital of the company.

2.7 Independent Commissioner

Independent commissioners according to the explanation of Article 120 paragraph (2) of the Limited Liability Company Law are from: outside the company, not affiliated with major shareholders, members of the board of directorsand/or other members of the board of

commissioners. The duty of the independent commissioner is to ensure GCG principles and practices are properly adhered to and applied, including: transparency, and disclosure of the company's financial statements, fair treatment of minority shareholders and other stakeholders, disclosure of transactions containing conflicts of interest fairly and fairly, the company's compliance with applicable laws and regulations, as well as ensuring the accountability of the company's organs [22].

2.8 Financial Performance

Performance can be interpreted as an achievement achieved by the company in a certain period that reflects the level of financial health of the company in achieving company goals. Financial performance is a description of the financial condition of a company which is analyzed with financial analysis tools, so that it can be known about the good and bad financial condition of a company that reflects work performance in a certain period.

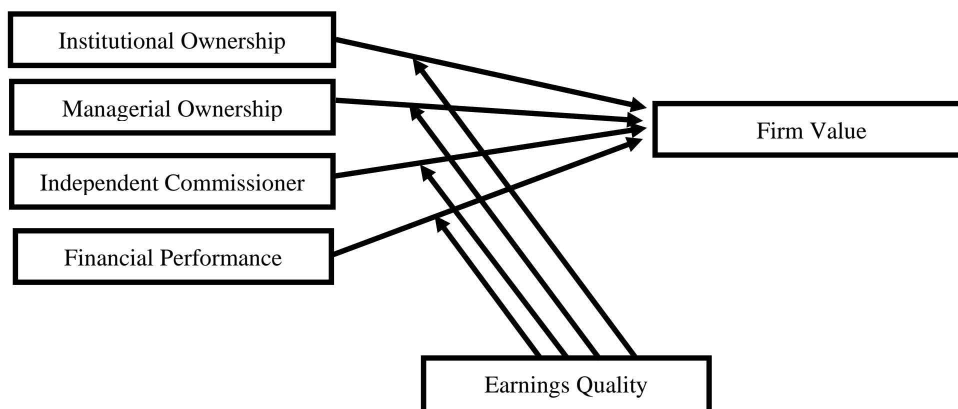

Figure 1. Research Model

H_1: Institutional ownership has a positive effect on firm value
H_2: Managerial ownership has a positive effect on firm value
H_3: Independent commissioner has a positive effect on firm value
H_4: Financial performance has a positive effect on firm value
H_5: Earnings quality strengthens the relationship of institutional ownership on firm value
H_6: Earnings quality strengthens the relationship of managerial ownership on firm value
H_7: Earnings quality strengthens the relationship of independent commissioner on firm value
H_8: Earnings quality strengthens the relationship of financial performance on firm value

3. Research Method

The location of this research was carried out on companies listed on the Jakarta Islamic Index in the observation period of 2017 – 2019. The population in this study were companies registered on the Jakarta Islamic Index for three consecutive years, namely 2017, 2018, and 2019. A total of 48 sample in this study and to determine the size of the sample using a sampling method, namely purposive sampling. Purposive sampling is a sampling technique with certain considerations or criteria.

4. Result and Discussion

4.1 Classic Assumption

The results of the classical assumption test in this study indicate that the normality test is expressed in a normal distribution through a normal P-P plot, the distribution points around the diagonal line, thus fulfilling the assumption of normality. The autocorrelation test shows that the Durbin Watson (D-W) value is 2.229 with n = 48 and parameter k = 4, so the dL value is 1.3619 and dU is 1.7206. This value is between dU = 1.7206 and 4 – dU = 2.6381 or 1.7206 < 2.229 < 2.6381. The multicollinearity test shows that the tolerance of each variable is more than 0.10 and the VIF value is less than 10.00, which means that there is no multicollinearity between the independent variables in this study. Heteroscedasticity test shows that there is no clear pattern and points below and above zero on the Y axis, it can be concluded that there is no heteroscedasticity. Based on this, it means that it has met the requirements and the regression model is feasible to use.

4.2 Coefficient Determination

The result of testing the coefficient of determination of the adjusted R^2 value of 0.433 means that the contribution of the variables of Institutional Ownership, Managerial Ownership, Independent Commissioner, Financial Performance to the Firm Value of the company is 43.3%, while 56 ,7% (100 – 43.3) is influenced by other variables outside the model.

4.3 Hypotheses Testing

Partial Test

Table 1. Summary of Hypotheses Testing

Hypothesis	Coefficient	t-Statistic	Sig	Conclusion
H_1	.874	1.134	.263	Not supported
H_2	-8.578	-1.844	.072	Not supported
H_3	7.846	4.007	.000	Supported
H_4	-.008	-1.055	.297	Not supported

Source: Data processed (2021)

Based on the table above, it can be concluded that independent commissioners have a positive effect on firm value (sig .000 < .05; coefficient 7.846), however, there is no effect of institutional ownership (sig 2.63 > .05), managerial ownership (sig .072 > .05) and financial performance (sig .297 > .05) on firm value.

Moderating Regression Analysis

Table 2. Summary of Moderating Hypotheses Testing

Hypothesis	Model	Coefficient	t-Statistic	Sig	Conclusion
H_1	X_1M	-3.829	-.263	.794	Not supported
H_2	X_2M	133.728	.331	.742	Not supported
H_3	X_3M	-7.464	-.218	.828	Not supported
H_4	X_4M	.138	.618	.540	Not supported

Source: Data processed (2021)

Institutional ownership provides a parameter coefficient of 1.722 with a significance level of 0.127. Earnings quality provides a parameter coefficient of 2.729 with a significance level of 0.216. Earnings Quality which has a parameter coefficient of -3,829 with a significance

level of 0.794, so it can be concluded that Earnings Quality is not able to moderate the relationship between institutional ownership and firm value.

Managerial Ownership provides a parameter coefficient of -7.844 with a significance level of 0.245. Earnings quality provides a parameter coefficient of 0.696 with a significance level of 0.864. The moderating variable of Earnings Quality has a parameter coefficient of 133,728 with a significance level of 0.742, so it can be concluded that Earnings Quality is not able to moderate the relationship between managerial ownership and firm value.

The Independent Commissioner provides a parameter coefficient of 6.884 with a significance level of 0.000. The earnings quality variable provides a parameter coefficient of 9.068 with a significance level of 0.055. Earnings Quality which has a parameter coefficient of -7.464 with a significance level of 0.050, so it can be concluded that Earnings Quality is not able to moderate the Independent Commissioner's relationship to firm value.

Financial Performance provides a parameter coefficient of 0.025 with a significance level of 0.007. Earnings quality provides a parameter coefficient of 0.809 with a significance level of 0.854. Earnings Quality which has a parameter coefficient of 0.138 with a significance level of 0.540, so it can be concluded that Earnings Quality is not able to moderate the relationship between Financial Performance and firm value.

4.4 Discussion

4.4.1. Institutional Ownership to Firm Value

The results of this study are contrary to agency theory [1],which states that institutional ownership can reduce agency costs because of the ownership of shares by institutional investors such as insurance companies, banks, investment companies and ownership by other institutions. in the form of a company will encourage increased monitoring (monitoring) that is more optimal on the performance of management so as to increase the value of the company. The results of this study are in line with research from Fitriani (2015) and Sugiarto (2011) which concluded that institutional ownership has no effect on firm value. Institutional ownership of holding companies that are affiliated with each other in Indonesia are still family companies where the company management is still part of the family companies (Sudarma, 2004). Share ownership by institutional parties is dominated by parties who are not independent (affiliated with each other) so that the function of institutional ownership as a supervisor for management cannot run properly even though share ownership by institutional parties is high. This condition causes agency problems cannot be suppressed and can have an impact on the company's declining market value.

4.4.2. Managerial Ownership to Firm Value

Based on the test results, it is proven that managerial ownership has no effect on firm value. According to Sulistiono [15], managers as well as shareholders will try to increase the value of the company, because with the increase in the value of a company, the value of its wealth as a shareholder will also increase. This also applies to Agency Theory where according to Jensen and Meckling [1] states that agency problems will occur if the proportion of manager ownership of company shares is less than 100% so that managers tend to act to pursue their own interests and are not based on maximizing value in making funding decisions, when the proportion of managerial ownership increases, the interests of shareholders and management begin to become one [16]. Thus, by referring at managerial ownership, each company manager can try to maximize the value or profit generated in decision making, so that it can have an impact on increasing value in a company.

Empirical studies in previous studies also show that the higher managerial ownership, the higher the impact on firm value. Previous research that examined the effect of managerial ownership with firm value stated that managerial ownership had an effect on firm [17].

4.4.3. Independent Commissioner to Firm Value

The existence of independent commissioners is expected to increase the effectiveness of supervision and strive to improve the quality of financial reports. The existence of good supervision will minimize fraudulent actions by management in financial reporting so that the value of the company will increase.

4.4.4. Financial Performance to Firm Value

Profitability in theory is positively related to firm value. The higher the profitability, the higher the firm value and the lower the profitability, the lower the firm value. The better the company pays returns to shareholders, the higher the value of the company. Profitability partially in the results of this study found that profitability has a significant positive effect on firm value. The results of this study are in accordance with Susilo [18] which shows that profitability has an effect on changes in stock prices of banking companies. The results of this study are also supported by Lestroyini [19] and Barasa [20]. Profitability shows the level of net profit that can be achieved by the company when running its operations. Profits that deserve to be distributed to shareholders are profits after interest and taxes, so that high profitability can add value to the company's value which is reflected in its share price.

According to the signaling theory, it is explained that the company will provide signals or information to market participants, then market participants will interpret and analyze the information into a good signal (good news) or a bad signal (bad news) which will then be used as a guide in making investment decisions. However, based on this research, this theory is not proven.

4.4.5 Earnings Quality as Moderating Variable

The existence of agency conflict in the company can trigger earnings management in the company. This study has found that earnings management cannot moderate the positive relationship between managerial ownership and institutional ownership on firm value. This is in accordance with the good control implemented by the company. Companies that have implemented good corporate governance so as to create optimal control by management and institutional parties. The management will try to align the interests by providing all the information it has optimally to the shareholders to avoid information asymmetry.

Earnings quality is not able to moderate the relationship of independent commissioners to firm value. This does not support the previous research that companies manipulate earnings are more likely to have a board of commissioners dominated by management and more likely to have a Chief Executive Officer (CEO) who doubles as chairman of the board [21]. This means that manipulation will be reduced if the structure of the board of directors comes from outside the company. if the independent function of the board of directors tends to be weak, there will be a tendency for moral hazard to be carried out by the company's directors for their interests through the ownership of estimates of accruals that have an impact on earnings management.

Profit is an indicator that can be used to measure the company's operational performance. Information about earnings measures the success or failure of a business in achieving its stated operating objectives. Both creditors and investors use earnings to evaluate

management performance, estimate earnings power, and to predict future earnings. The ability of earnings to predict future cash flows has been believed by several researchers. Ball and Brown found a positive relationship between contemporary earnings and returns. Dechow *et al*. found that current earnings provide the best forecast for future cash flows compared to current cash flows [21].

Independent Commissioner is a member of the Board of Commissioners who is not affiliated with the Board of Directors, other members of the Board of Commissioners and the controlling shareholder, and is free from business relationships or other relationships that may affect his ability to act independently. The existence of independent commissioners will encourage and create a more independent, objective climate and increase fairness as one of the main principles in paying attention to the interests of minority shareholders and other stakeholders.

Firm value is an investor's perception of the company, which is often associated with stock prices. High stock prices make the value of the company also high. The value of the company can be reflected in the value of its shares. If the value of the stock is high, it can be said that the value of the company is also good. Because the main goal of the company is to increase the value of the company through increasing the prosperity of the owners or shareholders.

Earnings quality may not be able to moderate the relationship between financial performance and firm value. Earnings quality is an assessment of the extent to which a profit can be obtained repeatedly, can be controlled, and can describe the profitability of the company in real terms. It can be measured by the ratio of operating cash to profit, the closer profit to operating cash shows the more qualified earnings. Performance can be interpreted as an achievement achieved by the company in a certain period which reflects the level of financial health of the company in achieving company goals. Financial performance is a description of the financial condition of a company which is analyzed with financial analysis tools, so that it can be known about the good and bad financial condition of a company that reflects work performance in a certain period.

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5. Conclusion

Based on the research conducted, several conclusions were obtained, namely, institutional ownership has no effect on firm value, managerial ownership has no effect on firm value, independent commissioners have no effect on firm value and financial performance has no effect on firm value. Earnings Quality is not able to moderate the relationship between institutional ownership and firm value. Earnings Quality is not able to moderate the relationship of managerial ownership to firm value. Earnings Quality is not able to moderate the relationship of Independent Commissioners to firm value. Earnings Quality is not able to moderate the relationship between Financial Performance and firm value.

The limitation in this study is that based on the results of the coefficient of determination, the adjusted R2 value is 0.433, meaning that the contribution of the variable Institutional Ownership (X1), Managerial Ownership (X2), Independent Commissioner (X3),

Financial Performance (X4) to the firm value of the company is 43 .3%, while 56.7% (100 – 43.3) is influenced by other variables outside the model.

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