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The Effect of Profitability, Leverage, and Managerial Ownership on Earnings Management

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ABSTRACT

This study aims to determine the effect of profitability, leverage, and managerial ownership on earnings management in manufacturing companies listed on the Indonesia Stock Exchange in 2017-2019. This study used 30 manufacturing companies as a sample with the purposive sampling method. In this research, Microsoft Excel and EViews 12 was used to assist in data processing. The results of this study show that profitability has positive and significant effect on earnings management, leverage and managerial ownership has no effect on earnings management. This research can be useful for company management, investors, and creditors in dealing with factors that affect earnings management.

Keywords: *Profitability, Leverage, Managerial Ownership, Earnings Management*

1. INTRODUCTION

The performance and effectiveness of the company's operation within a certain period of time can be seen by looking at the company's financial statements. Financial statements contain company financial information that can be used by various parties in making economic decisions. Therefore, the presentation of the financial statements provided must contain information that is reliable. [1] says that in assessing the performance and responsibility of management, information about profit can be the main focus. Profit and loss information is often used as a benchmark for whether or not the performance of a company and management is good, as well as assisting external parties such as investors in assessing the investment risks that can be faced when investing in the company. This can trigger the managers to take action to stabilize, minimize, or maximize profits. Manipulation of financial statements, especially on company profit and loss information, is also known as earnings management. Profit information is often be the target of manipulation and make the financial information provided by the company irrelevant [2].

Earnings management is a condition where management intervenes in the process of stabilizing, increasing, and decreasing profits in the preparation of financial reports [3]. According to [4], not a few managers think that earnings management practices are legitimate and reasonable behaviour. However, this practice can have negative consequences because it tends to mislead users of financial statements in the decision-making process [2]. The action of earnings management can provide information that can mislead and tend to not show the actual condition of the company. Earnings management can be considered as an accounting scheme, especially if it is an attempt to change information by adjusting the numbers in the components of financial statements when compiling company's financial information [5].

There are various factors that can lead to earnings management, one of the factors is profitability. Profitability is a ratio related to the company's ability to generate profits or operating profits within a certain period of time and each company is expected to be able to maintain the business' profitability. Profit is an indicator of management's performance in managing the company's assets and used to measure of the effectiveness of the company's operations. Profitability can affect earnings

management because the investors and other users of financial statements tend to be interested on a large level company profitability, so this can encourage managers to practice earnings management [6]. Another factor that can affect earnings management is leverage. Leverage refers to the amount of debt used to fund the company's assets and business operations other than equity. This variable is considered to see and assess how well management manages the company's loan funds, so that if the amount of debt is greater than the assets owned, the company tends to have a large business risk [7]. Companies whose assets are mostly funded by debt tend to take action to increase profits due to high interest expenses [5]. Managerial ownership is also one of the factors that can affect earnings management. The separation of ownership and management of the company can be the cause of earnings management due to differences in interests between the owners and managers of the company. Managerial ownership is the company's shares rights by management who are active in making decisions within the company, such as managers, directors, or commissioners [8]. Managerial ownership is often associated as an effort to increase the value of a company because managers in addition to acting as manager as well as being the owner of the company's shares will directly take the consequences of the business decision so that managers will not take actions that only benefit themselves [9].

This research is expected to be useful for investors to consider the factors that can influence investment decisions in the company, for creditors to consider factors that can affect credit decisions and agreements, for company managers to be able to identify and shows the factors that can influence the behaviour of external parties in making decisions on granting funds so that companies can determine the strategy, for accounting standard makers to be able to identify factors that can trigger earnings management in financial statements so that accounting standard makers can determine regulations to minimize the occurrence of earnings management, and for the academy to be able to increase knowledge of the factors that can influence the company's earnings management and can be additional empirical evidence in conducting further research.

2. LITERATURE REVIEW AND HYPOTHESIS

2.1. Agency Theory

Agency theory explains the relationship between the principal and the agent, where the principal delegates a responsibility or authority in the company's decision making to the agent [10], which indicates that the principal is no longer involved in the operation of the business because it has been delegated to management and monitors the company through reports provided by agents. However, empirical facts stated that agents do not always act in accordance with what is desired by the principal [11]. Principals tend to expect good company performance and are able to provide satisfactory returns from agents. Meanwhile, agents tend to be wanting to maximize their own welfare, such as high bonus compensation, by covering the actual company results so that the company's condition looks good.

2.2. Signalling Theory

Signalling theory, [12] says that in order for investors to be willing and interested in investing in the company to the point of having an impact on increasing the company's share price, publishing adequate information about the condition of the company by managers is necessary because managers are more aware of the conditions of the company. The signal given by the company can be information about the company's performance that contains both positive (good) and negative (bad) values for the future. Information that can be a signal for interested parties, especially investors, is annual reports related to financial statements and non-accounting information. This theory also shows that a complete, precise, relevant, and accurate information issued by the company is very influential and important for investors because it can determine investment decisions.

2.3. Earnings Management

Earnings management can be defined as manager's effort to intervene company's profits in financial statements by utilizing alternative accounting methods and procedures with the aim of deceiving stakeholders [13]. [14] says that earnings management occurs when managers use judgement in financial reporting and draft company's transactions to alter financial statements to influence contract outcomes that rely on reported accounting figures or to mislead some stakeholders about the underlying economic performance of the company.

Earnings management actions are carried out in various ways by managers to achieve the desired results, some are trying to increase profits, making company profits look stable in each period, some are trying to reduce profits, and so on. Earnings management variable is measured using discretionary accruals (DA) proxy which is calculated by Modified Jones Model. The company will be seen doing income increasing if the value of discretionary accruals is positive. Meanwhile, if the discretionary accrual value is negative, it can be concluded that the company is doing income decreasing [15].

2.4. Profitability

Profitability is the ability of a company to create or make a profit. The profitability of the company can influence investors in entrusting the funds that will be invested in the company and can trigger earnings management practices by company managers. This is in line with the findings of [6] and [16]'s research that shows profitability has a positive effect on profit management. However, there are studies that show different results, which is profitability has negative affects earnings management [17].

2.5. Leverage

Leverage is a ratio that can show the size of a company's asset level funded by debt. Companies with high leverage can face a variety of risks, such as default and bankruptcy risk. Management can be triggered to cover high leverage ratios by performing opportunistic actions such as earnings management. Previous research conducted by [11] shows positive results between leverage and earnings management practices. In contrast to the result of research conducted by [18] which stated that leverage negatively affects earnings management.

2.6. Managerial Ownership

Managerial ownership is an opportunity for managers to co-own shares of the company and be active in company decision-making. Managers that have a low company's shares rate or does not own shares of the company can increase the opportunistic behaviour of managers. Previous research on managerial ownership is conducted by [19] found that managerial ownership has a positive influence on profit management. However, the research conducted by [20] state a different result, that managerial ownership has negative affects earnings management, [21] and [22] states managerial ownership has no influence on earnings management.

2.7. Hypothesis

2.7.1. The Effect of Profitability on Earnings Management

Profitability refers to the efficiency of a company's performance in generating profits from the cash used in operating business as well as the company's assets. The higher the profitability that the company has can trigger managers to carry out profit management with the aim of raising the value of the company and attracting the attention of investors to invest. Thus, the research hypothesis can be developed as follow:

H₁: Profitability has a significant positive effect on profit management.

2.7.2. The Effect of Leverage on Earnings Management

A high level of leverage can result in the high level of risk experienced by the company. In the event of an increase in profits, creditors can have confidence that the company will be able to pay the funds given, this could trigger earnings management actions by management. Therefore, the research hypothesis can be developed as follow:

H₂: Leverage has a significant positive effect on profit management.

2.7.3. The Effect of Managerial Ownership on Earnings Management

The amount of managerial ownership in a company can suppress opportunistic actions by managers. This is because the manager who owns shares in the company will bear the results of the decisions manager make. Managers who have company's shares will act in accordance with the owners and their shareholders. Thus, the research hypothesis can be developed as follow:

H₃: Managerial ownership has a significant negative effect on profit management.

3. RESEARCH METHODOLOGY

This research method in this study is quantitative research that used secondary data obtained from the Indonesia Stock Exchange. This research is done by observing the financial statements that were published by the company. Unit of analysis of this study is manufacturing companies listed during the period of 2017-2019. The sample selection method used in this research is non-probability sampling with purposive sampling method in manufacturing companies. The total number of samples that can be used in this research is 30 companies.

3.1. Operationalization of Variables

Earnings management (Y) is a practice implemented by managers to meet personal interests by the means of manipulating profits and reporting them into the financial statements of the enterprise. Earnings management can be measured using discretionary accruals proxies which calculations can be done using the modified jones model. The modified jones model formula can be calculated using the following steps:

- 1) $TA_t = NI_t - CFO_t$
- 2) $TA_t/A_{t-1} = \beta_{1j}(1/A_{t-1}) + \beta_{2j}(\Delta REV_t/A_{t-1}) + \beta_{3j}(PPE_t/A_{t-1}) + e$
- 3) $NDA_t = \beta_{1j}(1/A_{t-1}) + \beta_{2j}([\Delta REV_t - \Delta AR_t]/A_{t-1}) + \beta_{3j}(PPE_t/A_{t-1})$
- 4) $DA_{jt} = TA_{jt}/A_{t-1} - NDA_{jt}$

Whereas TA_t : Total accruals year t, NI_t : Net income year t, CFO_t : Cash flow from operating activities year t, NDA_t : Non-Discretionary accruals year t, A_{t-1} : Total assets year t-1, ΔREV_t : Change in revenue/sales year t minus year t-1, ΔAR_t : Change in account receivables year t minus year t-1, PPE_t : The company's gross fixed assets year t, β_{1j} , β_{2j} , β_{3j} : Firm specific parameters.

Profitability (X1) is the company's ability to make a profit. Profitability can measure the efficiency and effectiveness of the company's operations in generating profits. Profitability variable in this study is measured with the following formula:

$$ROA = \frac{\text{Net Income}}{\text{Total Asset}}$$

Leverage (X2) shows the amount of debt owned by the company and shows how much risk the company has to deal over the debt. Leverage is the ratio between total liabilities and total assets of a company, where this ratio displays the amount of assets or operations of the company funded by debt. Leverage variable in this study uses the following formula:

$$DAR = \frac{\text{Total Hutang}}{\text{Total Asset}}$$

Managerial ownership (X3) is shares of the company owned by the manager in the company he manages, so the manager also acts as the owner of the company's shares. Managerial ownership can be calculated on a scale of the ratio through the percentage of shares acquired by the manager with the outstanding shares in the market. Managerial ownership in this study is measured by the following formula:

$$\text{Managerial Ownership} = \frac{\text{Shares Owned by Manager}}{\text{Total Outstanding Shares}}$$

3.2. Data Analysis Method

Analysis method used in this research is descriptive analysis and multiple regression analysis. This study is testing the hypothesis used to explain the effect of the independent variables on the dependent variable. The data must pass the classical assumptions in order to be used in testing of the hypothesis. The classical assumptions of this study are included in the multicollinearity test and heteroscedasticity test.

3.3. Panel Regression Analysis

Panel regression test is conducted to determine the effect of all the independent variables on the dependent variable with the equation as follows:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + e$$

Where in this equation, Y is earnings management, X1 is profitability, X2 is leverage, and X3 is managerial ownership.

4. RESULTS

The results of the multicollinearity test show that the overall value of the independent variable is below 0.85, so the regression model in this study is said to be free of multicollinearity. The heteroskedasticity test uses the Breusch-Pagan test, the results show a probability value of 0.4722. This value is greater than 0.05, so the conclusion can be drawn is that the data do not undergo heteroskedasticity.

The results of the influence test (t test) are carried out after the classical assumption test meets the requirements and obtains the following results:

Table 1. The Results of Regression

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.084739	0.085931	-0.986128	0.3282
X1	0.653575	0.260505	2.508876	0.0150
X2	0.292808	0.161125	1.817273	0.0744
X3	-0.616998	0.344314	-1.791966	0.0784
Effects Specification				
Cross-section fixed (dummy variables)				
R-squared	0.532211	Mean dependent var	-0.034808	
Adjusted R-squared	0.269592	S.D. dependent var	0.047963	
S.E. of regression	0.040991	Akaike info criterion	-3.274333	
Sum squared resid	0.095777	Schwarz criterion	-2.357736	
Log likelihood	180.3450	Hannan-Quinn criter.	-2.904707	
F-statistic	2.026554	Durbin-Watson stat	2.845842	
Prob(F-statistic)	0.009894			

Based on the results of the evaluation in the table above, a regression equation can be obtained that will be used in this study, which is as follows:

$$Y = -0.084739 + 0.653575X_1 + 0.292808X_2 - 0.616998X_3 + e$$

The test results in Table 2 of the regression analysis obtained that profitability showed a coefficient of 0.653575 and a significant value of 0.0150 which indicates that the higher the profitability value, the higher the level of earnings management practice by the company's managerial. Leverage has a coefficient value of 0.292808 and a significant value of 0.0744, this can be concluded that leverage cannot affect earnings management. Managerial ownership has a coefficient value of -0.616998 and a significant value of 0.0784, this result indicates that managerial ownership has no effect on earnings management.

The F test in this study shows the results of a prob(F-statistic) value at 0.009894. The value indicates that profitability, leverage, and managerial ownership have a joint effect on earnings management. The correlation of independent variables, namely profitability, leverage, and managerial ownership to the dependent variables of earnings management, was carried out determinant test (R). The adjusted R-Squared value in this study shows a value of 0.269592, which means that all the independent variables in this study only have 26.95% influence on earnings management.

5. CONCLUSIONS

This study examines the effect of profitability, leverage, and managerial ownership on earnings management in manufacturing companies listed on the Indonesia Stock Exchange for the period of 2017 to 2019. The results of this study show that high profitability can affect the practice of earnings management actions by managers. Leverage and managerial ownership in this study cannot affect the earnings management carried out by managers within the company.

This research is limited to data on manufacturing industry companies listed on the Indonesia Stock Exchange and the research data studied only represents a three-year period between the 2017-2019 period. In addition, the study is also limited to independent variables of profitability, leverage, and managerial ownership on the dependent variable of earning management. The suggestion for subsequent research is to add others variables that may have an effect on earnings management, expand the company's sample so that the research will not only be limited to the manufacturing companies, and add more period of research years.

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