Company Financial Ratios, Company Ownership and Company Conditions on Earnings Management

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Abstract: Recently, high-level scandals and financial crises that have occurred in several countries have brought issues of corporate governance to the forefront of developing countries, emerging markets and transitional economies. This scandal shook the integrity of accounting information and resulted in a decline in investor confidence. This has made the company need to achieve significant progress to carry out corporate governance to restore investor confidence in the quality of financial reporting. To achieve this, this paper proposes a conceptual framework to investigate the relationship between financial ratios (profitability, leverage and operating cash flow), ownership (Institutional ownership and managerial ownership), and company condition (board size, firm size, sales growth) to earnings management among manufacturing companies listed on the Indonesia Stock Exchange (IDX). Evidence from previous research shows that the company's financial ratios (profitability) that have large profits and meet targets has very little chance of manipulating earnings.

1 INTRODUCTION

Perusahaan Terbatas (PT) is one of the most popular business entities in the business world, and is widely used by business actors in Indonesia as well as in other countries. The company as an entity needs a reference to evaluate the performance of the management of the company over a period of time, for which it is prepared and required a record called the financial statements. PSAK No. 1 explains that the financial statements are a record that presents the financial condition of a company in a structured manner in a given accounting period. The purpose of the financial statements is to provide information related to the financial condition and cash flows of a company, beneficial to its users in terms of making an economic decision (Financial Accounting Standards Board, 2014).

Along with the advancement of technology and information technology, business competition is encouraged to happen more tightly. This is due to price transparency and ease to obtain a product quickly, for that the management to compete to obtain the maximum profit possible. Earnings are often the primary basis for assessing whether the company's management has contributed to the best interests of the company, leading to the birth of earnings management practices by management.

Profit management is the way managers use to systematically and systematically influence the rate of profit by selecting accounting policies and certain accounting procedures from existing accounting standards and scientifically maximizing their utility and / or market value (Scott, 2015). The Company will determine whether the profits earned will be allocated to shareholders or entirely retained for reinvestment. The information asymmetry that emerges between managers and shareholders provides the flexibility for management to freely determine the accounting methods and estimates used in reporting corporate profits thus providing an opportunity for earnings management (Indriani et al., 2014).

To minimize the practice of earnings management, Kusumawardhani (2012) explains that the concept of Good Corporate Governance can be a tool to monitor and control the actions taken by the management company, so that the opportunistic behavior of management to make earnings management can be reduced. Implementation of the concept of Good Corporate Governance can be seen from the existence of parties such as managerial ownership, institutional ownership, audit committee

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and independent commissioner in a company that emphasizes on management responsibility to mechanism and guidance and company objective, to protect shareholder's interest.

Jensen and Meckling (1976) explain the agency relationship is an agreement between the principal and the agent for a delegation of the authority of the work. Principal acts as the party giving the authority of the company's operational management to the agent in order to achieve the goals of the entity. In practice within the company, the investor who invests his capital for the company acts as a principal. While the management company acts as an agent, which is responsible to investors to manage the company's operational activities in accordance with the trust that has been given to him (Godfrey et al., 2010).

Separation of functions between ownership and management can lead to conflicting agencies, because in the case of decision-making, managers sometimes do not act in the interests of shareholders. The existence of such a difference of interest encourages the owner to exercise control in order to ensure that management actions are in conformity with the company's objectives and to reduce profit manipulation (Aygun et al., 2014).

Management has more information when compared with the investor. This is what causes information asymmetry. In addition, this also causes management to take actions that are profitable for him and very difficult for the investor to control the action so that management can implement certain policies that are not known by the investors (Lisa, 2012).

2 THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

The Signal Theory explains that the activities of a company can signal to the public. The Company strives to provide a positive signal to external parties, with the aim of improving the company's performance and reducing the occurrence of information asymmetry.

According to Ross (1977) that the management seeks to provide the best possible information to the public, this can lead to information asymmetry between companies and external parties company. If the company has increased leverage then the public will give a positive signal and if it publishes shares then the public will give a negative signal. The basis of this theory explains that the company is likely to compile financial statements that can generate the best possible profit but not necessarily show the real condition of real corporate finance.

Scott (2015) identified the existence of four patterns performed by the management to make earnings management, which are: (1) Taking a bath is done when there is a bad situation that is unprofitable and can not be avoided, that is by recognizing the costs in the period to be (2) Income minimization is done when the company obtains high profitability in order not to get political attention, (3) Income maximization is done by maximizing the profit in order to obtain bigger bonus. From positive accounting theory, managers can engage in maximized reported net income for bonus purposes, (4) Income smoothing is done by increasing or decreasing profits to reduce reported profit fluctuations so that the firm looks stable and not at high risk.

In addition, Ahmed and Belkaoui (2000) in Handayani and Rachadi (2009) explain earnings information has 5 main objectives for parties interested in the company. First, profit is used as the basis for the company to determine the policy of dividends and bonuses for shareholders. Second, the profit becomes the basis for calculating the tax obligations of companies that must be deposited to the government. Third, profit is used as a basis for economic and investment decision making. Fourth, earnings information is useful for assessing the prospects of the company for the future, and fifth, profit is used as the basis for the assessment of the performance of the management during a certain period of time. The importance of this profit encourages the manipulation of profit.

Good corporate governance mechanisms emphasize two important things: the investor must get the information that is appropriate to the real situation and delivery on time. The second thing is to emphasize that company management must disclose information to investors regarding the company's performance in a transparent and timely manner (Guna and Herawaty, 2010).

This research uses Discretionary Accrual model to measure earnings management by management. Discretionary Accrual is the utilization of accrual components in accounting conducted by the management company, through its interference with the preparation of financial statements. This intervention causes reported earnings do not reflect actual company conditions (Guna and Herawaty, 2010).

Researchers classify eight variables into three major groups, namely the Financial Ratio, Ownership company, and Company conditions. Financial Ratio

consists of: profitability, leverage, and operational cash flow. Ownership company comprised of institutional ownership and managerial ownership Company conditions consists of board size, company size, and company growth. Based on the theoretical description above, the research model formulated in this research is as follows:

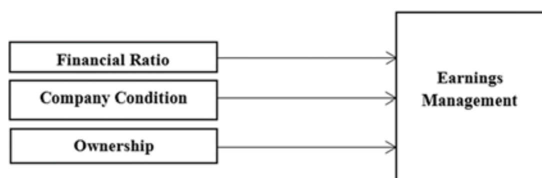

Figure 1: Research Model.

H1: Board size affects earnings management.
H2: Managerial ownership affects earnings management.
H3: Institutional ownership affects earnings management.
H4: Firm size affects earnings management.
H5: Profitability affects earnings management.
H6: Leverage affects earnings management.
H7: Operating cash flow affects earnings management.
H8: Sales growth affects earnings management.

3 RESEARCH METHOD

The sample used in this research is a manufacturing company consistently listed in Indonesia Stock Exchange (BEI) in 2014 until 2016. The sample selection is done by purposive sampling method that is the selection of sample based on certain criteria according to the purpose and research problem (Sugiyono, 2012). The results of sample selection can be seen in table 1 below:

Table 1: Sample Selection Procedure.

Sampel Criteria	Company	Data
manufacturing company consistently listed on the Indonesia Stock Exchange from 2014-2016	139	417
Companies that do not issue financial statements in rupiah currency	(29)	(87)
Companies that do not issue financial statements ending on 31 December	(1)	(3)
Companies that do not publish financial reports consistently from 2014-2016	(2)	(6)
The number of research samples used	107	321

Earnings management is measured using the discretionary accruals method, which is a modified cross-sectional model of Jones, in absolutes as research has been done by (Bassiouny et al., 2016). The stages for obtaining a discretionary accrual value are expressed in the following equation:

$$TA_t = NIt - NCFt \quad (1)$$

$$TA_{it}/A_{it-1} = \beta_1 (1/A_{it-1}) + \beta_2 ((\Delta REV_{it} - \Delta REC_{it})/A_{it-1}) + \beta_3 (PPE_{it}/A_{it-1}) + \varepsilon it \quad (2)$$

$$NDA_{it}/A_{it-1} = \beta_1 (1/A_{it-1}) + \beta_2 ((\Delta REV_{it} - \Delta REC_{it})/A_{it-1}) + \beta_3 (PPE_{it}/A_{it-1}) \quad (3)$$

$$DAC_{it} = TA_{it}/A_{it-1} - NDA_{it}/A_{it-1} \quad (4)$$

TAt Total Accruals in period t, NIt Net income t period, NCFt Cash flow from operating activity period t, NDAit Nondiscretionary accruals period t, Ait-1 Total corporate assets i period t-1 ΔREVit Changes in corporate income i from period t-1 to period t, ΔRECit Changes of corporate receivables i from period t-1 to period t, PPEit Gross property, plant and equipment company i period t, εit residual.

Board Size is the number of members of the board of directors and board of commissioners who are in a company (Alzoubi 2016). Here are the measurements:

BOD = Number of members of the board of directors and board of commissioners of the company (5)

Managerial ownership is the number of shares of the company owned by the management of the company personally and subsidiaries, as well as its affiliates (Agustia, 2013).

$$MANJ = \frac{\text{Number of shares owned by company management}}{\text{Total shares of outstanding companies}} \quad (6)$$

Institutional ownership is the number of shares owned by the institutional company (external), such as investment companies, banks, insurance companies and other institutions (Mahariana and Ramantha, 2014).

$$INST = \frac{\text{Number of shares owned by institutional investors}}{\text{Total shares of outstanding companies}} \quad (7)$$

The size of a company is a small size of a company that can be seen from several categories such as total assets, total sales, average sales, market value of stock companies, etc. but generally used is total assets (Yuliana and Trisnawati, 2015).

$$F_SIZE = Ln\ (Total\ Aset) \quad (8)$$

Profitability is the company's ability to earn an overall profit. Profitability is measured by the proxy of ROA measurement that is the ratio between net profit after tax which is obtained with total assets of company (Alzoubi 2016).

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$$ROA = \frac{\text{Net profit after tax}}{Total\ Aset} \quad (9)$$

Leverage is the percentage of company assets financed by using debt (Susanto, 2013).

$$LEV = \frac{Total\ Liabilitas}{Total\ Aset} \quad (10)$$

Operating cash flows represent cash receipts and disbursements from operating activities of the company. Operating cash flow is an indicator of the company's performance in generating cash flow for operational activities (Yuliana and Trisnawati 2015).

$$OCF = \frac{Operating\ cash\ flow\ in\ year\ t}{Total\ Assets\ in\ year\ t-1} \quad (11)$$

Sales growth represents a change in total sales in year t with total sales in the previous year compared to total sales in the previous year (Savitri 2014).

$$GROW = \frac{Sales\ in\ year\ t - Sales\ in\ year\ t-1}{Sales\ in\ year\ t-1} \quad (12)$$

4 RESEARCH RESULTS

The results of descriptive statistics and hypothesis testing results can be seen in table 2 and table 3 below:

Tabel 2: Descriptive Statistics.

Variabel	N	*Minimum*	*Maximum*	*Mean*	*Std. Deviation*
DAC	321	0,00026531	0,54183829	0,06101478	0,0721691
BOD	321	4,00000000	23,00000000	8,96884735	3,8052958
MANJ	321	0,00000000	0,83955667	0,04025514	0,1077708
INST	321	0,00000000	0,99769971	0,68552896	0,2206362
F SIZE	321	24,41415723	33,19881203	28,15127450	1,5804740
ROA	321	-0,54846648	0,43169784	0,04826462	0,1036859
LEV	321	0,04133741	3,02908570	0,50162620	0,3745281
OCF	321	-0,33998738	0,59426766	0,07763534	0,1224090
GROW	321	-0,89800090	5,94730877	0,07899234	0,5161147

Company Financial Ratio in Profitability (ROA) has a Sig value. of 0.007 less than 0.05 which means ROA is accepted. Profitability (ROA) has a regression coefficient of -0.145 which indicates a negative direction and a significant value (sig.) of 0.007. This means that profitability negatively affects earnings management, this explains that firms that have large profits and meet targets have very little chance of profit manipulation. The results of this study are consistent with research conducted by Alzoubi (2016) and Abbadi et al., (2016). From the results of the study, it was seen that company ownership (institutional ownership and managerial ownership) variables and company conditions (board size, firm size and sales growth) did not have a significant impact. As a result, it can be said that companies having high asset returns are less likely to manipulate their income. According to (Kothari et al., 2005; Machuga and Teitel, 2007) managers intend to increase profits obtained in other words manipulating income upwards makes the company more attractive.

Tabel 3: t- Test result.

Variabel	B	t	Sig.
(*Constant*)	,078	,822	,412
ROA	-,145	-2,736	,007
LEV	,014	1,191	,235
OCF	,065	1,526	,128
MANJ	-,006	-,133	,894
INST	,024	1,042	,298
BOD	-,001	-,717	,474
F_SIZE	-,001	-,279	,780
GROW	-,002	-,208	,835

5 CONCLUSIONS

Based on the results of the research can be concluded that profitability (ROA) affects earnings management. While the board size, managerial ownership, institutional ownership, firm size, leverage, operational cash flow, and sales growth have no effect on earnings management. A high rate of return on assets will affect earnings management. When the performance of the company is declining, then management increases profit on the other hand when the company is improving its performance then management is not motivated to do earnings management. This research has some limitations that is the object of research only use manufacturing companies so can not be generalized to the type of industry others and the research period is relatively short ie 2014-2016.

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