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Moderated Mediation Model of The Effect of Managerial Ownership on Financial Performance

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Abstract

This research examines the impact of managerial ownership on financial performance with earning management as an intervening variable and audit quality as a moderating variable. This study's population included all manufacturing enterprises in the basic industrial and chemical industries listed on the Indonesia Stock Exchange between 2016 and 2018. The sampling technique used in this study was purposive sampling, which yielded 60 observations from 20 companies. The results indicated that (1) Managerial ownership has a positive impact on financial performance, (2) Audit quality has a positive impact on financial performance,(3) The relationship between managerial ownership and financial performance is not mediated by earning management, (4) Audit quality moderates the impact of managerial ownership on financial performance.

Keywords: managerial ownership, financial performance, earning management, audit quality

JEL classification: G34; L25

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1. Introduction

Good Corporate Governance (GCG) is a structure implemented to regulate and control company operations with standards that regulate the behavior of owners, directors, and managers. GCG is intended to ensure the company's accountability to stakeholders. Corporate governance practices will increase investor confidence, reduce the cost of capital, and create sustainable company performance (International Finance Corporation, 2014). Applying a good corporate governance mechanism in the company's operational activities can positively signal investors and the public that management and company have done their job properly and well so that its performance can increase.

There has been a lot of research done on the impact of corporate governance on firm performance. Many studies found that governance has a positive effect on company performance (Tam & Tan, 2007; Munisi & Randøy, 2013; Vo & Nguyen, 2014; Akdogan & Boyacioglu, 2014; Wahyudin & Solikhah, 2017; Mahrani & Soewarno, 2018; Danoshana & Ravivathani, 2019; Muhammad & Damayanti, 2020; Hermuningsih et al., 2020). Further different results were found by Muhammad & Damayanti (2020), Khatib & Nour (2021), Wu (2021) that corporate governance has a negative effect on company performance. In contrast, other researchers found that corporate governance had no impact on company performance (Grove et al., 2011; Brenes et al., 2011; Castaner and Kavadis, 2013; Shank, Hill, and Stand, 2013; Murhadi, 2021).

Corporate governance represented by managerial ownership influences the company's financial performance. A manager who owns a considerable number of shares will be more driven to maximize performance since he will benefit from his actions. According to Vafeas and Theodorou (1998), when managers hold a large percentage of shares, they will be keen to maximize their performance. Conflicting results have been found in studies on the relationship between managerial ownership and corporate success. According to previous research, boosting managerial ownership in the firm is critical in reducing agency problems and encouraging managers to improve firm performance (Balatbat et al., 2004; li et al.,2007; Alabdullah, 2018; Al Farooque et al., 2019). On the other hand, other studies, such as Acharya and Bisin's, have found a negative association between managerial ownership mechanisms and business performance (2009). Previous research (Aluchna & Kaminski, 2017; Ghazali, 2020) has found no link between managerial ownership and company performance.

The researcher decided to employ another variable to moderate the association between managerial ownership and financial performance due to the inconsistency of prior research findings. The authors seek to review the influence of managerial ownership on financial success by including earnings management as a mediation variable. Earnings management can be caused by an information asymmetry between management (agent) and the owner (principal) (Harahap, 2018; Priyastiwi et al., 2020; Widagdo et al., 2021; Bachmid et al., 2021; Surbakti & Sudaryati, 2021) . The manager delivers the owner a signal about the company's state but does not convey information based on the actual situation. In these cases, a control mechanism is required to align the opposing objectives of both parties. One of the mechanisms that can be used is the managerial ownership mechanism.

In addition to examining earnings management mediation variables, this study also includes audit quality as moderating variable. An audit is one of the essential aspects of governance mechanisms, with the primary goal of improving the quality and effectiveness of financial management and internal audit systems. Audit plays a role in reducing information asymmetry and conflicts of interest between shareholders and managers (Arens et al., 2010). One of the control mechanisms that can help to reduce agency conflict is auditing (Zhou et al., 2018; Ali et al., 2020). The higher the quality of the audit, the better the company's performance. Independent auditors can reduce debt financing costs (Hou et al., 2019). High audit quality will produce appropriate recommendations for the company in achieving its objectives (Sayyar et al., 2015). The impact of managerial ownership on financial performance is investigated in this study, with earning management as an intervening variable and audit quality as a moderating variable.

The motivation of this study is twofold. First, this study analyzes the mediating effect of earning management on the relationship between managerial ownership and financial performance. Second, examine the influence of managerial ownership on financial performance with audit quality as a moderating variable.

2. Literature Review

2.1 Agency theory

According to agency theory, the company's internal relationships constitute a contract between the owner (principal) and the agent to conduct business in the principle's best interests. Agents (management) may act against the interests of the owner of the company. A conflict of interest occurs when management has an interest in obtaining rewards while the owner of the company has an interest in maximizing the welfare and profits of the company. Managerial ownership can reduce conflicts or agency problems between shareholders and company management. It is said that the greater the management's ownership of the firm, the fewer the stakeholder conflicts, and the lower the agency problem and cost associated with it (Friend and Lang, 1986; Jensen and Meckling, 1976). Because insiders have a motive to safeguard shareholders' interests, they require less oversight from the board, which is a costly monitoring option (Vafeas, 1999). It's also claimed that when the incentive alignment improves, more agent ownership lessens the requirement for monitoring.

2.2 The effect of managerial ownership on financial performance

Prior research has focused chiefly on the financial performance effects of various corporate governance mechanisms. The governance framework of a company can reduce information asymmetry and agency costs (Florackis, 2008; Tahir et al., 2019; Huu Nguyen et al., 2020). The corporate governance structure is formed by 2 (two) governance mechanisms, namely: 1) internal governance mechanisms (i.e., board of commissioner, audit committee) and 2) external governance mechanisms (i.e., various policies and regulations). Both mechanisms are expected to offer corporations monitoring services. Evidence suggests that certain governance mechanisms outperform other governance mechanisms in the system (Holm and Schler, 2010), meaning that adherence to the corporate governance code is a must for enhancing financial performance.

Separation of ownership and control has long been identified as a source of disagreement between shareholders and management. Prior research has demonstrated that the ownership structure, such as managerial ownership, is one of the essential components in corporate governance processes. Previous research has shown that managerial ownership of a company is a critical component in reducing agency disputes and improving company performance (Alfadhl & Alabdullah, 2013; Rashid, 2016; Jusoh, 2016; Serly & Zulvia, 2019). The financial performance of a corporation is influenced by corporate governance, which is represented through managerial ownership. Management who buys shares of the company will become the owner of the company. Managers will act as owners and controllers of the company, which makes them work harder to manage the company. Their efforts resulted in increased company performance. Furthermore, Li et al. (2007), Jusoh & Ahmad (2013), Alabdullah (2018), Al

Farooque et al. (2019) all agree that increased managerial ownership improves business performance.

H1: Managerial ownership influences the company’s financial performance.

2.3 The effect of audit quality on financial performance

An auditor plays a crucial role in managing and controlling accounting and financial activities, ensuring that financial statements are transparent and of high quality. An auditor's tasks include detecting errors and frauds, detecting deceptive data, and presenting them honestly for transparency. Auditing is a component of governance that is important in both the private and public sectors. In both areas, a professional and independent auditor can promote transparency. Audit quality is a critical component of a healthy equity market. An audit can boost the value of financial statements and directly support corporate governance actions through transparent financial reporting. In previous research, audit quality has been shown to improve a company's performance (Elewa & El-Haddad, 2019; Sayyar et al., 2015; Sattar et al., 2020).

H2: Audit quality has an impact on a company's financial performance..

2.4 Earnings management mediates the effect of managerial ownership on performance.

According to research, corporate governance has a negative impact on earnings management. (Kamran and Shah, 2014; Mahrani & Soewarno, 2018; Wahyuningsih & Rasmini, 2020). Managerial ownership can minimize differences in interests between company owners and managers. Managerial ownership will make managers feel they own the company, so managers will avoid actions that can harm the company, including reducing managers' motivation to practice earnings management.Furthermore, The rate of profit earned is closely tied to earnings management. When determining an entity's success rate, profit is frequently used as a benchmark. As a result, management is incentivized to manage earnings. The information presented by management to the owner cannot be guaranteed to reflect the company's true financial statement. Earnings management actions have the potential to decrease the quality of profit information provided in financial statements. The poor quality of information presented in the financial statements will harm the organization's financial performance.

H3: Earnings management mediate the effect of managerial ownership on financial performance

2.5 Audit quality moderates the relationship between the influence of managerial ownership on performance

The competence of the audit committee to oversee the financial reporting process and ensure truthful and fair financial reporting is defined by its audit committee skills (Abdulrahman, 2020). According to Amin et al. (2018), an audit committee meets at least four times a year and includes one person with financial competence linked to earnings quality. McMullen (1996) also states that the existence of an audit committee results in reduced errors, irregularities, and other indicators of unreliable financial reporting. The effectiveness of supervisory functions by external auditors requires high independence. Managers perceive independent auditors as more vigilant to agency concerns, according to agency theory, because an auditor is expected to provide reasonable confidence that financial statements are free of significant misstatements, and so protect stockholders' interests. Auditors of higher caliber are less likely to accept dubious accounting procedures and are more likely to report errors and irregularities uncovered during the audit.

It is hypothesized that audit quality moderates the relationship between managerial ownership and financial performance. Under high perceived audit quality, increased managerial ownership likely to increase financial performance. In other words, higher audit quality and coupled with higher managerial ownership will improve financial performance. Improved audit quality reduces knowledge asymmetry and conflicts of interest between shareholders and managers (Arens et al., 2010). As a result, auditing is viewed as a monitoring method that aids in improving financial performance. The statements lead to the following hypothesis:

H4: Audit quality moderates the effect of managerial ownership on financial performance

Based on the introduction, literature review, and theoretical basis, which have been explained previously, the research model can be described as follows.

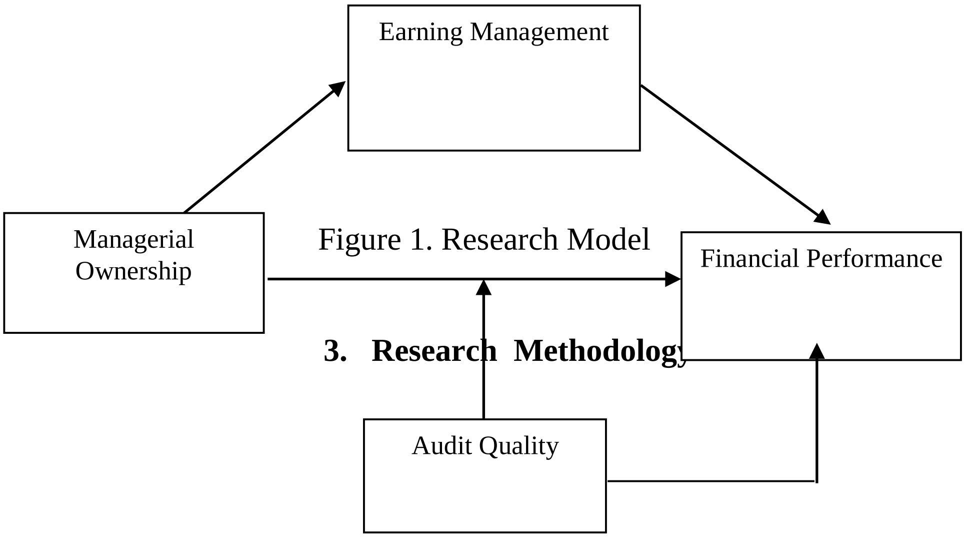

Figure 1. Research Model

3. Research Methodology

This research aim is to examine the causal relationship between variables studied through hypothesis testing. Causality research aims to explore the effect of one variable on other variables. The purpose of this research is to look into the impact of corporate governance on financial performance, with earning management as an intervening variable and audit quality as moderating variable. The data used in this study is secondary data obtained through available sources. The population of this study included all manufacturing enterprises in the basic industrial and chemical industries listed on the Indonesia Stock Exchange between 2016 and 2018. The basic and chemical industrial sector companies were chosen as research objects because these sectors have an important role in the Indonesian economy. In the 2016 - 2018 period, the sector had high growth and was recorded as the sector with the second highest growth after the financial sector. The technique for sampling in this study used a purposive sampling method and obtained 60 observations from 20 companies. SEM (Structural Equation Modeling) is used in this work to analyze data using a variance-based approach (VB-SEM) and PLS-SEM (Partial Least Square Path Modeling) approaches. PLS (Partial Least Square) has various advantages, including modeling multiple dependents and independents, handling multicollinearity between independents, and making more accurate predictions. SEM (Structural Equation Modeling) is used in this work to analyze data using a variance-based approach (VB-SEM) and PLS-SEM (Partial Least Square Path Modeling) approaches. PLS (Partial Least Square) has various advantages, including modeling multiple dependents and independents, handling multicollinearity between independents, and making more accurate predictions.

Managerial ownership refers to a company's management owning shares. The proportion of share ownership owned by the management of the total outstanding share capital is used to calculate managerial ownership. The ability of a corporation to create profit from operations through various business activities is referred to as financial performance. Return on assets (ROA) is a typical metric for assessing a company's financial performance and profitability (Belu and Manescu, 2013). ROA represents a better measure of the ability of the firm to generate returns on its portfolio of assets (San & Heng, 2013; Olalekan & Adeyinka, 2013). Earnings management is the manager's choice to use certain accounting policies to achieve personal goals. The measurement used to measure earnings management variables in this study calculates discretionary accruals using the Modified Jones Model (Dechow et al., 1995). A dummy variable was used to assess auditor quality in this study. If a company utilizes a big four public accounting firm to audit financial statements, the value is 1, but if it hires a non-big four accounting firm, the value is 0.

4. Findings and Discussion

4.1 Research Findings

Table 1 below is used to test the hypothesis of this study.

Table 1. Path Coefficient

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (O/STDEV)	P Values
AQ → FP	0.563	0.574	0.165	3.418	0.001
EM → FP	0.010	0.006	0.034	0.280	0.779
MO → EM	-0.150	-0.150	0.090	1.667	0.096
MO → FP	2.066	2.096	0.241	8.572	0.000
(MO*AQ) → FP	1.185	1.210	0.218	5.426	0.000

Hypotheses Testing

The effect of managerial ownership on financial performance

Table 1 shows that managerial ownership has a significant impact on financial performance with p-value < 0.05 (0.000 < 0.05) with T statistics of 8.572. As a result of these findings, managerial ownership appears to have a significant and positive effect on financial performance. Thus H1 is accepted.

The effect of audit quality on financial performance

Table 1 shows that audit quality has a significant effect on financial performance with p-value < 0.05 (0.001 < 0.05) with T statistics of 3.418. So these results indicate that audit quality has a significant and positive effect on financial performance. Thus H2 is accepted.

Earnings management mediates the effect of managerial ownership on performance.

According to Hypothesis 4, firms with higher managerial ownership will have better earnings management and, as a result, a higher level of performance.. Table 1 shows that the p-value of the effect of managerial ownership on earnings management is 0.096 > 0.05. Furthermore, Table 1 also shows that the effect of earnings management on performance is not significant (p-value = 0.779 > 0.05). Thus, because the two paths are not significant, managerial ownership does not appear to mediate the effect of managerial ownership on performance. Thus hypothesis 3 is not supported.

Audit quality moderates the relationship between the influence of managerial ownership on financial performance

The result suggests audit quality strongly strengthens the effect of managerial ownership on performance (p-value 0.000 < 0.05). The results denote that the higher audit quality, the stronger the impact of managerial ownership on performance. Thus, H4 is accepted.

4.2 Discussion

4.2.1 The effect of managerial ownership on financial performance

Managerial ownership shows that the manager owns shares of the company or the manager is a shareholder of the company. The finding is indicated by the percentage of share ownership by the management. The higher the managerial ownership, the more productive actions of managers in maximizing firm performance. Managerial ownership can assist shareholders and management align their interests. The greater the proportion of managerial share ownership, the bigger the company's performance. Managers who are also stockholders in a company will match their managerial interests with their shareholder interests. Meanwhile, managers who are not shareholders in a corporation may only be concerned with their interests.

Jensen and Meckling (1976) claim that expanding managerial ownership in a corporation can help to lessen the conflict of interest between agent and principle. Managers who are also shareholders will increase their wealth as individual shareholders by enhancing the company's value. According to Katper et al. (2018), boosting managerial ownership is vital for promoting enhanced organizational performance. According to previous research, increasing managerial ownership in the firm is a critical factor in reducing agency problems and encouraging managers to improve firm performance (Balatbat et al., 2004; li et al.,2007; Alabdullah, 2018; Al Farooque et al.,2019)

4.2.2 The effect of audit quality on financial performance

The findings of this study suggest that a higher level of audit quality leads to an improvement in firm financial performance. Financial reports must be audited by an independent and qualified auditor. Auditors must conduct themselves professionally and base their work on appropriate standards or regulations, as well as the public accountants' code of ethics. The information presented in financial reports is used by stakeholders in making economic, political, and social decisions. Therefore, companies need to use the services of auditors who provide adequate audit quality in auditing financial statements (Darwin, 2012).

Financial reports audited by a qualified auditor will help reduce information asymmetry and protect stakeholders by providing reasonable assurance that management's financial reports are free from material misstatement (Hassan & Farouk, 2014). The audit results from a reliable external auditor will be used by investors to form the basis for decisions on the allocation of company resources. When investors have confidence and trust in financial reports that external auditors have audited, they are interested in providing more funds to the company, which will increase financial performance. Elewa & El-Haddad (2019) investigated non-financial firms, and their findings show that audit quality positively affects financial performance.

4.2.3 Earnings management mediates the effect of managerial ownership on financial performance.

Share ownership by management in a company has not been proven to minimize earnings management practices. The average percentage of managerial ownership in this study is only 7,868%. This percentage of managerial ownership is relatively small compared to the total outstanding shares of the company, so it does not play a role in decision-making. These results are consistent with research conducted by Pambudi et al. (2020), Nguyen et al. (2020), and Wahyuni & Hamidi (2020) that managerial ownership did not affect earnings management.

4.2.4 Audit quality moderates the influence of managerial ownership on financial performance.

Audit quality services will increase the confidence of users of financial statements that financial statements are qualified financial reports, so they can be used as a basis for making economic decisions. There will be good information disclosure with a quality audit, making it easy for principals to oversee their agents. Financial statements are the source of information used to make choices by managers who rely on fundamental information. The company's published financial statements have gone through an auditing process. From these financial statements, the owner can assess the company's financial performance. The higher managerial ownership and supported by good audit quality will certainly encourage an increase in company performance.

5. Conclusion

Based on the description of the research results and discussion, the conclusions from this study can be drawn as follows. First, managerial ownership has a significant positive effect on financial performance. The finding indicates that the higher managerial ownership, the better the financial performance. The study supports the results of the past empirical studies that managerial ownership affects financial performance (Balatbat et al., 2004; Li et al.,2007; Alabdullah, 2018; Al Farooque et al.,2019). Second, the effect of audit quality on financial performance is positive and significant. The finding indicates that the higher the audit quality, the better the financial performance. The study supports the results of the prior empirical studies that audit quality affects financial performance (Elewa & El-Haddad, 2019; Sayyar et al., 2015; Sattar et al., 2020). Third, earning management does not mediate the relationship between managerial ownership and financial performance. Fourth, the impact of managerial ownership on financial performance is moderated by audit quality. The findings suggest that the influence of managerial ownership on financial performance is strengthened by audit quality.

This research has two limitations. Firstly, only one variables associated with corporate governance were selected in the current research, which may restrict the generalizability of the results. Other governance such as board independence, board size, audit committee, also influence firm performance. Future research can overcome this limitation by including other governance mechanistms in the existing model. Secondly, this study investigates basic industrial and chemical industries for the period 2016 - 2018. As a result, the results may not be applicable to different types of companies or years. Future research might cover all types of publicly traded corporations and conduct a longitudinal study to obtain a more complete picture of the relationship between managerial ownership, earnings management, audit quality, and corporate performance.

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