The Role of Profitability as A Mediator between Good Corporate Governance and Firm Value

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ABSTRACT
This research aims at evaluating and analysis the effect of good corporate governance on firm value mediated by profitability. Good corporate governance is a proxy Management ownership, institutional ownership and independent commissioner. Profitability is measured using Return on Equity and firm value is proxy for price book value. This research was conducted manufacturing companies listed on the Indonesian Stock Exchange for the period 2012-2017. There were 121 listed companies involved in this study. They were chosen based on several criteria resulted in 24 companies selected as the sample. The research unit of analysis is a panel data of 168 observations. Using path analysis, this study found that The effect of managerial ownership and institutional ownership on firm value is not significant, while the impact of the independent commissioner on firm value is significant. Furthermore, the three proxies of good corporate governance significantly influence profitability. In addition, profitability mediates the effect of independent commissioner on firm value, but it does not mediate the effect of managerial ownership and institutional ownership on firm value.

Keywords—good corporate governance, profitability, firm value

1. INTRODUCTION

The wellbeing of companies' stockholders is the objective and the reflection of the firms’ value [1]. A high firm value leads to better stockholder welfare and improves the trust of stockholders and stakeholders. This certainly a determinant of the company’s future prospects. Therefore, the management must make decisions regarding investments to improve the value of their company [2].

Decisions made by the management as the agent may cause conflicts with company owners/stakeholders as the principal. Such conflict is known as agency conflict, a conflict that affect firm value [3]. The management, as the agent who runs the company’s operation, sometimes acts or takes decision based on his personal interests or needs without taking company owners’, in this case stockholders’, interest into account. Meanwhile, stockholders or company owners as principals demand maximum return form their investments without thinking about the interest of management in running the company’s business.

Such conflict can be overcome through good corporate governance (GCG) application. The well managed application improves company’s profitability [4], [5] and [6]. Nevertheless, the study of [7] postulated that good corporate governance does not influence company’s profitability. GCG theoretically improves company performance, as well as firm value, as stated by [8], [9], [10], and [11]. This finding is not in line with [12] and [13] affirming that the influence of GCG on firm value is not significant.

Firm value can also be improved by better profitability, which is one of the indicators of firm value. Higher profitability reflects a company’s firm value. Several studies also found that profitability positively and significantly influences firm value, which means that The higher the profitability of the company, the higher the value of the company [14], [15].

Based on the description above, the objective of this research concerns with the effort in evaluating and analyzing the effect of GCG on firm value mediated by profitability.

2. LITERATURE REVIEW

Conflicts between principals and agents in companies frequently happen due to different interest between the two regarding decisions (to be) made [3]. Therefore, companies require a certain mechanism to maintain their image in front of investors, i.e. good corporate governance. GCG is a control mechanism aimed at managing and arranging company’s activities to enhance prosperity and accountability [16].

In this research GCG is the proxy of independent commissioner (IC), managerial ownership (MO), and institutional ownership (IO) while profitability is proxy of return on equity (ROE), and firm value is the proxy of price book value (PBV).

2.1 Independent commissioner – firm value

To attain good firm value, independent commissioner is totally needed in managing the company. Its presence is expected to overcome conflicts of interest between the main officer and the agent. The research of [17] found that
corporate governance that includes board size significantly influences firm value. This finding is different from the previous finding stating that the independent commissioner’s influence on firm value is negative. Therefore, the first hypothesis of this research is stated as follows.

H1: Independent commissioner significantly influences firm value

### 2.2 Managerial ownership – firm value

The study of [18] showed that management ownership influences firm value statistically, contrasting with the study of [19] that the effect of management ownership on firm value is significantly negative. Consequently, this study’s second hypothesis is as follows.

H2: Managerial ownership significantly influences firm value.

### 2.3 Institutional ownership – firm value

A research on the influence of institutional ownership on firm value was performed by [20], resulting in institutional ownership positively impacting firm value. This is similar to the study [21] that firm interest is significantly influenced by institutional ownership. Thus, this study’s third hypothesis is as follows.

H3: Institutional ownership significantly influences firm value.

### 2.4 Independent commissioner – firm value

The presence of independent commissioners in a company can influence decisions to be made by managers, increasing company’s profitability. One of the conditions of becoming an independent commissioner is having neither family nor business relationship with board of directors and stockholders.

This is relevant with the studies of [22] and [23] that independent commissioners positively and significantly influence company’s profitability, implying that the greater the number of independent commissioners in a firm, the greater the profitability of the company. This finding differs from the finding of [24] which shows a negative and significant effect on the profitability of the company, indicating that the more independent commissioners there are, the lower the profitability of the company.

In contrast to previously mentioned findings, [25] found that the relationship between independent commissioners and profitability is not relevant. Therefore, they proposed the following hypotheses.

H4: Independent commissioner significantly influences profitability.

H5: Profitability mediates the significant influence of independent commissioner on profitability.

### 2.5 Managerial ownership – profitability

Managerial ownership enhances employee’s motivation and performance since their manager considers the interest and the welfare of employees and company owners in their actions and decisions [3]. Managerial ownership in several researches has different effect. The studies of [26] and [29] concluded that managerial ownership positively and significantly influences profitability, as postulated by agency cost theory.

However, the study of [30] resulted in a different finding, in which managerial ownership negatively affects company’s profitability because the manager sometimes manipulates figures in the company’s financial report, which reduces profitability. On the contrary, [28] it was found that Management ownership has not affected the profitability of the company. Thus, the following hypothesis were formulated.

H6: Managerial ownership significantly influences firm value

H7: Profitability mediates the effect of management ownership on firm value

### 2.6 Institutional ownership – profitability – firm value

Institutional ownership is defined as stock ownership by special institution on behalf of certain investors to reduce transaction cost through professional management [31], [32] and [33]. This is supported by the studies of [31], [32] The IO has a substantially positive effect on ROE, which means that higher institutional ownership increases return on equity. Institutional ownership is the control of certain portion of shares by institutions outside the company. It drives the company to a better condition due to the presence of parties with certain professional, experiential, and educational backgrounds.

The explanation above implies that good institutional ownership improves profitability and eventually increases firm value. Therefore, the following hypotheses were formulated.

H8: Institutional ownership significantly influences firm value

H9: Profitability mediates the influence of institutional ownership on firm value

### 2.7 Profitability – firm value

One of the factors considered by investors in their investment decisions is a company’s ability to generate profits (profitability) because it deals with stock price and dividend for them. In this case, one of the standards frequently used in determining alternative funding for the company is profitability. The study of [15] showed that profitability positively and significantly influences firm value. Thus, the following hypothesis was formulated.

H10: Profitability significantly influences firm value
Generally, the model of this research is depicted in the following Fig. 1.

![Fig. 1. Relationship between variables](image)

3. RESEARCH METHOD

This research is categorized into explanatory research, which aims at obtaining explanation regarding the causal relationship between its variables. The population of this study is manufacturers listed on the Indonesian stock exchange during the period 2012-2017. Using purposive sampling 24 companies were selected as the sample for a six-year research period resulting in 168 observations. The data of this study was analyzed using path analysis.

4. RESULT AND DISCUSSION

Table 1 shows the results of the hypothesis testing that IC substantially affects PBV with the p-value of 0.000, which is lower than the α=0.05. IC has a direct effect on PBV of 0.372 (37.2% per cent). This means that 1% increase on IC will create a 37.2% increase on PBV. Hence, H1, which states that independent commissioner significantly influences firm value is accepted. This result suggests that as shown by the value of PBV, the higher the number of independent commissioners in a manufacturing company, the greater the firm value. That finding supports [17]'s claim. The influence of IC on PBV in Table 1 shows the significance value of 0.000, this means that IC significantly influences ROE. The direct effect of IO on ROE is 0.533, which means that 1% increase in IC will create a 543.3% increase on ROE. This is relevant with the findings of [22] and [23]. Therefore, H4 of this study is accepted.

Therefore, according to Table 1, the impact of MO on PBV is negligible, since the p-value of 0.807 is greater than that of α=0.05, while its indirect effect is 0.008, which means that 1% increase on MO will create a 0.8% increase on PBV. This means that H2, which states that MO significantly influences firm value, is rejected. This result explains the MO of manufacturing companies during the research period does not improve firm value. This finding contradicts the research of [18] and [19]. Unlike the effect of MO on profitability, Table 1 shows that with a p-value of 0.002, the effect of MO on ROE is significant. Effect of MO on ROE is 0.312 (31.2%), meaning that one percent increase on MO will create a 31.2% increase on ROE. This finding confirms the studies of [26] and [28], so H6 is accepted.

Table 1. The Hypothesis Testing of the Direct Influence

| Independent Variable | Dependent Variable | Path Coef. | t-stat | p-value |
|-----------------------|--------------------|------------|--------|---------|
| IC                    | PBV                | 0.372      | 2.44   | 0.000   |
| IC                    | ROE                | 0.807      | 7.25   | 0.000   |
| MO                    | PBV                | 0.008      | 0.32   | 0.725   |
| MO                    | ROE                | 0.312      | 2.26   | 0.002   |
| IO                    | PBV                | 0.021      | 1.58   | 0.725   |
| IO                    | ROE                | 0.038      | 1.32   | 0.000   |
| ROE                   | PBV                | 0.326      | 3.65   | 0.002   |

Significant at α=5%

Table 1 above shows that the impact of IO on PBV is insignificant, suggested by the p-value of 0.725, greater than that of α=0.05. The coefficient of the direct effect is 0.021, implying that 1% increase on IO will create 2.1% increase on PBV. Therefore, H3, which states that IO significantly influences PBV, is rejected. This result indicates that, during the research period, the number of institutional ownerships does not influence firm value, so investors do not consider much about the institutional ownership of the manufacturing companies being studied. This also indicates that there are other factors besides IO that need to be considered by investors before making investments in such companies, which increase firm value. This finding contradicts the findings of [20] and [21] that IO significantly influences firm value.

Unlike the insignificant effect of IO on PBV, Table 1 shows that the impact of IO on ROE is significant at 0.000. This explains that IO significantly influences ROE at 0.038 (3.8%). This means that 1% increase on IO will create a 3.8% increase on ROE. This result confirms the studies of [32] and [33], so H8 is accepted. The effect of ROE on PBV, as shown in Table 1, is significant with a p-value of 0.002, which is lower than 5-007=0.05. This means that ROE significantly influences PBV at 0.326, indicating that 1% increase on ROE will create a 32.6% increase on PBV, confirming the study of [15]. Therefore, H9 is accepted.

The indirect effect of IC, MO, and IO on PBV through ROE can be determined by referring to the following table 2.
Table 2. The Hypothesis Testing of the Indirect Influence

| Independent Variable | Intermediating Variable | Dependent Variable | Original Sample (O) | t-stat | p-value |
|----------------------|-------------------------|--------------------|---------------------|--------|---------|
| IC                   | ROE                     | PBV                | 0.257               | 2.428  | 0.001   |
| MO                   | ROE                     | PBV                | 0.044               | 1.124  | 0.203   |
| IO                   | ROE                     | PBV                | 0.025               | 1.261  | 0.152   |

Significant at \( \alpha=5\% \)

The table above describes the indirect effect of the three variables of GCG (i.e. IC, MO, and IO) on PBV through ROE, where ROE only mediates the effect of IC on PBV, while the effects of MO and IO are not mediated by ROE. ROE mediation can be calculated using the \([34]\) approach, where the VAF of more than 80% indicates complete mediation, the VAF of between 20-80% indicates partial mediation, and the VAF of less than 20% indicates no mediation. The assessment on the nature of the mediation is explained in the following Table III.

Table 3. Mediation Assessment

| Ind. Var | Inter. Var | Dep Var | Direct | Indirect | Total | VAF |
|----------|------------|---------|--------|----------|-------|-----|
| IC       | ROE        | PBV     | 0.372  | 0.257    | 0.629 | 0.408 |

Source: processed data (2019)

The table above shows that the VAF of the influence of IC on PBV through ROE is 0.408 (40.8%). Since the VAF is between 20-80%, it can be concluded that ROE partially mediates the influence of IC on PBV.

Based on the above results, the test hypotheses can be summarized as follows.

- Hypothesis 1 stating that The IC has a significant influence on the value of the firm is accepted.
- Hypothesis 2 stating that management involvement has a significant effect on the valuation of the company is rejected.
- Hypothesis 3 stating that IO has a major impact on the valuation of the firm is rejected.
- Hypothesis 4 stating that IC significantly affects profitability is accepted.
- Hypothesis 5 stating that Profitability mediates the effect of the IC on the value of the firm is accepted.
- Hypothesis 6 stating that MO influences ROE is accepted.
- Hypothesis 7 stating that ROE mediates the effect of MO on firm value is rejected.
- Hypothesis 8 stating that IC affects productivity is accepted.
- Hypothesis 9 stating that ROE mediates the impact of IO on firm value is rejected.
- Hypothesis 10 stating that ROE significantly affects firm value is accepted

5. CONCLUSION

In general, this work has fulfilled its objective of evaluating and examining the effect of GCG on the valuation of the business mediated by profitability. The analysis of the three metrics used to characterize GCG indicates that there is only one effect of the independent commissioner on the firm interest mediated by profitability, and mediation is partial.

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