

Audit Quality And Earnings Management: Informative And Opportunist Perspective

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Abstract: This study is aimed to examine the effect of audit quality on earnings management in informative and opportunist perspective. Samples are 615 firm-year of manufacture companies listed in Indonesian Stock Exchange 2013-2017. Audit quality is measured by big 4 affiliation. Earnings management is measured by discretionary accruals. Analysis method uses logistics regression. Result shows that high audit quality increases informative earnings management and reduces opportunist earnings management. This result consistent to auditor's role to mitigates asymmetric information between managers and shareholders.

Index Terms: Audit Quality, Big 4 Auditor, Discretionary Accruals, Earnings Management, Indonesian Stock Exchange, Informative, Opportunist

1. INTRODUCTION

EARNINGS information is one measurement of firm performance. Therefore, it becomes key target to be managed by manager. It is called earnings management. Earnings management rises from agency conflict between manager and shareholders because of information asymmetric. Earnings management leads to high needs of auditor. Auditor is needed to give assurance service that financial information can be reliable for decision making. High quality audit result makes decision makers sure on their decision. Auditor comes as mediator in the middle conflict between manager and shareholders because auditor reduces information asymmetric. As a result, auditor becomes key role to mitigate earnings management [1]. Previous studies provide conflict of results of the effect of audit quality on earnings management. In one hand, Ahmad et al. [2], Kanagaretnam et al. [3], Memiş and Çetenak [4], Yaşar [5], Christiani and Nugrahanti [6], and Pujilestari and Herusetya [7] find that high audit quality can reduce earnings management. In the other hand, Rahmawati et al. [8] find that audit quality increases earnings management while Reni and Nugroho [9] find no effect of audit quality on earnings management. Inconsistencies of previous results allow more unclearness of relationship between audit quality and earnings management. Inconsistent results of previous researches because it do not split earnings management up in to informative and opportunist context. Scott [10] states that earnings management can be seen as opportunist one or efficient contract (informative). In informative context, earnings management helps to increase earnings power to reflect economic value and predict future performance [11]. Stock market has positive responses on earnings management [11], [12]; because it can be used as signaling [13] and evaluate management performance better [14]. In opportunist context, earnings management is used to covers bad condition [15].

Context of negative relationship between audit quality and earnings management assumes that manager engaged in opportunist earnings management. Accordingly, high audit

quality increases informative earnings management. Mascarenhas et al. [16] states that auditor increase informative earning management, as Subramanyam [11] findings, informative earning management positively responded by investor, so auditor has interest on it. This study is aimed to examine whether high auditor quality increases informative earnings management and reduces opportunist one.

2 LITERATURE REVIEW

2.1 Earnings Management

Earnings management is alternatives used to manipulate reported earnings to fulfill certain purposes. There are two ways to understand earnings management. First, earnings management as management opportunist behavior in maximizes their utilities in terms of face contract of compensation, debt, and political cost [10]. Second, earnings management as efficient contract perspective, which is earnings management gives management a flexibility to protect themselves and company in terms of anticipates unexpected events for benefits of related parties [10]. In terms of opportunist behavior, earnings management tends to cover bad condition of company and have bad effect in the future. Opportunist earnings management is done in order to boost up share price [17] or to cover bankruptcy up. Opportunist earnings management reduces the credibility of information [18], destroys economic value [19], loose investment opportunity [20] and future growth. In terms of information signaling, earnings management increases earnings informativeness and predictability [13]. Subramanyam [11] finds that managerial accrual discretion improves the ability of earnings to reflect economic value as well as help predict future cash flows, earnings, and dividends. Lipe [21] shows that earnings management is technique that reduces earnings variability to reduce uncertainty and increases predictability of future earnings. In this case, managers will use earnings management to communicate some private information to the public. Siregar and Utama [12] as well as Rezaei and Roshani [22] find evidences that accrual earnings management as efficient purpose.

2.2 Role of Auditor

Generally, auditor has important role to mitigate interest conflict between managers and principal. Auditor ensures financial statement is reported fairly, regarding to accounting standard [23]. Case of Enron shows that auditor role has

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critical position in financial statement manipulation behavior. For some reasons, auditor office size captures the quality of audit. It is related to big N office affiliation. Big N auditors remain independent because they have the biggest client globally. In order to maintain their reputation, big N auditors are not afraid to lose client and can keep their economics dependent away from the client [24]. Based on deep pocket theory, big N auditors have more revenue, thus, have more resources to maintain and improve their quality, such as by providing intense training to increase their staffs' competence [25]. Based on the explanation, this study uses big N affiliation as picture of audit quality.

2.3 Audit Quality and Earnings Management

Previous studies show that high audit quality reduces opportunist earnings management. In 29 countries, Kanagaretnam et al. [3] find that high auditor reputation reduces earnings management. In Turkey, Memiş and Çetenak[4] and Yasar[5] find that big 4 auditor is able to detect earnings management. In USA, Krishnan [26] also find high auditor quality reduces earnings management. In Indonesia, high quality auditor decreases earnings management [6], [7]. In the other hand, high audit quality also improves earnings management, in context of signaling perspective. Mascarenhas et al. [16] state that auditor has motivation to increase informative earnings management, because as Subramanyam[11] findings, informative earnings management is responded well by investor and auditor has interest in it to improve reputation and market share. Rahmawati et al. [8] find that audit quality increases earnings management. For example, bad debt reserves, in one side can be a tool for opportunist behavior to estimate low bad debt reserves estimation for cover bad performance and for bonus scheme, while in other side can be a tool for communication of private information that manager has customer with "clean" profile and good receivable collection system and management. High quality auditor can detect it. High quality auditor will suggest bad debt reserves for communication of private information about good receivable collection system and management rather than for cover up bad performance. As Ching et al. [27], high quality auditor increases profitability by reducing monitoring cost, include reducing opportunist earnings management. Ha: High audit quality improves informative earnings management and reduces opportunist earnings management

3 METHODS

3.1. Sample

Research sample are manufacture firms listed in Indonesian Stock Exchange in 2013-2017. Ahmed and Azim[28], manufacture firms are more likely to engage in earnings management because of earnings and revenues uncertainties. Result of sample selection is as followed.

TABLE 1
SAMPLE

| Criteria | Firm | Firm-Year |
|---|------|-----------|
| Manufacture companies listed in Indonesian Stock Exchange 2013-2017 | 128 | 640 |
| Incomplete data | (2) | (10) |
| Change financial reporting period | (3) | (15) |
| Total | 123 | 615 |

3.2. Variables

Dependent variable is earnings management. This research uses discretionary accrual as proxy of earnings management because management commonly uses accounting policy and estimation to manage earnings [29] and auditor tends to detect accruals earnings management. Discretionary accrual measured by modified Jones model as followed [30].

$$\frac{TAC_t}{TA_{t-1}} = \beta_0 + \beta_1 \frac{1}{TA_{t-1}} + \beta_2 \frac{\Delta Sales_t}{TA_{t-1}} + \beta_3 \frac{PPE_t}{TA_{t-1}} \quad (1)$$

$$NDAC_t = \widehat{\beta}_0 + \widehat{\beta}_1 \frac{1}{TA_{t-1}} + \widehat{\beta}_2 \frac{\Delta Sales_t - \Delta Receivable_t}{TA_{t-1}} + \widehat{\beta}_3 \frac{PPE_t}{TA_{t-1}} \quad (2)$$

$$DAC_t = \frac{TAC_t}{TA_{t-1}} - NDAC_t \quad (3)$$

where,

$$TAC_t = \text{Net income after tax}_t - \text{Operation cash flow}_t \quad (4)$$

Where TAC_t is total accrual period t , TA_{t-1} is total assets period $t-1$, $\Delta Sales_t$ sales change period t , $\Delta Receivable_t$ is receivable change period t , PPE_t is gross fixed assets period t , $NDAC_t$ is non-discretionary accrual period t , DAC_t is discretionary accrual period t .

In order to determine informative and opportunist earnings management, discretionary accrual compared to earnings growth as followed (Lin et al. 2016).

TABLE 2

INFORMATIVE AND OPPORTUNIST EARNINGS MANAGEMENT

| | Discretionary Accruals (+) | Discretionary Accruals (-) |
|---------------------|----------------------------|----------------------------|
| Earnings Growth (+) | Informative | Opportunist |
| Earnings Growth (-) | Opportunist | Informative |

Source: Lin et al. [29]

If discretionary accrual is positive (income maximization) and earnings growth is positive; or discretionary accrual is negative (income minimization) and earnings growth is negative; then it is informative earnings management. For example, if decreasing of bad debt expenses (income maximization) followed by positive earnings growth; or increasing of bad debt expenses (income minimization) followed by negative earnings growth; then management gives signal about ability of receivable collection. If discretionary accrual is positive (income maximization) and earnings growth is negative; or discretionary accrual is negative (income minimization) and earnings growth is positive; then it is opportunist earnings management. For example, if decreasing of bad debt expenses (income maximization) followed by negative earnings growth, then management try to cover performance decreasing that motivated by compensation or debt contract. If increasing of bad debt expenses (income minimization) followed by positive earnings growth, then management try to cover performance increasing that motivated by compensation or debt contract political cost, tax expenses, or share buyback. This research measures earnings management as dummy variable. Score 1 if informative earnings management is occurred, score 0 if opportunist earnings management is occurred [29]. Independent variable is audit quality. Audit quality is measured by auditor affiliation. Score 1 if auditor is affiliated with big 4 auditor, score 0 otherwise [6], [7]. In order to control monitoring role of shareholders on the effect of audit quality on earnings management; this study use institutional, managerial, and foreign ownerships as control variables. In

order to control firms' characteristics on the effect of audit quality on earnings management this study use market to assets value, size, and debt to assets ratio as control variables.

3.3. Analysis Model

Hypothesis test is done by logistic regression test. This research runs tests of overall fit, goodness of fit, nagelkerke R square, and matrix classification before hypotheses test. Logistic regression model is as followed.

$$\text{Logistic (Y)} = \text{Ln} \frac{Y}{1-Y} = a + b_1X_1 + b_2X_2 + b_3X_3 + b_4X_4 + b_5X_5 + b_6X_6 + b_7X_7 + e(5)$$

Where, Y is earnings management, $\text{Ln} \frac{Y}{1-Y}$ is probability of informative and opportunist earnings management, X1 is audit quality, X2 is institutional ownership, X3 is managerial ownership, X4 is foreign ownership, X5 is market to assets value, X6 is firms' size, X7 is debt to assets ratio.

4 RESULT

4.1. Descriptive of Audit Quality and Earnings Management

TABLE 3
AUDITOR AND EARNINGS MANAGEMENT

| | Auditor | | Total |
|--------------|------------|------------|------------|
| | Non-big 4 | Big 4 | |
| Opportunist | 195 | 91 | 286 |
| Informative | 164 | 165 | 329 |
| Total | 359 | 256 | 615 |

Sig. of Chi Squared = 0.000

Source: proceed data

Table 3 shows that based on 615 samples, there are 286 sample engaged in opportunist earnings and 329 sample engaged in informative earnings management. Based on 615 samples, there are 359 samples audited by non-big 4 auditor and 256 samples audited by big 4 auditor. For 359 samples audited by non-big 4 auditor, firms that engaged in opportunist earnings management (195 samples) are pronounced more than informative one (164 sample). For 256 samples audited by big 4 auditor, firms that engaged in informative earnings management (91 samples) are pronounced more than opportunist one (165 sample). Significance value of chi squared is 0.000 (significant in 0.01), while indicates that there is significant difference of engagement of informative and opportunist earnings management between big 4 and non-big

4 auditors.

4.2. Preliminary Test

TABLE 4
PRELIMINARY TEST

| Test | Result | Notes |
|-----------------|---|--------------------------------------|
| Overall fit | -2LogL decrease 26.155* | Model fitted with data |
| Goodness of fit | Significance value of Hosmer and Lemeshow's Goodness of | Model is suitable with observed data |

| Fit Test is 0.711** | | |
|-----------------------|------------------------------------|--|
| Nagelkerke R Square | 0.056 | Explanatory power of model is 5.6% |
| Classification matrix | Overall Percentage Correct is 59.3 | Prediction accuracy of model is 59.3%. |

*Significant in 0.01

**Insignificant

Source: proceed data, 2019

Table 4 shows that model fitted with data since there is decreasing of 2LogL value 26.155 (significant in 0.01). Significance of Hosmer and Lemeshow's Goodness of Fit Test is 0.711 (insignificant) indicates that model is suitable with observed data. Nagelkerke R Square value is 0.056 shows that independent variables can explain dependent variable 5.6%, while 94,4% dependent variable explained by other variables. Classification matrix shows that model can predict probability of dependent variable about 59.3%.

4.3. Hypothesis Test

TABLE 5
HYPOTHESIS TEST

| | Coefficient | Notes |
|------------------------------|--|----------------|
| Audit Quality (X1) | 0.629* | Ha is accepted |
| Institutional Ownership (X2) | -0.428 | |
| Managerial Ownership (X3) | -1.519 | |
| Foreign Ownership (X4) | 0.155 | |
| Market to Assets Value (X5) | -0.018 | |
| Size (X6) | 0.170 | |
| Debt to Assets Ratio (X7) | -0.033 | |
| Dependent Variable | 1 = informative earnings management 0 = opportunist earnings management | |

*Significant in 0.01

Source: proceed data

Table 5 shows that audit quality has coefficient value 0.629 (significant in 0.01). It indicates that hypothesis is accepted. High audit quality improves informative earnings management and reduces opportunist earnings management. Previous studies show that high audit quality reduces opportunist earnings management. In 29 countries, Kanagaretnam et al. [3] find that high auditor reputation reduces earnings management. In Turkey, Memiş and Çetenak[4] and Yasar[5] find that big 4 auditor is able to detects earnings management. In USA, Krishnan [26] also find high auditor quality reduces earnings management. In Indonesia, high quality auditor decreases earnings management [6], [7]. In the other hand, high audit quality also improves earnings management, in context of signaling perspective. Mascarenhas et al. [16] state that auditor has motivation to increases informative earnings management, because as Subramanyam[11] findings, informative earnings management is responded well by investor and auditor has interest in it to improves reputation and market share. Rahmawati et al. [8] find that audit quality increases earnings management.

4.4. Alternative Test

Alternative test is used to ensure if the effect of audit quality on earnings management is consistent with other measurement. This study use alternative measurement of opportunist earnings management. Lo et al. [31] suggest that opportunist earnings management come from increasing earnings management (positive discretionary accruals) to beat earnings

benchmark. It is consistent with auditor conservatism that auditor only focus on earnings overstatement so increasing earnings management (positive discretionary accruals) will be captured as opportunist behavior. Benchmark to be beat defined as return on assets above zero but below 5 percent or as change between current return on assets and previous return on assets above zero but below 5 percent [14]. Opportunist earnings management measured by dummy variable, score 1 if positive discretionary accruals is occurred and return on assets is between zero until 5 percent, 0 otherwise. Result of alternative test is as follow:

TABLE 5

ALTERNATIVE TEST

| | Main Test | Alternative Test | Notes |
|-------------------------|--|--|------------|
| Audit Quality | 0.629* | -0.847* | Consistent |
| Institutional Ownership | -0.428 | 0.882 | |
| Managerial Ownership | -1.519 | 0.178 | |
| Foreign Ownership | 0.155 | -0.316 | |
| Market to Assets Value | -0.018 | 0.038 | |
| Size | 0.170 | -0.199 | |
| Debt to Assets Ratio | -0.033 | 0.057 | |
| Dependent Variable | 1 = informative earnings management 0 = opportunist earnings management | 1 = opportunist earnings management 0 = non-opportunist earnings management | |

*Significant in 0.01

Source: proceed data

Based on table 6, audit quality has coefficient value -0.847 (significant in 0.01). It shows that high audit quality reduces opportunist earnings management. It is consistent with main test result.

5 CONCLUSION

This study examines the effect on audit quality on earnings management. Based on analysis data, high audit quality increases informative earnings management and reduces opportunist earnings management. This result consistent to auditor's role to mitigates asymmetric information between managers and shareholders. This study contributes to fill gap of inconsistency of previous studies about relationship between audit quality and earnings management.

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