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Factors Affecting Earnings Management in the Indonesian Stock Exchange

Nico Alexander[1]* and Hengky[2]

[1,2]Trisakti School of Management, Kyai tapa No. 20, 11440, Jakarta, Indonesia

ABSTRACT

Objective – The purpose of this research is to analyze the effect of growth, leverage, fixed asset turnover, profitability, firm size, firm age, industry, audit quality, and auditor independence toward earnings management.
Methodology/Technique – The population of this research consist of various sectors of non-financial companies that were listed on the Indonesian Stock Exchange (IDX) between 2013 and 2015. The research uses three recent years of data and tests variables that have not been used by prior research. The sample was chosen by using a purposive sampling method. The hypothesis is tested using multiple regression with an SPSS program to investigate the influence of each independent variable to earnings management.
Findings – The research results show that return on assets influences earnings management and growth, leverage, fixed asset turnover, profitability, firm size, firm age, industry, audit quality, and auditor independence do not influence earnings management.
Novelty – The study supports that the manager in a company will engage in earnings management to receive a bonus from investors because they have received a higher profit.
Type of Paper: Empirical

Keywords: Earnings Management; Growth; Leverage; Fixed Asset Turnover; Profitability; Firm Size; Firm Age; Audit Quality; Auditor Independence; Industry
JEL Classification: L25, M12, M41.

1. Introduction

A financial report is a source of information that is used to view the financial position and performance of a company. Financial statement contains information of the company's financial position, income statements, changes of equity, statement of cash flow, and notes to financial statements. Financial statement are often used by investors to assess the performance of the company. If the company cannot reach the targets set by the investor, the company's manager often conducts earnings management tasks to generate the desired profit thereby increasing investment in the company. Earnings management is regarded as a task of the business manager and involves deliberate manipulation of financial statements within the limits allowed by prevailing principles common to providing misleading information to users of financial statements in the interests of the

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* Corresponding author:
E-mail: nico@stietrisakti.ac.id
Affiliation: Trisakti school of Management, Indonesia.

manager. The Indonesian Institute of Accountants (IAI) has created Accounting Standards that allow managers to apply a policy in using accounting methods to deliver information about the company's performance to external parties. However, this flexibility provides an opportunity for the managers to commit acts of fraud. This forms the motivation for this research. The study uses variables that effect the way management uses earnings management in Indonesian companies. The research shows growth, leverage, fixed asset turnover, profitability, firm size, firm age, industry, audit quality, and auditor independence all have an effect onearnings management. The purpose of this research is to analyze this effect.

2. Literature Review

2.1 Agency Theory

Jensen and Meckling (1976) express that the separation between the owners and managers of a company may cause agency problems because there are moral hazards and adverse selection possibilities. Jensen and Meckling (1976) also describes how agency costs which contain (1) the monitoring of expenditure by the principal which represents the costs incurred by the principal to supervise the behavior of agents; (2) the bonding of expenditure by the agent which represents the costs incurred by the agent to ensure that the agent will not perform actions that could harm the principal; and (3) the residual loss from decreased levels of well-being, both for the principal and the agent flowing from the agency relationship that exists between them.

2.2 Growth and Earnings Management

Growth is the value that shows how much the company has grown from the time the company made to the present point in time. With high growth, the manager will try to lower its profits which will then be allocated at a time when the company is experiencing a decrease in growth (Zouari et al., 2012). The larger the company, the more money is needed for running the company, and this may lead to the manager engaging in management profit behavior to attract investors or lenders (Nozarpour & Norouzi, 2015). Based on the explanation above, the following hypothesis will be tested:
H_1: Growth has a positive effect on Earnings Management.

2.3 Leverage and Earnings Management

Leverage is used to determine the amount needed to finance a company. Companies need to gain profit and the higher the value of leverage held by the company, the higher the risk for investors who are trying to make their investment money back along with profit. According to Ma'ruf (2006) in Guna and Herawaty (2010) managers will likely undertake earnings management activities when the leverage ratio is high. Based on the explanation above, the following hypothesis will be tested:
H_2: Leverage has a positive effect on Earnings Management.

2.4 Fixed Asset Turnover and Earnings Management

Fixed asset turnover is used to measure the efficiency of long-term capital investment, in which the ratio will reflect the level of sales generated in any investment that was planted in production capacity (Warrad & Omari 2015). If the turnover is low, it indicates that the company was not able to capitalize on its assets as best as possible. So, companies with smaller ratios tend to revamp the financial documents to make it appear as though the manager has performed well. Based on the explanation above, the following hypothesis will be tested:
H_3: Fixed Asset Turnover has a negative effect on Earnings Management.

2.5 Profitability and Earnings Management

Profitability ratios are used to measure the company's ability to obtain profit during a certain period. According to Gunawan et al. (2015), the manager would undertake earnings management to show the best performance in their company. Based on the explanation above, the following hypothesis will be tested:
H_4: Profitability has a positive effect on Earnings Management.

2.6 Firm Size and Earnings Management

Firm size is one value that can show the scale of how big a company is. Firm size is also related to the internal control system; a bigger a company will have more internal control in order to maintain the accuracy of information that is reported to the public (Rahmani & Akbari 2013). Therefore, large companies will tend to avoid management profit due to the possible effect of encouraging the public. Based on the explanation above, the following hypothesis will be tested:
H_5: Firm Size has a negative effect on Earnings Management.

2.7 Firm Age and Earnings Management

Firm age is used to show that a company still exists and is able to compete in the economy of a country. According to Bassiouny et al. (2016), a company that has been operating for a longer period of time will have low earnings management compared to a newer company because the older company may wish to avoid a bad reputation by the public. Based on the explanation above, the following hypothesis will be tested:
H_6: Firm Age has a negative effect on Earnings Management.

2.8 Audit Quality and Earnings Management

Auditing is the process that consists of data gathering and processing evidence about the information that will be used to determine and report the extent of the similarities between the information made to the criteria that have been made. Auditing is also used to reduce information asymmetries between the owners with the manager. According to Guna and Herawaty (2010), the audit quality of the big four is capable of preventing earnings management by the manager. Based on the explanation above, the following hypothesis will be tested:
H_7 Audit Quality has a negative effect on Earnings Management.

2.9 Auditor Independence and Earnings Management

The independence of the Auditor's Standard Statement No. 04 (SA 220) requires that the auditor should be independent, meaning not easily influenced, since the auditor is carrying out his work for the public interest. Therefore, the independence of the auditor is important because they have an obligation to provide the results of the examination of a company’s financial statements that can be trusted by public. Independence of the auditor becomes a major issue when the company uses auditor services from same auditor continuously (Wea & Murdiawati, 2015). The bigger the audit fee, the better the audit services provided, which makes it harder for managers to engage in earnings management (Okolie, 2014). Based on the explanation above, the following hypothesis will be tested:
H_8: Audit Independence has a negative effect on Earnings Management.

2.10 Industry and Earnings Management

The industrial sector is a sector that the company chose to run its business in and has been one of the main factors causing managers to engage in earnings management. According to Sarumpaet (2012), industry sectors correlated to political costs; the company faces larger political costs if the manager engages in earnings management. Based on the explanation above, the following hypothesis will be tested:

H_9: Industry has a positive effect on Earnings Management.

3. Methodology

The population used in this research are non-financial companies listed on the Indonesian Stock Exchange between 2011 and 2015. The sample selection technique used in this research is the purposive sampling method. The purpose of using this method is to get the sample which matched the purpose of the research. The sample consists of 103 companies. To test the hypothesis, a multiple regression is used.

Earnings management is measured using discretionary accruals developed by Dechow et al. (1995). Growth is measured by market capitalization divided by total equity; leverage is measured by debt to total asset; fixed asset turnover is measured by sales divided by fixed asset; profitability is measured by return on assets; size is measured by the logarithm natural of total assets; age is measured by the year the company incorporated; audit quality is measured by if the company is audited by one of the big four otherwise, auditor independence is measure by if the company is audited by different auditors within three years; and industry is measured by if the company is the included in agribusiness, consumer, industrial, property, natural resources, service, and technology sectors or otherwise.

The research framework is shown below:

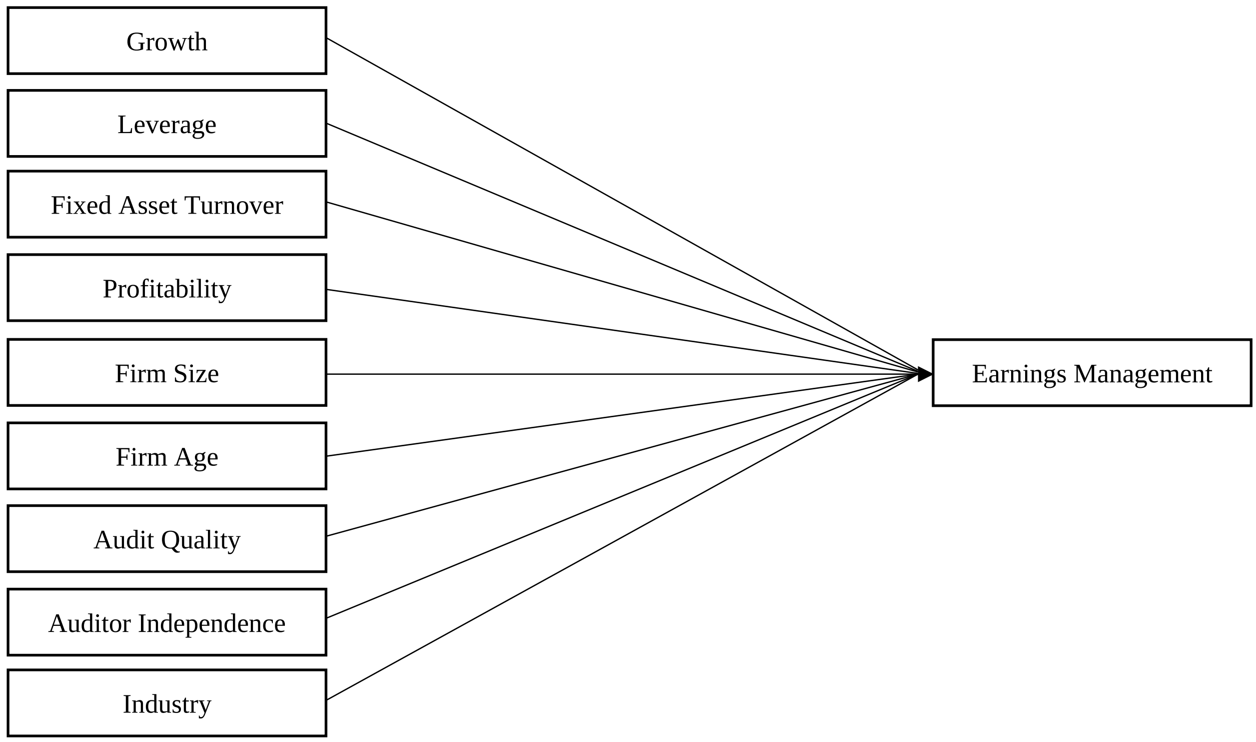

Figure 1. Research framework

4. Results

The results of the descriptive statistic and hypothesis result are show in table 1 and table 2 below.

Table 1. Descriptive Statistic

	N	Minimum	Maximum	Mean	Std. Deviation
EM	309	0.000038	0.348045	0.0512901	0.0466363
Growth	309	-41.07787	246.459661	4.1045964	15.385815
LEV	309	0.069879	1.266055	0.4416127	0.1906925
SFA	309	0.090735	77.707412	3.6467116	6.9931851
ROA	309	0.000656	0.577180	0.1208215	0.1057586
FS	309	24.587699	33.134053	28.882117	1.6466941
AGE	309	2.5	84.1	33.311	14.0304
AQ	309	0	1	0.81	0.391
AudInd	309	0	1	0.83	0.372
IND	309	0	1	0.53	0.500

Table 2. Hypothesis Result

Variable	B	t	Sig.
(Constant)	0.084	1.598	0.111
Growth	-0.00001384	-0.070	0.944
LEV	0.008	0.517	0.605
SFA	0.000219	-0.524	0.601
ROA	0.090	2.944	0.003
FS	-0.001	-0.436	0.663
AGE	0.000259	-1.292	0.197
AQ	0.004	0.602	0.547
AudInd	-0.011	-1.573	0.117
IND	-0.009	-1.083	0.280

5. Discussion

Table 3 shows that profitability (ROA) has a positive effect on earnings management. It shows that a higher profitability of the company will make it more likely that the company will engage in earnings management. This is done to make the performance of the companies look better which results in managers getting a bigger bonus (Amertha, 2013). The higher the profitability ratio, the more earnings management done, and this result is supported by Gunawan et al. (2000). Growth opportunity does not determine the magnitude of profit management (Wibiksono & Rudiawarni 2015). Leverage does not affect earnings management. It is possible the company does not have to rely on earnings management to keep security agreements for debt still intact (Christiani, 2014). Firm size has no effect on earnings management. This is possibly because earnings management does not depend on the size of their company. Firm age is not one of the determinant of earnings management (Savitri, 2014).

Audit quality variables have no effect on earnings management. This shows that, whether the company is audited by one of the big four or not, earnings management may still occur because the company has a desire to make the financial performance of the company look good in the eyes of potential investors. The independence of the Auditor has not effect on earnings management. This shows that no matter how many times the same auditor has been used, earnings management is still a possibility. This is concerned with the inability of auditors to detect the onset of earnings management through the audit process (Susanto, 2013). The type of industry has no effect on earnings management.

6. Conclusion

The purpose of this research is to obtain empirical results of the effect of growth, leverage, fixed asset turnover, profitability, firm size, firm age, industry, audit quality, and auditor independence on earnings management. The sample used in this research is 309 data and the result show that from 9 variables, only profitability has a positive effect on earnings management. Growth, leverage, fixed asset turnover, size, age, audit quality, auditor independence, and industry therefore do not have an effect on earnings management. The manager in a company will engage in earnings management in order to receive a bonus from investors because they have received a higher profit. These results are consistent with research conducted by Guna and Herawaty (2010), Widyaningsih (2012), Armetha (2013), and Nozarpour and Norouzi (2015).

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