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# The Influences of Business Strategy to Earnings Management:

## Moderated by Market Competition

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***Abstract*—This study aims to examine the effect of cost leadership strategies on earnings management, differentiation strategies on earnings management, market competition negatively moderate the effect of cost leadership strategies on earnings management and market competition to positively moderate the effect of differentiation strategies on management. The results showed that the cost leadership strategy had a positive effect on company performance, the differentiation strategy had a negative effect on earnings management, market competition positively moderated the influence of the cost leadership strategy on earnings management, and market competition negatively moderated the effect of the differentiation strategy on management.**

***Keywords: business strategy, cost leadership strategy, differentiation strategy, earning management, market competition***

## I. INTRODUCTION

One of the indicators used to measure company performance, and the information that is needed by the company is profit. Profit is also an indicator of measuring manager performance [1]. The importance of earnings information is very much realized by management, to remain competitive in the eyes of investors, management tends to do dysfunctional behavior, namely by carrying out earnings management to achieve profit targets. The information asymmetry influences the dysfunctional behavior in the agency theory concept.

Many cases that occur regarding earnings management, including the case of fraudulent financial statements by PT. Indofarma and PT. Garuda Indonesia. Earnings management practices cause financial reports that are reported to be unreliable and result in low earnings quality [2].

Business strategy is a set of integrated actions aimed at achieving long-term goals and the company's strength to face competitors [3]. Business strategy has a significant role in stimulating managers to do earnings management [4]. Business strategy framework consists of a cost leadership strategy and a differentiation strategy used to achieve a competitive advantage [5]. Cost leadership strategies can be defined as a series of integrative actions designed to produce goods or services at the lowest cost [6]. Companies that implement a cost leadership strategy tend to have a strong need for external funding based on two reasons [4]. First, one of the primary sources for achieving cost advantage is with the right economies of scale and operational excellence. Second, companies that implement cost leadership strategies tend to have lower profit margins compared to companies that implement differentiation strategies.

Differentiation strategy is a series of actions designed to produce goods or services that are considered by customers to differ in matters considered important to them [6]. The business strategy aims to differentiate a product from other similar products offered by competitors in the market. Companies that employ differentiation strategies have high-profit margins. Competition is when an organization or individual competes to achieve the desired goals such as consumers, market share, survey ratings, or needed resources [7].

## II. LITERATURE REVIEW

### A. *Agency Theory*

Agency theory explains agency relationships as a contractual relationship that arises and has been established between principals (shareholders) who use agents to perform services that are of principal interest in decision making [8]. Agency as a relationship based on an agreement between two parties, where management (agent) agrees to act on behalf of another party, namely the owner (principal) [9]. The relationship between agency theory and management is where the agency theory itself emphasizes the importance of the principal, leaving the management of the company to the agents.

 

*B. Pecking Order Theory*

Pecking Order Theory states that companies determine the optimal capital structure based on a hierarchical funding decision based on the lowest cost of capital sourced from internal funding sources (profits) to external funding sources (debt and shares) [10]. Thus, the determination of capital structure based on POT begins when the company's internal cash flow is not enough to fund real investment and dividends, the company will issue debt, and then shares will be issued if the company's financial distress is high [11].

*C. Market Competition Theory*

Market competition is inseparable from the influence of reputation that illustrates the overall quality of a company. A company's reputation is an economic concept that illustrates the fundamental difference between the perceived and quality of a company related to how to make a profit based on performance [12].

*D. Previous Research and Hypothesis Development*

*E. Cost Leadership Strategy and Profit Management*

Based on POT states that the need for external funding is one of the main motivations for company management to conduct earnings management [13,14]. In order to obtain funding through equity or debt, the company will strive to satisfy the needs of investors and creditors. Management seeks to present financial statements with earnings higher than the reality. Management tends to be involved in earnings management practices to improve the company's financial performance [15-17]; Furthermore, management compensation is often influenced by the profitability of the company. Therefore, management in companies that implement cost leadership business strategies has a strong motivation in carrying out earnings management practices to improve their financial performance. Thus, the hypothesis proposed is:

**H1: The cost leadership strategy has a positive effect on earnings management practices**

*F. Differentiation Strategy and Profit Management*

The pecking order theory states that companies tend to look for sources of funding that have minimal risk. Based on the Pecking Order Theory [10] to reduce costs in terms of funding, a company will first choose internal funding compared to external funding.

High profits, in addition to helping management survive and eliminate the possibility of bankruptcy in the future, also help them to meet their investment needs. Meanwhile, management has the responsibility to produce new products and create market opportunities, so the demand for investment in activities and higher compared with other divisions in the company. Meanwhile, to meet the unique needs of manufacturing design or customization, assets in the differentiator are more specialized and have less market value compared to what they can create in the company. Therefore, the researcher proposes the following hypothesis:

**H2: The differentiation strategy has a negative effect on earnings management practices**

*G. Effect of Cost Leadership Strategy Moderated by Market Competition on Profit Management*

In agency theory, market competition is the reason for managers to act as best they can in making decisions related to earnings. Perfect market competition refers to markets where there are no participants large enough to have the market power to set comparable product prices. Companies that are in an environment of intense market competition and have a high need for external funding (indicating the implementation of a cost leadership strategy) tend to have incentives to practice earnings management [18].

Companies that implement cost leadership strategies find it challenging to fund business activities from the company's results; this is because companies that implement cost leadership strategies tend to have lower profit margins compared to companies that implement differentiation strategies. So companies that implement a cost leadership strategy, usually have a strong need for external funding. Indirectly will motivate managers to improve their financial performance so that investors will be interested in investing their capital in the company, this is because companies that are in a competitive environment will try to attract the attention of stakeholders for the sustainability of the company's business [19].

**H3: Market competition weakens the positive influence of cost leadership strategies on earnings management**

*H. The Effect of Differentiation Strategies on Earnings Management Moderated by Market Competition*

The market competition requires managers to be able to maintain company performance and gain market share, so one of the steps taken by managers is to implement business strategies. Business strategy is the company's primary key in competing with the aim of the company being able to generate high profits and survive in a competitive competition environment [20]. Based on the pecking order theory, companies that are in a competitive environment and can generate high-profit margins to fund company activities through internal resources, tend not to be motivated to practice earnings management. Therefore, the researcher proposes the following hypothesis:

**H4: Market competition reinforces the negative effect of differentiation strategies on earnings management**

## III. RESEARCH METHODS

*A. Earnings Management*

Earnings management is measured using manipulation activities of the real (real earnings management). First, estimate the level of standard production costs (PROD), discretionary expenditure (DISX), and operating cash flow (CFO) by processing using cross-sectional regression for all manufacturing companies in each subsector that meets the criteria for the sample. Next, calculate the general levels of PROD, DISX, and CFO [19].

### *B. Cost Leadership Strategy*

Based on the approach from previous studies [19], researchers used the turnover of assets (asset turnover - ATO) to measure the strategy cost leadership.

### *C. Differentiation Strategy*

In line with the research [19], this study uses the profit margin (PM) to measure the differentiation strategy.

### *D. Market Competition*

In calculating industry-level market competition, this study uses the Herfindahl-Hirschman index (HHI) [19,21,22]. If HHI approaches 0, this indicates a low market share and competition. If HHI reaches a minus number, it indicates that the company does not have market share. Moreover, if the index approaches 1, it indicates that there are companies that dominate the market [23]. A higher value of HHI means that the market share and competition level is high. Second, market competition at the company level (CSHARE). In calculating enterprise-level market competition, this research uses market share index (SHARE) [19].

## IV. RESULTS AND DISCUSSION

### *A. Testing Hypotheses 1 and 2*

TABLE I. RESULTS OF TESTING HYPOTHESES 1 AND 2

| equation 1 | | | | |
|---|---|---|---|---|
| *variables* | *Koef. B* | *t* | *Sig.* | *Information* |
| constants | 0.503 | 0,425 | 0.672 | - |
| ATO | 0.567 | 3,035 | 0,003 | Be accepted |
| PM | -0.085 | -0.742 | 0,459 | Rejected |
| ROA | 0.132 | 1,294 | 0.198 | - |
| LEV | 0.222 | 2,198 | 0,030 | - |
| SIZE | -0.155 | -1.186 | 0.238 | - |
| GROWTH | -0.021 | -0.290 | 0.772 | - |
| *R Square* | .193 | | | |
| *Adj R Square* | 0.152 | | | |
| F | 4.671 | | | |
| Sig | 0000 | | | |

Source: Secondary data processed in 2019.

The coefficient value of ATO indicates a positive direction and has a significance value of 0.003, indicate that the cost leadership strategy (ATO) has a positive effect on earnings management and is significant so that the conclusion is the cost leadership strategy has a positive effect on earnings management, so hypothesis 1 is accepted (see Table 1). These results indicate that companies that implement cost leadership strategies can influence earnings management. This research can prove that in pecking order theory, there is a tendency for companies with low-profit margins to conduct external funding. Companies with a cost leadership strategy tend to have low-profit margins, making it difficult for companies to fund operations through internal sources. Thus, the need for external funding is high which further motivates.

In the hypothesis 2 equation (see Table 1), the coefficient value PM in the hypothesis 2 equation is -0.085, with a significance level of 0.495. These results indicate that the PM differentiation strategy does not negatively affect the management of hypotheses 2 rejected. These results indicate that companies that implement differentiation strategies can influence earnings management. This study cannot prove the pecking order theory [10,19] but found results that companies that implement differentiation strategies will practice profit management [20].

### *B. Testing Hypothesis 3*

TABLE II. HYPOTHESIS TESTING RESULTS 3

| equation 2a | | | | | | | |
|---|---|---|---|---|---|---|---|
| | ***before Moderation*** | | | ***after Moderation*** | | | |
| ***variables*** | ***Koef. B*** | ***t*** | ***Sig.*** | ***Koef. B*** | ***t*** | **Sig.** | **Info** |
| constants | -0227 | -0311 | 0756 | 2.841 | 0,959 | .340 | - |
| ATO | -0059 | -0602 | 0548 | 0.261 | .528 | 0.599 | - |
| CHHI | - | - | - | .903 | 1,428 | .157 | - |
| ATOCHHI | - | - | - | -0.861 | -1.386 | 0.169 | Rejected |
| ROA | -0058 | -1116 | 0267 | 0.382 | 2,467 | 0,016 | - |
| LEV | -0082 | -1376 | 0172 | .250 | 1,523 | 0.132 | - |
| SIZE | 0018 | 0415 | 0679 | -0.328 | -1.048 | .298 | - |
| GROWTH | 0091 | 1104 | 0272 | -0.166 | -1.371 | 0.174 | - |
| *R Square* | .193 | | | | | | |
| *Adj R Square* | 0.152 | | | | | | |
| F | 2,710 | | | | | | |
| Sig | 0000 | | | | | | |
| **equation 2b** | | | | | | | |
| | ***before Moderation*** | | | ***after Moderation*** | | | |
| ***variables*** | ***Koef. B*** | ***t*** | ***Sig.*** | ***Koef. B*** | ***t*** | ***Sig.*** | ***Info*** |
| constants | -0227 | -0311 | 0756 | .460 | 2,176 | 0,030 | - |
| ATO | -0059 | -0602 | 0548 | 0,025 | 0,929 | 0.353 | - |
| CSHARE | - | - | - | 0.134 | .808 | .419 | - |
| ATOCSHARE | - | - | - | -0.007 | -0.267 | .790 | Rejected |
| ROA | -0058 | -1116 | 0267 | 0,243 | 1,900 | .058 | - |
| LEV | -0082 | -1376 | 0172 | 0,023 | 0,960 | 0.338 | - |
| SIZE | 0018 | 0415 | 0679 | -0.022 | -0.876 | .381 | - |
| GROWTH | 0091 | 1104 | 0272 | 0,016 | 1,771 | 0.077 | - |
| *R Square* | 0,071 | | | | | | |
| *Adj R Square* | 0,053 | | | | | | |
| F | 3.936 | | | | | | |
| Sig | 0000 | | | | | | |

Source: Secondary data processed in 2019.

The coefficient value (β) of the interaction of the variable cost strategy and industry-level market competition (ATO_CHHI) of -0.861 shows a negative direction and has a significance value of 0.169 (see Table 2). The coefficient value (β) of the interaction of the variable strategy of cost leadership and company-level of -0.007 indicates a negative direction and has a significance value of 0.790. The results of this test provide an interpretation that industrial-level market competition is not proven to weaken earnings management in. Market competition is not able to weaken the relationship between the cost leadership strategy and earnings management. The market competition variable also proved not to be an independent variable. The results of this study cannot prove the market competition theory that states the company will describe the overall quality. So that even though market competition has increased, it will not reduce the effect of the cost leadership strategy on earnings management. Where companies that implement cost leadership strategies still do earnings management even though the market competition is rising [24].

The variable market competition also proved to be not an independent variable. The results of this study cannot prove market competition theory that states the company will describe the actual quality overall. The variable market competition also proved to be not an independent variable. The results of this study cannot prove market competition theory that states the company will describe the actual quality overall [24].

### C. Testing Hypothesis 4

TABLE III. RESULTS OF TESTING HYPOTHESIS 4

| equations 3a | | | | | | | |
|---|---|---|---|---|---|---|---|
| | *before Moderation* | | | *after Moderation* | | | |
| *variables* | *Koef. B* | *t* | *Sig.* | *Koef. B* | *t* | *Sig.* | *Info* |
| constants | 1.559 | 1.288 | .200 | 1,033 | 2.339 | 0,020 | - |
| PM | -0.138 | -1.263 | .209 | -0.059 | -0.362 | .718 | - |
| CHHI | - | - | - | 0,017 | .553 | 0.581 | - |
| PMCHHI | - | - | - | 0,019 | 0.351 | 0.726 | Rejected |
| ROA | .278 | 3,354 | 0,001 | .117 | 0.581 | 0.562 | - |
| LEV | 0.274 | 2,793 | 0,006 | 0.095 | 2.945 | 0,003 | - |
| SIZE | -0.229 | -1.663 | 0.099 | -0.048 | -1.328 | 0.185 | - |
| GROWTH | 0,012 | 0,153 | 0,879 | 0,031 | 0.779 | 0.436 | - |
| *R Square* | 0,048 | | | | | | |
| *Adj R Square* | 0,024 | | | | | | |
| F | 2,710 | | | | | | |
| Sig | 0000 | | | | | | |
| **equation 3b** | | | | | | | |
| | *before Moderation* | | | *after Moderation* | | | |
| *variables* | *Koef. B* | *t* | *Sig.* | *Koef. B* | *t* | *Sig.* | *Info* |
| constants | 1.559 | 1.288 | .200 | 0,414 | 1,401 | 0.162 | - |
| PM | -0.138 | -1.263 | .209 | 0.122 | 1.279 | .202 | - |
| CSHARE | - | - | - | .219 | 1,561 | 0.119 | - |
| PMCSHARE | - | - | - | -0.727 | -1.305 | .193 | Rejected |
| ROA | .278 | 3,354 | 0,001 | 0,242 | 1,375 | .170 | - |
| LEV | 0.274 | 2,793 | 0,006 | 0,047 | 2,427 | 0,016 | - |
| SIZE | -0.229 | -1.663 | 0.099 | -0.016 | -0.337 | .736 | - |
| GROWTH | 0,012 | 0,153 | 0,879 | 0,019 | 2.568 | 0,011 | - |
| *R Square* | 0,047 | | | | | | |
| *Adj R Square* | 0,028 | | | | | | |
| F | 2.546 | | | | | | |
| Sig | 0014 | | | | | | |

Source: Secondary data processed in 2019.

The coefficient (β) of the interaction of the differentiation strategy variables and industry level market competition (PM_CHHI) and interaction between the differentiation strategy and firm-level market competition (PM_CSHARE) is insignificant direction (see Table 3). The results of this test indicate that industrial-level market competition is not proven to strengthen the influence on companies that implement differentiation strategies on earnings management.

## V. CLOSING

### A. Conclusions

The following conclusions can be drawn: (1) The cost leadership strategy has a positive effect on earnings management. It can be interpreted that the cost leadership strategy can influence earnings management. The higher the cost leadership strategy adopted by the company, the higher the earnings management activities carried out, (2) The differentiation strategy influences earnings management. It can be interpreted that the differentiation strategy can influence earnings management. The higher the cost leadership strategy adopted by the company, the higher the earnings management activities undertaken, (3) Market competition used as a moderating variable in this study was not proven to weaken the positive relationship between the cost leadership strategy on earnings management, (4) Market competition used as a moderating variable in this study was not proven to weaken the positive relationship between differentiation strategies on earnings management.

### B. Research Limitations

This research has not been able to reveal the overall factors contained in the business strategy on earnings management about market competition. This research can only find 15.2% of the cost leadership strategy and the differentiation strategy as the independent variables. Then the role of moderation is also still limited, which is around 5% -15% in weakening the positive relationship between the cost leadership strategy and earnings management, and around 2% in strengthening the positive relationship between the differentiation strategy and earnings management, so it does not yet represent the majority of variables that can influence the relationship.

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