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Factors Influencing Earnings Management Practices

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ABSTRACT
The purpose of this study was to obtain empirical evidence about the factors influencing earnings management practices. Quantitative method was used to conduct this study by using purposive sampling method. After selecting the company, there were 38 manufacturing companies listed on the Indonesia Stock Exchange (IDX) from 2016 - 2019 as research samples. The hypotheses in this research were being tested by using SPSS program with multiple regression analysis method. As conclusion, company size, audit quality, institutional ownership, and managerial ownership have significant influence on earnings management practices. Meanwhile, profitability, leverage, board of directors, board of independent commissioners, and sales growth do not have influence on earnings management.

Keywords: *Earnings Management, Profitability, Leverage, Company Size, Audit Quality, Corporate Governance, Institutional Ownership, Managerial Ownership, Sales Growth*

1. INTRODUCTION

Manufacturing companies are the representative of companies in Indonesia. They produce any kind of product such as automotive, palm oil, milk, consumer goods, etc. Indonesia Stock Exchange (IDX) has become a reference for Indonesian people in watching the performance of public companies, because they provide free and legal information about those companies. In paying attention to the performances of public companies, Indonesian people, especially investors, will give special attention to the company's audited financial statement, as the result of business processes and company management decisions, which is in agreement with the opinion of IAI or the Indonesian Institute of Accountants about the definition of financial statements [1].

Specifically, there are two types of the company's financial statements users, namely internal users (such as company management staff, directors, and commissioners) and external users (such as shareholders and creditors). Internal users usually use financial reports to help determine business decisions, while external users use financial report to help them considering whether they will provide financial assistance or not.

As a matter of fact, external users frequently only use earnings or profits (one of the information within financial statement) as a parameter to measure the company's management capacity in reducing their doubts about investment risk. This information tends to be a signal and generates an expectation that if there is an increase in the level of profit, then the profits received by both parties (management and investors) will also increase, which makes the possibility of earnings management to increase if a company cannot meet these expectations [20]. General public can find out about earnings management cases, because the financial manipulations carried out by management are too large to be believed [2]. Implementing Good Corporate Governance is intended to reduce earnings management practices and to protect the company's related parties, such as investors, government, etc [4].

This research was conducted to obtain empirical evidence regarding the effect of independent variables, which consist of profitability, leverage, company size, board of directors, board of independent commissioners, audit quality, institutional ownership, managerial ownership, and sales growth, on earnings management as the dependent variable.

According to [2] and [23], profitability affects earnings management in positive way, but [24] and [25] had an opposite opinion mentioning that profitability affects earnings management in negative way. Meanwhile, [21], [22] and also [1] told that profitability doesn't affect earnings management.

Based on [2] and [11], leverage has positive effect on earnings management. Unfortunately [9] and also [26] provided a contra result, whereas leverage has a negative effect on earnings management. Meanwhile, [22] and [1] explained that leverage has no effect on earnings management.

In accordance with [2] and [21], company size positively affects earnings management. Meanwhile, [14] and [27] said that company size negatively affects earnings management, whilst [23], [1] and [28] said that company size doesn't affect earnings management.

According to [24], board of directors has a positive effect on earnings management, while according to [31], board of directors has a negative effect on earnings management.

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Meanwhile, [29] and [30] mentioned that board of directors doesn't have any effect on earnings management.
Based on [17], [19] and [33], board of independent commissioners has a negative effect on earnings management. However, [14] and [32] explained that board of independent commissioners has no effect on earnings management.
According to [14], audit quality affects earnings management in positive way, but [23] had an opposite opinion mentioning that audit quality affects earnings management in negative way. Meanwhile, [24] told that audit quality doesn't affect earnings management.
In accordance with [26], institutional ownership positively affects earnings management, while [2] said that institutional ownership negatively affects earnings management. Meanwhile, [14] concluded that institutional ownership doesn't affect earnings management.
According to [32], managerial ownership affects earnings management in positive way, but [2] had an opposite opinion which mentioned that managerial ownership affects earnings management in negative way, while [14] told that managerial ownership doesn't affect earnings management.
In accordance with [2], sales growth positively affects earnings management, whilst [34] and [25] said that sales growth doesn't affect earnings management.

2. THEORETICAL FRAMEWORK

2.1. Agency Theory

This theory discusses the misalignment of goals and the relationship between the principal (owner of the company) and the agent (management) whereas the principal wants a high rate-of-return on capital, while the agent also wants a high return [3]. Even though return for the agent is one of the operational burdens for the principal, which causes principal to distrust the agent's performance result and raises the agency costs [4]. Management's anxiety to get high returns even though it doesn't meet the interests of the principal, is the impetus that increases the possibility of implementing earnings management practices [5].

2.2. Signalling Theory

This theory discusses about the possibility of reducing the risk that investors get in making decision, if they receive signals or information from within the company [6]. The management gives a signal to investors in order to change the company's market value [7].

2.3. Good Corporate Governance

GCG discusses about a system applied by management to reach a continuous authority needed, and to assure the sustainability toward investors [35]. In maintaining GCG, KNKG explained that there are 5 principles needed to protect the interests of shareholders, such as: transparency, accountability, responsibility, independence, and fairness and equity [20].

3. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

3.1. Earnings Management

Earnings management is a practice of earnings manipulation carried out by company management, that will change profits value without violating the related regulations (such as PSAK) in order to fulfil certain desires. Healy and Wahlen found that there are three kinds of motives that usually stimulate the management to perform earnings management, namely: the existence of expectations and market valuation of the company, the pressure in applying related regulation to every business contract, and the existence of government regulations together with related accounting provisions that should be applied [8].

3.2. Profitability and Earnings Management

Profitability is measured by return-on-asset and is useful for measuring the effectiveness of company performance in managing its assets to earn profit [9]. The higher the return-on-asset is, the higher the possibility will occur that the company's management might do earnings management to get a big bonus [9].
H_1: Profitability has a positive impact on earnings management.

3.3. Leverage and Earnings Management

The likelihood of earnings management rises as it is affected by pressure to avoid the contract breaches with creditors [10]. Leverage is used to measure the company's ability in paying debts [1]. The greater the leverage ratio is, the more likely that earnings management will occur, so as management can avoid the contract breaches.
H_2: Leverage has a positive impact on earnings management.

3.4. Company Size and Earnings Management

The size of company declares to public how much information must be managed by management, which will interest many parties and affect the possibility of earnings management to happen in the company [11]. Along with the adjustment of accounting methods, company size becomes an important variable in determining the potential of earnings management to occur [10].
H_3: Company Size has a negative impact on earnings management.

3.5. Board of Directors and Earnings Management

There are usually several factors used in measuring Good Corporate Governance (GCG), one of which, is the proportion of the Board of Directors so that increasing the numbers of Directors will have direct influence on the probability of earnings management in the company [12]. Board of Directors includes all Directors, both dependent and independent, because their duties are similar [19].
H_4: Board of Directors has a negative impact on earnings management.

3.6. Board of Independent Commissioners and Earnings Management

Another factor that also determines GCG is the proportion of Independent Commissioners, in which it refers to the parties outside the company management, does not have share ownership, and no familial relationships with any members of management, Directors, and shareholders of the company [13]. With the rising number of Independent Commissioners, it is less likely that earnings management practices will occur.
H_5: Board of Independent Commissioners has a negative impact on earnings management.

3.7. Audit Quality and Earnings Management

The auditor's quality of work can to be observed from their length of working experience and good reputation, so people usually assume that companies with reasonable financial statements are those audited by well-known accounting firms. This phenomenon influences the measurement of audit quality to be dummy, whereas number 1 indicates that the company is audited by "The Big Four" accounting firms, such as Deloitte, Price Waterhouse Coopers, Ernst & Young, and KPMG, while number 0 indicates otherwise [14].
H_6: Audit Quality has a negative impact on earnings management.

3.8. Institutional Ownership and Earnings Management

Institutional ownership tends to be one among the factors that will also determines GCG and is intended as share ownership by institutions that are bound to strict financial laws, such as banks and insurance companies [15], whereas according to [16], institutional ownership is share ownership by the government, legal entities, financial institutions and so on. With the increase in institutional ownership, managers' limitations in making business decisions also increase resulting in the institutional ownership directly influencing the probability of earnings management to occur in the company [17].
H_7: Institutional Ownership has a negative impact on earnings management.

3.9. Managerial Ownership and Earnings Management

Managerial ownership frequently is also used as one among the factors determining GCG. Its definition is share ownership given to management (such as Directors or Commissioners) as a form of company appreciation to their contributions. Jensen and Meckling have revealed about the concentration of interest hypothesis, which stated that by giving the shares to management, the principal and agent will have the same interests with the aim to decrease the agency problems and reduce the possibility of earnings management [3].
H_8: Managerial Ownership has a negative impact on earnings management.

3.10. Sales Growth and Earnings Management

Sales growth is closely related to profit and is represented in percentage that shows the amount of profit earned by the company in one business period. Along with an increase in the percentage of sales growth, the profits received by shareholders will also increase, encouraging management to achieve the expected profit. This makes sales growth directly increase the probability of earnings management to happen, if the expected profit isn't achieved [2].
H_9: Sales Growth has a positive impact on earnings management

4. RESEARCH METHOD

In this research, the population covers the manufacturing companies listed on IDX from 2016 - 2019. All data was processed using IBM SPSS version 25. In testing the hypotheses, multiple regression analysis method was used and all the proxies used are as follows:

Table 1 Proxies from All Variables

Variable	Description
EM	Earnings Management
ROA	Return-on-Assets
LEV	Leverage
SIZE	Company Size
AQ	Audit Quality
BOD	Board of Directors
BOIC	Board of Independent Commissioners
IO	Institutional Ownership
MO	Managerial Ownership
SG	Sales Growth

Earnings management is an act of manipulating the amount of profit carried out by the management, in order to achieve a certain goal. Earnings management is measured using Modified Jones Model and the formula is displayed as follow [1]:

$$\frac{TACC_{it}}{TA_{i,t-1}} = \alpha_1\left(\frac{1}{TA_{i,t-1}}\right)+\alpha_2\left(\frac{(\Delta REV_{it}-\Delta REC_{it})}{TA_{i,t-1}}\right)+\alpha_3\left(\frac{PPE_{it}}{TA_{i,t-1}}\right)+\varepsilon$$

$$NDACC_{it}=\alpha_1\left(\frac{1}{TA_{i,t-1}}\right)+\alpha_2\left(\frac{(\Delta REV_{it}-\Delta REC_{it})}{TA_{i,t-1}}\right)+\alpha_3\left(\frac{PPE_{it}}{TA_{i,t-1}}\right)$$

$$DACC_{it}=\left(\frac{TACC_{it}}{TA_{i,t-1}}\right)-NDACC_{it}$$

Profitability is measured using this formula [18]:

$$ROA = \frac{\text{Net profit after tax}}{\text{Total assets}}$$

Leverage is measured using the formula below [1]:

$$LEV = \frac{\text{Total debt}}{\text{Total assets}}$$

Company Size is measured using the following formula [1]:

$$SIZE = Ln\ (\text{Total Assets})$$

Board of Directors is measured using this formula [19]:

$$BOD = \text{Total numbers of the board}$$

In measuring Board of Independent Commissioners, the formula used is [20]:

$$BOIC = \frac{\text{Total number of the board of independent commissioners}}{\text{Total number of the board of commissioners}}$$

Audit Quality variable was measured by using dummy variable [20].

Institutional Ownership uses this formula to measure it [19]:

$$IO = \frac{\text{Total shares owned by institution}}{\text{Total number of shares issued}}$$

Managerial Ownership is measured by this formula [20]:

$$MO = \frac{\text{Total shares owned by managerial}}{\text{Total number of shares issued}}$$

The following formula is used to measure Sales Growth [17]:

$$SG = \frac{(\text{total sales in current year} - \text{total sales in previous year})}{\text{total sales in previous year}}$$

The regression equation was developed as follow:

$$EM = \alpha + \beta_1\ ROA + \beta_2\ LEV + \beta_3\ SIZE + \beta_4\ AQ + \beta_5\ BOD + \beta_6\ BOIC + \beta_7\ IO + \beta_8\ MO + \beta_9\ SG + \varepsilon$$

The purposive-sampling method is used to filter-out the appropriate data that matches certain predetermined criteria, as presented in Table 2.

Table 2
Sample Selection Procedure

No	Criteria	Total Company	Total Data
1	Manufacturing companies that are officially listed on Indonesia Stock Exchange from 2016 to 2019.	123	492
2	Manufacturing companies that aren't presenting financial statements consistently in Rupiah since 2016-2019.	(24)	(96)
3	Manufacturing companies that aren't publishing financial statements at December 31 as fiscal year end since 2016-2019.	(2)	(8)
4	Manufacturing companies that don't have complete data on managerial ownership and institutional ownership as research data.	(59)	(236)
	Total research data used (before outlier test)	38	152

Source: Data processed by researchers

5. RESULTS AND DISCUSSIONS

Table 3 and Table 4 contains the results of descriptive-statistical test and hypothesis test.

Table 3 Descriptive-Statistics Test Results

Variable	N	Minimum	Maximum	Mean	Standard Deviation
EM	152	-0.000000000002	0.000000000006	0.000000000001	0.000000000002
ROA	152	-0.254880608923	0.227306790169	0.032694277640	0.067170950705
LEV	152	0.092482892314	3.744477387365	0.500126418060	0.483570815210
SIZE	152	25.6635440107127	33.494532966225	28.1334123235778	1.684336095562
AQ	152	0	1	0.28	0.449
BOD	152	2	16	4.94	2.559
BOIC	152	0.300000000000	0.500000000000	0.391298558897	0.075212906491
IO	152	0.000490277778	0.940115240818	0.591713582020	0.243086915681
MO	152	0.000055613304	0.682758999832	0.097130716775	0.145393972383
SG	152	-0.986759074524	0.786750652596	0.057920500268	0.230286091494

Source: IBM SPSS Version 25 – Data Processing Results

Table 4 t-Test Results

	B	Sig.	Conclusion
(Constant)	0.00000000002403	0.000	-
ROA	-0.00000000000004	0.983	H_1 was rejected
LEV	0.00000000000017	0.483	H_2 was rejected
SIZE	-0.00000000000080	0.000	**H_3 was accepted**
BOD	-0.00000000000004	0.381	H_4 was rejected
BOIC	-0.00000000000156	0.258	H_5 was rejected
AQ	0.00000000000062	0.020	**H_6 was accepted**
IO	-0.00000000000140	0.004	**H_7 was accepted**
MO	-0.00000000000268	0.002	**H_8 was accepted**
SG	0.00000000000020	0.670	H_9 was rejected

Source: IBM SPSS Version 25 – Data Processing Results

The constant value 0.00000000002403 shows that if all independent variables consisting of Profitability (ROA), Leverage (LEV), Company Size (SIZE), Audit Quality (AQ), Board of Directors (BOD), Board of Independent Commissioners (BOIC), Institutional Ownership (IO), Managerial Ownership (MO), and Sales Growth (SG) have no value or equal to zero, then it would cause the Earnings Management (EM) as dependent variable to be 0.00000000002403.

The coefficient of Profitability (ROA) is -0.00000000000004 with the significance level of 0.983, which is higher than or equal to alpha (0.05), that makes H_1 rejected. Thus, there is no partial influence of Profitability (ROA) on Earnings Management (EM), because profit is only part of the financial statement. Also, the bigger the profit is, the bigger the bonus that management will get, so they will likely have zero urge to do earnings management. This result is consistent with three previous research results, namely [21], [22], and also [1]. However, the result of this research is not consistent with the results of [2], [23], [24], and [25].

The coefficient of Leverage (LEV) is 0.00000000000017 with the significance level of 0.483, which is higher than or equal to alpha (0.05), which results H_2 to be rejected. So, there is no partial influence from Leverage (LEV) on Earnings Management (EM), because there will be constant pressure from creditors if the leverage rate is higher than the usual rate, which will less encourage the management in conducting earnings management. The result of this research is in line with the results of [22] and [1]. However, this result is not consistent with the results from [2], [11], [9], and [26].

The coefficient of Company Size (SIZE) is -0.00000000000080 with the significance level of 0.000, which is less than alpha (0.05), which indicates that H_3 was accepted. So, there is a partially negative influence of Company Size (SIZE) on Earnings Management (EM). The conclusion is that the bigger the size of the company is, the more regulations it must comply which increases the number of parties who supervise the company management and decreases the earning management chances, and at the same time with small company, they will focus on optimizing their performance and build a good image to earn more profits rather than doing earnings management. This result is consistent with the research results of [14] and [27]. In contrast, this result is not consistent with [2], [21], [23], [1], and [28].

The coefficient of Board of Directors (BOD) is -0.00000000000004 and its significance level is 0.381, which is higher than or equal to alpha (0.05). This caused H_4 to be rejected so that there was no partial influence of Board of Directors (BOD) on Earnings Management (EM), because there is no definite assurance that larger or smaller number of Directors will affect earnings management. This research result is in line with [29] and [30], but in contrast with [24] and [31].

The coefficient of Board of Independent Commissioners (BOIC) is -0.00000000000156 with the significance level of 0.258, which is higher than or equal to alpha (0.05). This caused H_5 to be rejected, so there was no partial influence of Board of Independent Commissioners (BOIC) on Earnings Management (EM), because a large number of Independent Commissioners usually results in higher effective oversight of the company’s performance in carrying-out earnings management. This means that the result is consistent with [14] and [32], and on the contrary, it is not consistent with [17], [19], and [33].

The coefficient of Audit Quality (AQ) is 0.00000000000062 with the significance level of 0.020, which is less than alpha (0.05). This makes H_6 rejected, resulting in a positive influence partially of Audit Quality (AQ) on Earnings Management (EM). The conclusion is that Auditors from The Big Four accounting firms do not have the power to reduce earnings management occurrence, because they are only external parties and do not have great influence over the company’s decision. This result is in line with the research result from [14]. Even so, it is not in line with the research results from [23] and [24].

The coefficient of Institutional Ownership (IO) is -0.00000000000140 with the significance level of 0.004, which is less than alpha (0.05). This causes H_7 to be accepted, so there is a negative influence partially from Institutional Ownership (IO) on Earnings Management (EM). The conclusion is that with institutional ownership, the management performance supervision increases resulting in the increased demand for clean business. Then the managers’ limitations in making business decisions would also increase, thereby reducing the earnings

management occurrence. This result is consistent with [2]. However, it is not consistent with [26] and [14].
The coefficient of Managerial Ownership (MO) is -0.00000000000268 with the significance level of 0.002, which is less than alpha (0.05). This indicates that H_8 was accepted, resulting in a negative influence partially from Managerial Ownership (MO) on Earnings Management (EM). The conclusion is that managerial ownership improves the company management's attitude and makes them realize that they would be held responsible, if a bad scheme is known to public. The knowledge that they would get more net profits in form of salaries and dividends, supports good management performance and reduces earnings management. This result is in line with [2]. On contrast, it is not in line with [32] and [14].
The coefficient of Sales Growth (SG) is 0.00000000000020 with the significance level of 0.670, which is higher than or equal to alpha (0.05). This makes H_9 rejected, resulting in no partial influence of Sales Growth (SG) on Earnings Management (EM), which was caused by the ups and downs of sales that have no significant effect on the implementation of earnings management in the company. This result is in line with [34] and [25]. However, it is not in line with [2].

6. CONCLUSIONS

This research was intended to obtain empirical evidences regarding the effect of independent variables, which consist of Profitability, Leverage, Company Size, Board of Directors, Board of Independent Commissioners, Audit Quality, Institutional Ownership, Managerial Ownership, and Sales Growth on Earnings Management as dependent variable among manufacturing companies listed on IDX from the year 2016 to 2019. The result of this research revealed that Company Size, Audit Quality, Institutional Ownership, and Managerial Ownership have either positive or negative influence on Earnings Management, while Profitability, Leverage, Board of Directors, Board of Independent Commissioners, and Sales Growth have no influence on Earnings Management.
Several limitations were found in this research: (1) The residual data distribution was not normal; (2) There was a heteroscedasticity problem in Company Size (SIZE), Audit Quality (AQ), Board of Independent Commissioners (BOIC), Institutional Ownership (IO), and Managerial Ownership (MO), which means that the residual data variance from one observation to another is different; (3) There was an autocorrelation problem in the regression model, which shows that the error from the current regression model had a relationship with those from the previous model.
Recommendations that could be applied in further research are: (1) The research object could be converted to non-financial companies in IDX so that the data samples would be more similar to the actual total population to achieve normal distribution of residual data; (2) The total years of research could be added; (3) The independent variables could be added or replaced in order to reduce the possibility in having autocorrelation problems.

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