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The Effect of Internal Factors and Audit Quality on Profit Management in Basic and Chemical Industry Sectors

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Abstract:- This study aims to examine and analyze the effect of profitability, leverage, firm size and audit quality on earnings management in the Basic and Chemical Industrial Sector Companies. Research data is annual financial report for 5 years observation period (2013 until 2017). The sampling method used was purposive sampling. From a population of 66 companies, 37 companies met the criteria to be the sample. The method of analysis used in this study is panel data regression. The results showed that profitability, leverage, firm size and audit quality simultaneously are having significant influence to earnings management. Partially, profitability has positive significant effect on earnings management, while leverage has positive but not significant effect on earnings management. Firm size and audit quality are having negative and not significant influence on earnings management. Profitability is the only significant variable in influencing earnings management.

Keywords:- *Profitability, Firm Size, Audit Quality, Earnings Management, Leverage*

I. INTRODUCTION

Financial statements are a source of information used to see the company's performance. Alexander and Hengky (2017) state that if a company cannot achieve the targets set by investors, company managers often apply earnings management practices to generate the expected profits.

In previous studies, including Usman and Yero (2012) and Indriastuti (2012) measure earnings management with Discretionary Accruals (DA) that can be generated from the Modified Jones Model equation. The author examines earnings management (DA) in companies in the basic and chemical industry sectors listed on the Indonesia Stock Exchange during 2013 - 2017. Perdana (2018) states that the higher the absolute value of discretionary accruals (DA) means the lower the quality of accounting information. Conversely, the smaller the Discretionary Accruals, the higher the quality of earnings or accounting information. This statement reinforces the low quality of earnings or accounting information in the metal sub-sector and the like, so it is quite interesting to do research. The results of research conducted by Wiyadi, et al (2015) show that profitability has no effect on earnings management. The results of research conducted by Kamran and Shah (2014) show that profitability has a significant positive effect. From the results of the study above it can be concluded that the influence of profitability, leverage, company size and audit quality variables according to Xu (2014) has different results from research conducted by other researchers. From the differences in the results of research conducted by researchers, this will review (replicate) this research by updating the study period to determine the effect of profitability, leverage, company size and audit quality on earnings management with different scope of company sectors.

II. LITERATURE REVIEW

A. *Agency Theory*

The owner is motivated to enter into contracts to make himself prosperous with ever-increasing profitability. While the manager (agent) makes himself prosperous by maximizing the fulfillment of his economy and psychology, among others in terms of obtaining investments, loans and compensation contracts (Herlambang and Darsono, 2015).

B. *Conceptual Definition of Earnings Management*

Diri (2018: 6) defines earnings management as manipulation of financial statements to achieve specific targets. In addition, Sulistyanto (2014: 51) states "earnings management is a managerial activity to influence and intervene financial statements." Other observers, especially practitioners, consider that during the actions taken by managers to influence financial statements, this is done to take advantage for themselves by exploiting other people's ignorance of information about the real company, then earnings management is considered cheating.

C. *Various Ways of Profit Management*

Self (2018: 13) states that earnings management primarily takes part by choosing specific accounting treatment of certain transactions, or it can also take economic decisions that can affect the cash flow, investment, or production of a company.

D. *Profit Management Objectives*

According to Sulistyanto (2014: 55-56), "Conceptually, the effort to hide, postpone disclosure, and change information is done by managers to trick the users of financial statements who want to know the condition and performance of the company." The reason is that these efforts are made by managers to mislead other parties who want to know and assess the performance and condition of the company.

E. Costs and Benefits of Profit Management

Before conducting earnings management, a manager must consider the costs (benefits) and benefits (benefits) that are borne and also felt. According to Sulistyanto (2014: 59), "if the manager wants the stock to be offered positively responded by the market, then the pattern of earnings management he must do is increase profits." He continued, "This is due to the higher profits achieved by the company will make the higher the company's stock price "(Sulistyanto, 2014: 60). If managers are wrong in choosing a pattern of action, for example by decreasing profits, then what actually wants to be achieved may not be possible.

III. THEORETICAL FRAMEWORK

Arifin and Destriana (2016) state that the ability of a company to achieve profit is called profitability. Profitability shows the company's ability to earn profits in relation to the assets or capital used to generate these profits. So, the higher the profitability of a company, the higher the possibility of the implementation of earnings management practices at the company. Naftalia and Marsono (2013) state that the magnitude of corporate leverage can affect earnings management actions. High leverage is caused by management mistakes in managing the company's finances or the application of inappropriate strategies from the management. So, the higher the leverage of a company, the higher the possibility of the implementation of earnings management practices at the company.

Arifin and Destriana (2016) state that company size is a basic measure that reflects the level of sales and internal control of the company. In large companies, the level of stability tends to be higher and involve more parties. So, the larger the size of the company, the greater the possibility of the adoption of earnings management practices. An audit is a form of monitoring that is used by companies to reduce corporate agency costs with debt holders and shareholders. Indriastuti (2012) states that the results of the audit process are reflected in the financial statements presented by the company. The better the audit quality of a company, the more difficult it is for management to adopt earnings management practices.

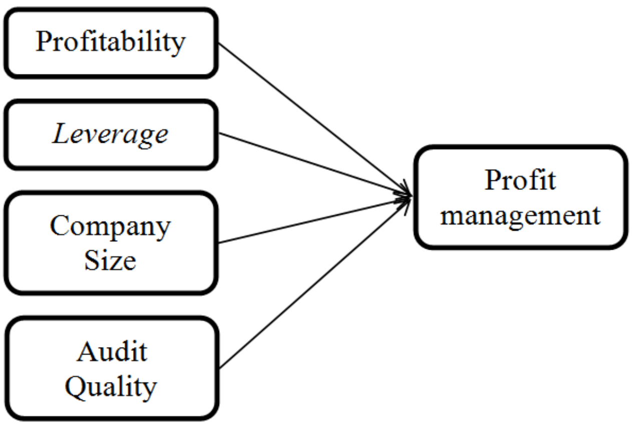

Fig 1:- Theoritical Framework

- H1 : Profitability has a negative effect on earnings management.
- H2 : Leverage has a positive effect on earnings management.
- H3 : Company size has a negative effect on earnings management.
- H4 : Audit quality has a negative effect on earnings management.

IV. RESEARCH METHODOLOGY

This research is a quantitative study in which the authors use secondary data in the form of annual financial statements of each company as of December available on 2013 to 2017. Meanwhile, the data has been obtained from the official website of IDX at the address http: //www.idx. co.id accessed in 2018 and 2019.

A. Sample and Population

The population in this study are companies in the basic and chemical industry sectors that have been Tbk (open) and were listed on the Indonesia Stock Exchange during 2013-2017. This study uses financial statements as of December 31, 2013 - 2017 as a sample. By using a relatively new sample, it is expected that research results will be more relevant to understanding the actual conditions in Indonesia.

The companies that became the sample in this study were companies selected based on the purposive sampling method, which is data retrieval based on certain criteria. The criteria, namely metal sub-sector companies and the like which successively from 2013 to 2017 are listed on the Indonesia Stock Exchange (IDX) and the financial statements are presented in Rupiah.

B. Data Collection Methods

- Study documentation of the company's annual financial statements obtained from the official website of IDX at the address *http://www.idx.co.id accessed* in 2018 and 2019.
- Literature, in the form of books and research journals related to the information needed.

C. Data Analysis Method

- *Descriptive statistics*

The statistics in this study use descriptive statistics, because they are knows the mean (mean), frequency distribution, minimum value, maximum value and standard deviation.

- *Stationary Test*

In the stationarity test or data feasibility test, a test will be conducted on the data whose results will determine whether the data is feasible or not

- *Panel Data Regression Equation*

$Yi,t = \alpha + \beta 1\ (X1i,t) + \beta 2\ (X2i,t) + \beta 3\ (X3i,t) + \beta 4(X4i,t) + \varepsilon i,t$

- *Model Selection Test*

Consists of Chow Test, Hausman Test, LM Test, and (Langrange Multiplier)

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Model Selection Test	Significance	Selected Model
Chow Test	> 0,05	*Common Effect*
	< 0,05	*Fixed Effect*
Hausman Test	> 0,05	*Random Effect*
	< 0,05	*Fixed Effect*
LM Test (Langrange Multiplier)	> 0,05	*Common Effect*
	< 0,05	*Random Effect*

Table 1:- Model Selection Test

- *Hypothesis testing*

Consists of the Coefficient of Determination Test, Statistical Test F, and Statistical Test T

V. RESULTS AND DISCUSSION

A. Descriptive Profitability Statistics

Based on statistical calculations, profitability data with ROA (Return on Assets) benchmarks in metal and similar sub-companies listed on the Indonesia Stock Exchange (IDX) during 2013 – 2017

Year	N	Minimum	Maximum	Mean	Standard Deviation
2013	37	.01505.	4.54552..	1.05151...	.73577....
2014	37	.02672.	5.02437..	1.02580...	.80698....
2015	37	.16567.	5.17980..	.98475...	.80405....
2016	37	.10859.	8.42933..	1.01187...	1.31465...
2017	37	.00405.	6.33266..	.96590...	1.01571...

Table 2

Above can be concluded that from a total of 37 ROA data in metal and similar sub-sector companies listed on the IDX in 2013, 2014, 2015, 2016 and 2017 have minimum figures of 0.01505, 0.02672, 0.16567, 0 10859 and 0.00405. It also has a maximum number of 4,54552, 5,02437, 5,17980, 8,42933 and 6,33266. The data above shows that the average profitability of metal and similar sub-sector companies listed on the Indonesia Stock Exchange in 2013 to 2017 were 1.05151, 1.02580, 0.98475, 1.01187 and 0.96590, respectively. The lowest standard deviation was in 2013, which was 0.73577. Whereas, the highest standard deviation was in 2016 with the number 1.31465.

B. Descriptive Leverage Statistics

Year	N	Minimum	Maximum	Mean	Standard Deviation
2013	37	.07382.	2.55422..	.50332...	.42233....
2014	37	.04450.	2.37790..	.49884...	.40295....
2015	37	.09139.	2.66063..	.53799...	.43223....
2016	37	.09848.	2.61707..	.53591...	.43689....
2017	37	.11656.	2.76687..	.56705...	.46912....

Table 3

It can be concluded that from a total of 37 Dept Ratio data for metal sub-sector companies and the like that were listed on the Indonesia Stock Exchange in 2013, 2014, 2015, 2016 and 2017 had minimum figures of 0.07382, 0.04450, 0.09139, 0 , 09848 and 0.11656. It also has a maximum number of 2.55422, 2.3790, 2.66063, 2.61707 and 2.76687, respectively. The data above shows that the average leverage in metal and its sub-sector companies listed on the Stock Exchange in 2013 to 2017 was 0.50332, 0.49884, 0.53799, 0.53591 and 0.56705. The lowest standard deviation was in 2014, which was 0.40295. Whereas, the highest standard deviation is in 2017 with 0.46912.

C. Descriptive Statistics of Company Size

Based on statistical calculations, company size data using the Natural Logarithm benchmark of Total Assets in metal and similar sub-sector companies listed on the Indonesia Stock Exchange (IDX) during 2013 – 2017.

Year	N	Minimum	Maximum	Mean	Standard Deviation
2013	37	25.63696.	31.05830..	27.81282...	1.49203....
2014	37	25.66431.	31.16659..	28.00434...	1.50769....
2015	37	25.61948.	31.27263..	27.97211...	1.56234....
2016	37	25.64046.	31.42035..	28.03652...	1.57108....
2017		25.80568.	31.52210..	28.08450...	1.54807....

Table 4

from a total of 37 Natural Logarithms data from Total Assets in metal and similar sub-sector companies listed on the Stock Exchange in 2013, 2014, 2015, 2016 and 2017 have a minimum number of 25.63696, 25.66431, 25.61948, 25 , 64046 and 25.80568. It also has a maximum number of 31.05830, 31.16659, 31.227263, 31.42035 and 31.52210. All of the data above shows that the average size of companies in the metal and similar sub-sector companies listed on the Stock Exchange in 2013 to 2017 were 27.81282, 28.00434, 27.997211, 28.03652 and 28.08450, respectively. . The lowest standard deviation was in 2013, which was 1.49203. Meanwhile, the highest was in 2016 with a number of 1.57108.

D. Statistik Deskriptif Kualitas Audit

Year	N	Minimum	Maximum	Mean	Standard Deviation
2013	37	0.	1	.27027	.45023
2014	37	0.	1	.27027	.45023
2015	37	0.	1	.27027	.45023
2016	37	0.	1	.29730	.46337
2017	37	0.	1	.29730	.46337

Table 5

➢ *Based on the table*

above it can be concluded that from a total of 37 dummy variable data of audit quality in metal sub-sector companies and the like listed on the Indonesia Stock Exchange in 2013, 2014, 2015, 2016 and 2017 have a minimum number of 0. In addition, it also has a maximum number, namely 1. All of the above data shows that the average audit quality in metal and similar sub-sector companies listed on the Indonesia Stock Exchange in 2013 to 2015 was 0.27027, while in 2016 and 2017 it was 0.29730. The lowest standard deviation is in 2013 – 2015, which is 0.45023. Meanwhile, the highest was in 2016 and 2017 with a number of 0.46337.

E. Descriptive Statistics of Earnings Management

Year	N	Minimum	Maximum	Mean	Standard Deviation
2013	37	.07382.	2.55422..	.50332…	.42233….
2014	37	.04450.	2.37790..	.49884…	.40295….
2015	37	.09139.	2.66063..	.53799…	.43223….
2016	37	.09848.	2.61707..	.53591…	.43689….
2017	37	.11656.	2.76687..	.56705…	.46912….

Table 6

➢ *Based on the table*

above it can be concluded that from a total of 37 DA data in metal and similar sub-sector companies listed on the IDX in 2013, 2014, 2015, 2016 and 2017 the minimum figures were -0.90270, -1.36986, - 0.68491, -0.70794 and -0.74424. It also has a maximum number, namely 7.37476, 5.10555, 3.00666, 7.70937 and 14.00874. All of the above data shows that the average earnings management in metal and similar sub-sector companies listed on the Indonesia Stock Exchange in 2013 to 2017 were 0.73723, 0.63960, 0.45138, 0.50029 and 0, respectively. 71381. The lowest standard deviation was in 2015, which was 0.67905. Meanwhile, the highest standard deviation is in 2017 with 2.31449.

F. Stationary Test Research Data

- ➢ Stationary profitability at the 1st difference stage.
- ➢ The variable leverage turns stationary at the 1st difference stage.
- ➢ Company size variables are stationary at the level stage.
- ➢ Audit quality variables turned out to be stationary at the 2nd difference stage.
- ➢ Stationary earnings management variables at the level stage.

G. Model Selection Test Results

➢ *Chow Test*

Then in this study the prob value of 0.1675> 0.05, the chow test chooses the common effect.

➢ *Hausman Test*

Hausman test where in this study the value of 0.0001. The value of p valie 0.0001 is less than 0.05, so accept H1, which means the best method to use is fixed effect rather than random effect.

➢ *LM Test (Lagrange Multiplier)*

Of the many calculation methods that can be done, namely the Breusch-Pagan, Honda and King-Wu methods in the One-sided Cross-section column, the p value is indicated by the numbers below, each of which is 0.0100 (Breusch- Pagan), 0.9950 (Honda) and 0.9950 (King-Wu). Because there are differences in results where the results are <0.05 and some are> 0.05, then the most dominant ones are taken, namely Honda and King-Wu, both of which have a p value of 0.9950. With 0.9950 which means> 0.05, then this LM test shows that H0 is accepted which means the best estimation method is the Common Effect. Conversely, if the p value is smaller than 0.05, then H1 is accepted where the best estimation method is the Random Effect.

H. Hypothesis Test Results

➢ *Determination Coefficient Test*

In this panel data regression, the adjusted R2 value has a value of 0.791324 which means that the independent variable is very strong in explaining the dependent variable.

➢ *Statistical Test F*

In this panel data regression, the value of Prob (F-statistic) has a value of 0.000000 which means receiving H1 or the simultaneous influence of the independent variable on the dependent variable statistically influences.

➢ *Statistical Test t*

In this panel data regression, the coefficient value on the constant is 0.629785 which means the value of the independent variable (Y) or earnings management is positive at 0.629785 when the dependent variable is profitability (X1), leverage (X2), company size (X3) and also audit quality (X4) has zero value.

I. Panel Data Regression Model Analysis

Based on the results of the panel data regression analysis tests that have been carried out in this study, the following equation can be obtained:

Yi, t = 0.629785 + 1.305949 (X1i, t) + 0.089944 (X2i, t) - 0.047539 (X3i, t)- 0.195561 (X4i, t) + Ɛi, t

A constant of 0.629785 means that if the variable X1 (profitability), X2 (leverage), X3 (company size) and X4 (audit quality) are zero, then the Y variable (earnings management) will be positive, which is 0.629785.

VI. DISCUSSION

➢ *Effect of Profitability on Earnings Management*

Profitability can show the ability of a company to make a profit in relation to the assets or capital used to generate these profits. Based on the t statistical test presented in table 4.22, profitability has a coefficient of 1.305949 and a significance value of 0.0000. Therefore, it can be concluded that profitability has a significant positive effect on earnings management, so H1 is rejected.

The results of this study support previous research conducted by Alexander and Hengky (2017), Kamran and Shah (2014), Aygun, et al (2014), Usman and Yero (2012), Lestari (2018), Arfin and Destriana (2016), and Amertha (2013) which states that profitability has a positive influence on earnings management.

➢ *Effect of Leverage on Earnings Management*

High leverage is caused by management mistakes in managing the company's finances or the application of inappropriate strategies from the management. Based on the t statistical test presented in table 4.22, leverage has a coefficient value of 0.089944 and a significance value of 0.4287. Therefore, it can be concluded that leverage has a positive effect on earnings management insignificantly, so H2 is accepted. The results of this study support previous research conducted by Linasmi (2017), Ahmad, et al (2016), Xu (2014), Kamran and Shah (2014), Manzano and Conesa (2014), Usman and Yero (2012), Arifin and Destriana (2016), and Naftalia and Marsono (2013) which states that leverage has a positive influence on earnings management.

➢ *Effect of Company Size on Profit Management*

Large companies, the level of stability tends to be higher and involve more parties. Based on the t statistical test presented in table 4.22, company size has a coefficient value of -0.047539 and a significance value of 0.2109. Therefore, it can be concluded that company size does not have a significant negative effect on earnings management, so H3 is accepted.

The results of this study support previous research conducted by Debnath (2017), Ahmad, et al (2016), Zouari, et al (2015), Manzano and Conesa (2014), Usman and Yero (2012), and Herlambang and Darsono (2015) which states that company size has a negative influence on earnings management.

➢ *Effect of Audit Quality on Earnings Management*

Audit results are reflected in the financial statements presented by the company. Based on the t statistical test presented in table 4.22, the size of the company has a coefficient value of -0.195561 and a significance value of 0.1299. Therefore, it can be concluded that audit quality has a significant negative effect on earnings management, so H4 is accepted.

The results of this study support previous research conducted by Zouari et al (2015) which states that audit quality has a negative influence on earnings management.

VII. CONCLUSIONS AND SUGGESTIONS

A. Conclusions

➢ Profitability has a significant positive effect on earnings management. The higher the profitability of a company, the higher the possibility of the implementation of earnings management practices at the company. The results of this study are not consistent with research conducted by Xu (2014) which states that profitability has a negative effect on earnings management, or Wiyadi et al (2015) and also Saputra (2016) which states that profitability has no effect on earnings management.

➢ Leverage has a non-significant positive effect on earnings management. The higher the leverage of a company, the higher the possibility of the implementation of earnings management practices in the company. The results of this study are not consistent with research conducted by Shirzad and Haghighi (2015) and Aygun, et al (2014) who have stated that leverage negatively affects earnings management, or Alexander and Hengky (2017), Zouari, et al (2015), Wiyadi , et al (2015), Ardison, et al (2010), Saputra (2016), and Christiani and Nugrahanti (2014) who have stated that leverage has no effect on earnings management.

- The size of the company has a significant negative effect on earnings management. The larger the size of the company, the less likely the adoption of earnings management practices in these companies. The results of this study are not consistent with research conducted by Surifah (2015), Xu (2014), and Kamran and Shah (2014) which states that company size has a positive effect on earnings management, or Alexander and Hengky (2017), Wiyadi, et al ((2015), Aygun, et al (2014), Siregar and Darmajaya (2017), Arifin and Destriana (2016), Saputra (2016), Christiani and Nugrahanti (2014), and Sudibyo and Sabeni (2013) which stated that company size had no effect towards earnings management.
- Audit quality has a significant negative effect on earnings management. The worse the quality of the audit, the higher the possibility of the implementation of earnings management practices at the company. The results of this study are not consistent with research conducted by Xu (2014) and Indriastuti (2012) which states that audit quality has a positive effect on earnings management, or Alexander and Hengky (2017), Kamran and Shah (2014), Jordan, et al (2010)), Arifin and Destriana (2016), and Christiani and Nugrahanti (2014) which state that audit quality has no effect on earnings management.

B. *Suggestions*

- Investors are advised to be able to anticipate and be more careful in investing their wealth into several companies. That is because there is a possibility of the adoption of earnings management practices in a company. Earnings management is useful for companies to "beautify" their financial statements, so that many investors are interested in investing their assets into the company.
- The dependent variable used in this study is only four variables which are relatively minimal, so it is necessary to test several other variables that affect earnings management, which totals more than four variables.
- The companies used in this study are only in the metal and other sub-sectors where there are relatively few to represent the sample. Therefore, in future studies it is recommended to use a broader scope of companies to better represent the research sample.
- The research period used is five years which may be relatively few to represent the sample. Future research periods are recommended to add time periods by using longer year periods and of course more up-to-date ones.

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