Whether Reputation of Auditors, Board of Directors, Leverage, and the Initial Public Offering (IPO), Triggering Earnings Management? An Evidance in Indonesia

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Abstract

Earnings management is a management act in financial statement preparing process in order to obtain whether his personality welfare or his company's value. This research is a replication from Dechow et. al (1996) who had tested causes and consequences of earnings manipulation in firms subject to AAER (Accounting and Auditing Enforcement Release) by SEC (Securities Exchange Commission). Purpose of this research is to give empirically evidence the influence of auditor reputation, board of directors, leverage, and public offering stock percentage at IPO time to the earnings management in initial public offering's firms which was listed in Indonesian Stock Exchange at 2014 until 2016. Statistical analysis method used is multiple regression. This research's result shows that leverage has significant influence to earnings management. It is mean that earnings management has a relation with external financing, especially debt.

Keywords: earnings management, discretionary accruals, initial public offering (IPO), leverage

JEL Classification: G2

Introduction

The financial report is a communication medium that is used to connect the parties concerned against the company. The importance of financial statements also disclosed Belkaoui (2000); Adisetiawan & Ahmadi (2016); Adisetiawan & Surono (2016) that the financial report is a means to account for what is done by the manager upon the resource owner. One of the important parameters in the financial statements used to measure performance management is profit. According to Statement of Financial Accounting Concepts (SFAC) No. 1, profit information is a major concern to estimate the performance or accountability of management. In addition spider information also helps the owner or another party in estimating earnings power of the company in the future. The existence of a tendency of paying more attention to profit is realized by management, especially the managers whose performance was measured based on that information, thereby encouraging the incidence of dysfunctional behaviour, which is one of its forms is earnings management.

There has been no clear definition of earnings management. Each researcher gives his definition. Dechow, et. al (1996) define earnings management as earnings manipulation, both inside and outside the bounds of Generally Accepted Accounting Principles (GAAP). Scott (1997) define earnings management as management actions to choose accounting policy of a certain standard with the goal of maximizing welfare and or the market value of the company. Researchers limiting earnings based on their nature, this is because there is still confusion about the terminology earnings in

Financial Accounting Standards Indonesia. Researchers assume earnings consist of cash earnings and accruals components well under policy management (discretionary) or not (nondiscretionary). (Adisetiawan, 2013); (Adisetiawan & Ahmadi, 2016); (Adisetiawan & Surono, 2016)

Earnings management as a phenomenon is influenced by a variety of factors are driving the emergence of the phenomenon of being. There are several factors that influence earnings management. Watts and Zimmerman (1986) as quoted by Sugiri (1998); Adisetiawan & Ahmadi (2016); Adisetiawan & Surono (2016) divided the motivation of earnings management into 3 (three), the bonus plan hypothesis, debt to equity hypothesis, and the political cost hypothesis. The hypothesis of the bonus plan States that managers at the company's bonus plan tend to use accounting methods that will increase your income today. Debt to equity hypothesis States that in companies having debt to equity ratio of the company managers tend to use accounting methods that will increase your revenue or profit. As for the political cost hypothesis States that in large companies, whose activities touch the majority of operations will tend to reduce the reported profit.

Dechow et. al (1996) identify factors demand for external financing, insider trading, debt, bonuses, and governance structure as factors that have an effect on earnings management. There are a variety of proxy used to measure these factors. Some of these are leveraged, the reputation of the auditor, and the number of Board of Directors. In addition to these three factors above, the study also adds one new factor, i.e. the percentage of the shares offered to the public when the IPO.

Theoretical Review
Agency Theory

The concept of Agency theory, according to Anthony & Govindarajan (2007) is a relationship or contract between principal and agent. Principal hires an agent to perform tasks for the benefit of the principals, including the delegation of decision-making authority from the principal to the agent. On corporate capital consisting of shares, shareholders are acting as principal, and the CEO (Chief Executive Officer) as their agent. Shareholder hiring CEO to act in accordance with the interests of the principal.

Agency theory has the assumption that each individual is solely motivated by self-interest so as to give rise to a conflict of interest between a principal and an agent. Principal parties motivated contracting in order to prosper themselves with the always increasing profitability. Agent motivated to maximize the fulfillment of economic and psychological needs, among other things in terms of obtaining investment, loan, or contract compensation. Conflict of interest has increased mainly because the principal cannot monitor the daily activities of the CEO to ensure that the CEO'S work in accordance with the wishes of shareholders.

Principal does not have enough information about the performance of the agent. Agent has more information on the capacity of self, work environment, and the company as a whole. This resulted in the existence of an imbalance of information possessed by the principal and the agent. This information is called the imbalance with the asymmetry of information. The presence of the assumption that individuals Act to maximize himself, resulting in the agent utilizes the existence of information asymmetry that he had to hide some information that is not known to the principals. Asymmetry information and conflict of interest that occurs between the principal and the agent pushing the agent to present information that is not actually to the principal, especially if that information relates to the measurement of the performance of the agent.

Based on the research of Watts and Zimmerman (1986), empirically proven that the relationship of principal and agent is often determined by the accounting figures. This spurred the agent to think about how these accounting figures can be used as a means to maximize their significance. One form of action of these agents is called earnings management.

Earnings Management

Sugiri (1998) definition of earnings management divides into 2 (two), namely: (a) a narrow definition, Earnings management in this case only with regard to the selection of accounting method. Earnings management in this narrow sense is defined as the behaviour of managers to "play" with the discretionary accruals components in determining the magnitude of the earnings; and (b) the broad definition, Earnings management is the Act of a Manager to increase (reduce) the reported current profit of a unit where the manager responsible, without resulting in increased (decreased) long-term economic profitability of the unit.

Sugiri (1998) gives a definition of earnings management is technically, then Surifah (1999) gives his opinion on the impact of earnings management against the credibility of the financial statements. According to Surifah (1999) earnings management can reduce the credibility of financial reports used for decision making, because earnings management is a form of manipulation of financial statements into a means of communication between the company's managers and external parties. Referring to the opinion Sugiri (1998) and Surifah (1999), then the earnings management stated in the perspective of the opurtunistis. In general the study of earnings management stated in opurtunistis perspective than the perspective of efficiency. Points out that the efficiency of the perspectives of managers doing the accounting policy choice to provide better information about cash flow and to minimize the agency cost which occurs because of a conflict of interest between stakeholders and managers (Jiambalvo, 1996).

The Factors that Motivate the Occurrence of Earnings Management

In addition to three (3) factors proposed Watts and Zimmerman (1986); Sugiri (1998); Scott (1997); Adisetiawan & Ahmadi (2016); and Adisetiawan & Surono (2016) suggests several other factors that motivate the occurrence of earnings management, namely taxation motivation, turn of the CEO, and the initial public offering (IPO). The factors tested Dechow et. al (1996) and became a reference in this study is the reputation of an auditor, the Board of Directors, leverage and one variable added researchers i.e. the percentage of the shares offered to the public when the IPO.

Auditor reputation largely determine the credibility of the financial statements. The independence of the auditor and the quality will affect the detection of earnings management. There are allegations that a reputable auditor can detect the possibility of earnings management in more early. The Board of directors effective influence on whether surveillance Performance Manager (CEO). According to Jensen (1993) a number of relatively small Board of Directors can help improve their performance in monitoring Manager. The number of Board of Directors that is too large (in this case Jensen mentions more than 7 people cannot function optimally and will be more easily controlled by the Manager, especially since the Board itself preoccupied by problems of coordination). If the Manager can control the Board of Directors as well as the existence of asymmetry of information then it will more freely for managers perform earnings management.

Leverage used in this study was a comparison between the debts and assets which shows how parts of the assets used to secure the debt. This measure is associated with the presence and absence of an ironclad agreement debt. Companies that have a high leverage ratio due to the large amount of debt compared with the assets owned by the company, allegedly do earnings management because the company threatened to default, that is unable to meet debt payment obligations in due time. The company will try to avoid it by making the wisdom that can increase revenue or profit. Thus, it will give the bargaining positions are relatively better in negotiating or rescheduling the debts of the company (Jiambalvo, 1996).

The percentage of the shares offered to the public when the IPO shows the magnitude of the private information that should be on sharing it managers to the public. Private information is internal information that previously was only known by managers, such as: standard used in the measurement of the performance of the company, the existence of planning bonuses, and so on. The existence of

public investors result in managers are obligated to provide information periodically as the internal form was. According to Jensen (1993) the public has an important role in creating a well-functioning governance system because they have a financial interest and act independently in assessing the management. The larger the percentage of the shares offered to the public, then the greater the internal information that must be disclosed to the public, so it can potentially reduce the intensity of the occurrence of earnings management.

Hypothesis

Ha1: Reputation auditors significant effect on earnings management.

Ha2: Board of directors significant effect on earnings management.

HA3: Leverage a significant effect on earnings management.

Ha4: Percentage of shares offered to the public during the IPO significant effect on earnings management.

Method

The nature of this research is a survey of secondary data. This research is explanatory research, that highlights the relationship between variables and test the research hypotheses are formulated (Singarimbun and Effendi, 1982:6). The population in this research is a company that has been listed on the Indonesia stock exchange period 2014 – 2016. The determination of the sampling done in a purposive, with criteria: (a) the Issuer is a company that did the IPO 2014 up to 2016; (b) Issuers are on the manufacturing industry and other industries in addition to the services and banking; and (c) the issuer has a fiscal year 1 January to 31 December with the summary financial statements in the prospectus at least 2 full years (2 annual reports) before doing an IPO.

The population in this study are 53 issuers incorporated in the Stock Exchange's LQ45 group Indonesia (IDX) during the period from 2014 – 2016; of the population of 53 issuers, gained 37 issuers as final samples based on criteria such as in Table 1. Determination of the total sample in detail are outlined as follows:

Table 1: Determining Number of Sample

Description	Number Of Samples
Issuers incorporated in the Group's LQ45 IDX	53
Reduced: Issuers are not always incorporated in the Group during the period of observation LQ45	16
Issuers that are used as samples per year	37
Number of observations for each of the issuers	3
Total of the units of analysis	**111**

Data Types and Variables

Types of data used are secondary data in the form of financial statements derived from the prospectus, the Board of Directors, the percentage of the total number of shares offered to the public when the IPO, leverage and the accountant audit company samples. All data is obtained from the Indonesian Capital Market Directory. Free variables (the independent variable) in this research is measured as follows:

a. the Auditor Reputation

This variable is a dummy variable, that is, by using a scale of '1' to prestigious auditor and a scale of '0' to an auditor non prestigious. Researchers make tabulating company samples and did a ranking of Auditors based on the frequency of the auditors audit the company's financial report samples. After doing the ranking, 3 prestigious categorized accountant is: Purwantono & Co; Tanudiredja & Co; Doli & Co; Osman & Co; Tanubrata & Co; Amir Abadi Yusuf & Co;

Hendrawinata & Co; Paul Hadiwinata & Co; Kosasih & Co; and Mulyamin & Co (Rangking of Accounting Firms in Indonesia),the way this has been done by Sunariyah (1993) to test the variable influences the reputation of Auditors against the accuracy of the forecast profit.

b. Board of Directors

This variable is also a dummy variable with the criteria refers to research Jensen (1993). The company has a Board of Directors less than 7 people (1-7) were given a scale of 1 (optimal control the alleged management) and more than 7 persons were given a scale of 0 (allegedly not optimal in controlling management).

c. Leverage

This variable is measured by using the ratio of total debt to total assets.

d. percentage of shares offered to the public when the IPO

This variable is measured by the magnitude of the percentage shares are offered to the community as an IPO.

The dependent variable in this research was earnings management as measured by the proxy of discretionary accruals (DA). The use of discretionary accruals as a proxy earnings management in addition to referring to research Dechow et. al (1996); Adisetiawan (2011, 2013); Adisetiawan & Ahmadi (2016); Adisetiawan & Surono (2016) also due to discretionary accruals measurement with current has been used extensively to test earnings management hypothesis. Based on the managerial perspective, accruals showed instruments that support the existence of earnings management. Measurement based on accruals also theoretically more attractive because accruals is a collection of a number of net impact of accounting policy that includes determining portfolio income. Models used to calculate DA is as follows:

$$DA_{it} = TA_{it} - NDA_{it} \tag{1}$$

Notation: DA_{it} = Discretionary accruals company i in year t; TA_{it} = Total accruals company i in year t; and NDA_{it} = Non discretionary accruals company i in t

$$TA_{t-1} = \frac{(\Delta CA_t - \Delta CL_t - \Delta Cash_t + \Delta STD_t - Depr_t)}{A_{t-1}} \tag{2}$$

Notation: ΔCA_t = Delta current assets in year t; ΔCL_t = Delta current liabilities (debt smoothly) in t; $\Delta Cash_t$ = Delta cash and cash equivalents in year t; ΔSTD_t = Delta debt included in current liabilities in year t; $Depr_t$ = the cost of depreciation and amortization in year t; and A_{t-1} = total assets 1 year before t

Counting the Non Discretionary Accruals (NDA) in this study contrasts with the NDA tally conducted Dechow et. al (1996). Dechow et. al (1996) using the calculation period with NDA estimation over 10 years, due to the limitations of the data, then this research using a simple method of calculating the NDA, i.e Industry Adjusted Model. This model uses the same assumption with the market model in calculating adjusted return securities.

Based on the adjusted market model, the best guesses for the estimation of the return of a securities market index return is at the moment. This model does not require a period estimated to form the model estimation due to return the securities being estimated is the same as the market index return. Analogous to the adjusted market model, then the NDA based on industry adjusted models assume that the alleged best to estimate the NDA in 't' is total accruals market (in this case the industrial companies that are doing an IPO or non-IPO) during the period in question. This model can use the central tendency size within the application, either the mean or the median. Industry adjusted model can be formulated as follows:

$$NDA_t = \text{Mean or Median } (TA_{tIND}) \tag{3}$$

Notation: NDA_t = Non discretionary accruals in the period t; and NDA_t = Total accruals industries (the company's IPO as well as non-IPO)

Data Analysis and Hypothesis Testing

Procedures of data analysis and hypothesis testing can be outlined as follows:

a) After all data is recorded then the first step is to calculate the discretionary accruals.

b) Whole variables, either independent or dependent variables included in the analysis.

c) Prior to testing the independent variable influences the strength against the dependent variable, then the first testing done to prove that they had observed the existence of acts of earnings management. The variables tested using the DA_t test t. If t-count > from (+) t-table or t-count < (-) t-table; then in that year they the existence of acts of earnings management.

d) Model used is as follows:

$$Y = b0 + b1X1 + b2X2 + b3X3 + b4X4 + e \qquad (4)$$

Notation: Y = Discretionary accruals; b0 = constant; X1 = the reputation of Auditors; X2 = the Board of Directors; X3 = Leverage; X4 = the percentage of the shares offered to the public when the IPO; b1-b4 = regression Coefficient; e = error

e) Hypothesis testing in this study using the software SPSS (Statistical Program for Social Science). Sequence done:

1. Normality test

So that data is Gaussian then outliers (data that has a value outside of the normal range) were omitted. This method is called with the trimming. The value of his statistics can be found with Kolmogorof-Smirnov test (liliefors). If the value of liliefors-count < value liliefors-tables, then the data is Gaussian (Hair et al., 1998).

2. Goodness of Fit test

This test is intended to find out the best accuracy in regression analysis revealed the determination of the compound by a coefficient (R^2). $R^2 = 1$ means the independent variable effect perfectly against the dependent variable, otherwise if $R^2 = 0$; means the independent variable does not have an effect on the dependent variable.

3. Simultaneous Regression Coefficient Testing – F test

This testing to see if the independent variables are simultaneously affect the dependent variable. If the value of the F-count > F-table; then the independent variable simultaneously affect the dependent variable.

4. Partial Regression Coefficient Testing – t test

This testing to see if the independent variable individually affect the dependent variable. If the value of t-count > (+) t-table or t-count < (-) t-table; then the independent variable individually affect the dependent variable.

5. a Classic Assumption Test Regression

- Autocorrelation test

To find out if there is a perfect correlation between the members of the observation. The detection using the Durbin Watson Test (Gujarati 1991:201). If the value of the Durbin Watson among the du (Durbin Watson a maximum) and 4-dl (Durbin Watson at least), autocorrelation is not happening.

- Multicollinearity test

Multicollinearity is a situation where there is a perfect relationship between some/all of the independent variables in the regression model. The detection is done by using the tolerance value and VIF (Variance Inflation Factor). If the value of the tolerance value > 0.10 and VIF < 10; then multicollinearity does not occur.

- Heteroscedasticity test

Heteroscedasticity means there are variants that are not in the same mistake bullies. The detection is done by the method of Glejser (Arief, 1993) that perform the regression residuals absolute values. If t-caunt between ± t-table, then it should happen heteroscedasticity.

Results

Normality test results showed 17 values of outliers, so data are tested further amounted to 34 companies, with a value of liliefors-count = 0.08 and liliefors tables = 0.23; so liliefors-count < liliefors-tables, which means data is gaussian. Results of the pre-testing (to determine whether the observed earnings management happened) showed the value of t-count = 9,055 and t-table = ± 2.021, so t-count > t-table which means in t (the last period before the IPO) they do a sample company earnings management. Based on the results of the processing of data obtained regression equation Y = -0.169 + 0.096X1 + 0.021X2 + 0.029X3 + 0.019X4 + e, where Y = discretionary accruals as a proxy over the earnings management, X1 = reputation Auditors, X2 = Board of Directors, X3 = leverage, X4 = the percentage of the shares offered to the public when the IPO), and e = error.

Goodness of Fit Test showed the value of R^2 = 36.3 meaning only amounted to 36.3% of the dependent variable can be explained by the independent variable. The results, F-test shows the value F-count = 4.130 and F-table = 2.61; because F-count > F-table, then simultaneously the independent variable effect on the dependent variable. Result t-test and hypothesis testing is indicated as follows:

Table 2: Hypothesis Test Results

Variable	t-count	t-table	Description
X1	2.010	± 2.021	H0 is accepted; or Ha denied
X2	0.434	± 2.021	H0 is accepted; or Ha denied
X3	3.497	± 2.021	H0 is rejected; or Ha received
X4	1.258	± 2.021	H0 is accepted; or Ha denied

Source: processed data

Classical assumptions of regression test
1) Autocorrelation test
   Durbin Watson Test results indicate the value of the Durbin Watson-count = 1.931; While du = 1.728 and dl = 1.208, both of which are retrieved from the tables of values of the Durbin Watson. So, 1.728 < DW-calculate < 2.729; thus not occur autocorrelation.
2) Multicollinearity test

Table 3: Multicollinearity Test Results

Variable	t-count	t-table	Description
X1	0,983	1,017	Non collinear
X2	0,940	1,064	Non collinear
X3	0,987	1,013	Non collinear
X4	0,949	1,054	Non collinear

Source: processed data

3) Heteroscedasticity test

Table 4: Heteroscedasticity Test Results

Variable	t-count	t-table	Description
X1	0,862	± 2,021	Not occur heteroscedasticity
X2	1,069	± 2,021	Not occur heteroscedasticity
X3	-0,593	± 2,021	Not occur heteroscedasticity
X4	-0,233	± 2,021	Not occur heteroscedasticity

Source: processed data

Refers to a hypothesis that has been formulated, then based on the test data obtained the result that the only leverage that effect on earnings management. This can be explained by some alternative possibilities:

1. the company experienced defaults (not able to pay off its obligations at maturity) because of financial difficulties. Companies of this kind are particularly susceptible to the action of earnings management. Usually the action of earnings management is done by the company, when the company learned of the threatened default, i.e. by choosing accounting methods that can increase its profits. Such action can give a better bargaining position when negotiations restart occurs if the company really can't pay off its obligations.

2. Leverage is too high compared to leverage industry in General, resulting in difficulties of a company to acquire additional funds by making loans. This is because creditors refused to lend more money because the lender requires collateral for the funds that are loaned, then it will be difficult for companies that have a high leverage to borrow additional funds without adding equities in advance. Therefore the company did go public or IPO with the purpose of increase of equity through the issuance of new shares, the company may go public with extending search funds. Although the cost to go public is relatively quite large and should bear the risk of reduced control over the company, but by going public the company gets at least 2 (two) advantages, namely the injection of fresh funds gained considerable emission of new shares and most likely the lender will add to the loan fund, due to the risk of loss will be borne by the joint investors. In this case the earnings management is carried out against the financial statements contained in the prospectus with the intention of influencing the perception of investors over the company's performance, so investors willing to infuse capital.

Conclusion

This research aims to test the influence of reputation of the auditor, the Board of Directors, leverage, and the percentage of the shares offered to the public at the moment against the IPO earnings management, which proxied with discretionary accruals. Based on the test results just leverage the influential course significantly to earnings management. The results of this study support findings Dechow et. al (1996) that the debt as a proxy one motivation is the leverage effect, significantly to earnings management. The company threatened default tend to do earnings management by raising profits. This is done in order to improve its bargaining position when negotiations restart or do companies go public to get fresh funds because of the difficulty of searching for loan funds. Earnings management to companies that go public are conducted on the company's financial reports before the prospectus of IPO investors interested in order to infuse capital.

This research has some limitations, that still are the replication. These limitations are, among others: the observation period is relatively short, discretionary accruals and calculation model of total accruals that is still simple, and factors that researched most of the quantitative nature. However, the research is expected to be a reference for other researchers who are interested in researching the phenomenon of earnings management and the factors that affected it.

Implications for research that is coming is coming should research can enhance the action detects how earnings management model that has stood the test of his power. Besides the forthcoming research can also observe earnings management by time period, number of samples, as well as a different event. Event mergers and acquisitions, the adoption of accounting standards and taxation it early, as well as the economic crisis can be event observations over the actions of earnings management.

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