



## Return On Asset, Audit Quality and Accrual Earning Management Practice of LQ 45 Companies Listed in IDX

Tabita Wibowo<sup>1</sup>, Murtianingsih<sup>1</sup>

<sup>1</sup> Faculty of Economics and Business, Institut Teknologi dan Bisnis Asia, Malang, Indonesia

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### Abstract

This study aims to analyze and test the effect of the variable Return On Asset and Audit Quality on earnings management practices at LQ 45 companies listed on the Indonesia Stock Exchange in the 2016-2018 period. The population consists of the LQ 45 companies listed on the Indonesia Stock Exchange. The researchers took the sample with the purposive sampling technique and resulted in 33 companies. The audit quality used is the auditor in the rank the big-four. The type of research is associative causal with quantitative data and secondary data using descriptive statistical analysis, classic assumption techniques, multiple regression analysis, coefficient of determination ( $R^2$ ), and t-test hypothesis. The research result stated that Return on asset dan audit quality has an effect positive and significantly on earnings management practice. An interesting research finding is that the managers of LQ 45 companies tend to do little accrual earnings management.

## Return On Asset, Kualitas Audit dan Praktik Manajemen Laba Perusahaan LQ 45 di Bursa Efek Indonesia

### Abstrak

Penelitian ini bertujuan menguji pengaruh return on asset dan kualitas audit terhadap praktek manajemen laba pada perusahaan LQ 45 di Bursa Efek Indonesia tahun 2016-2018, dengan sampel perusahaan yang konsisten terdaftar di LQ 45 selama tiga tahun yaitu sejumlah 33 perusahaan. Kualitas audit yang digunakan adalah auditor dengan peringkat "the big four". Jenis penelitian ini adalah asosiatif kausal dengan data penelitian yang digunakan adalah data kuantitatif dan sumber data sekunder. Analisis data yang digunakan adalah statistik deskriptif, uji asumsi klasik, analisis regresi berganda, koefisien determinasi ( $R^2$ ) dan uji t. Hasil penelitian menyatakan bahwa return on asset dan kualitas audit berpengaruh positif signifikan terhadap praktik manajemen laba. Kemampuan kedua variabel tersebut menjelaskan praktek manajemen laba juga cukup baik. Temuan penelitian yang menarik adalah bahwa manajer perusahaan LQ 45 ternyata cenderung sedikit melakukan accrual earning management.

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Correspondence Address

Institutional address: FEB Institut Teknologi dan Bisnis Asia, Malang

E-mail: [murtia.ningsih78@gmail.com](mailto:murtia.ningsih78@gmail.com)

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One of the managerial performance measurements is the corporate capability to analyze the profit information in the financial report. The stable profit earning in each period or the proportionally increased profit based on the capability or assets indicate the excellent corporate performance (Davidson, Goodwin, Stewart & Kent, 2005; Yaping, 2005; Iskandar & Suardana, 2016). The earning or profit information presented in a financial report becomes the targeted action of opportunistic managers to actualize their intentions. Managers use the opportunities to manipulate the corporate earnings, known as *window dressing*. Window dressing is a financial report presentation with certain accounting policies about the corporate profits or financial portfolio presented based on the certain intention of agents or managers. Thus, the report seems excellent (Zaidi, Akhter & Akhtar, 2018).

The opportunistic actions by managers appear due to information asymmetry between the managers and the shareholders as the owners in which the managers are fully aware of the corporate operation activities and have the authority to arrange the financial report. Managers are those with the information of corporate internal conditions and prospects. The investors or principals only use the presented information to know the

condition and the prospect of a company in the future.

Purwanti, Triyuwono, Irianto & Riduwan (2015) argue that managers must ensure corporate performance improvement although the economic situation has a lot of turbulence. They must ensure it even when the performance is lower so that the organization attempts to do anything to manipulate the data. Thus, the data seem positive from the managerial and financial performance perspectives in front of the shareholders. This action is called accrual earning management. This earning management aims to make the profit or earning equal for each year. Thus, it can be used as the managerial success measurement in running the organization (Bell & Carcello, 2000). The accrual earning management practices became an interesting issue for these recent two decades. It could be used as the financial report quality standard (Ali & Kamardin, 2018).

The *agency theory* of Jensen and Meckling (1976) explains that the agency relationship appears when the shareholders employ agents or hire the agents to run business activities and delegating the authorities to decide on the agents. The frequent problem with the agency theory is the agent conflict because the shareholders and the agents have different motifs.

These different motifs or interests lead both parties to earn profits for themselves. The shareholders want the maximum return of their investment while the agents want higher bonuses or compensation for their performance. The conflict becomes the trigger of accrual earning management.

This practice is mostly done by managers that are the agents of companies due to the agent conflict. The agents intentionally make and intervene in the financial report or manipulate the accrual components of the financial report. They determine or change the estimated value so the financial reports seem excellent in front of the shareholders. Yaping (2005) defines earning management, from various perspectives, as profit manipulation, profit deviation, and creative accounting report. Profit manipulation refers to the reported profit or earning by a manager with a certain demanded level but it is still under the accounting standard normality and corporate policy in which profits or earnings are the reflections of the corporate performance. On the other hand, the profit deviation is the profit manipulation made outside of the accounting standard normality. It is by reducing the corporate value expectation. The creative accounting report refers to earning or profit manipulation that is still

under the accounting standard normality threshold.

Scott (2009:325) defines “*Earnings management as the choice by a manager of accounting policies or actions affecting earnings, to achieve some specific reported earnings objectives.*” Sastradipraja (2010: 33) argues the managers committed the earning management based on the accounting principles and correct accounting standards, or normal earning and loss estimation. Thus, earning management will be useful for the company. This action is known as *cosmetics earning management*. Contrary, if the earning management does not adhere to the principles and the accounting standard, the earning management practice will influence negatively because of the obtained incentive. This action is known as *real earning management*. The investment decision and financial decisions by managers influence the incentive to commit the earning management. Therefore, real earning management is troublesome compared to *cosmetics earning management*.

Some previous researchers found that earning management might lead to information asymmetry between the managers and the shareholders. Managers might also argue that their earning management practice had the purpose to improve the financial report, increase the

profit, and improve the market value (Alzoubi, 2016; Kanagaretnam, Lobo, & Wang 2015; Leventis, Dimitropoulos & Anandarajan, 2011). Some previous studies found that the practice was an earning smoothing effort by replacing the losses of some periods so that the profit would be stable for each period (Kanagaretnam, Lobo, & Yang, 2005; Lobo & Yang, 2001). It means the managers commit the earning management.

Return on Asset is a profitability ratio that assesses the corporate capability to create profit and as the standard of managerial success in running the corporate activities (Kasmir, 2015: 114). This ratio uses the asset as the corporate earning capability measurement. ROA is also the information source for the investors' considerations while assessing the performance. If the ROA is positive, the investors will receive the gain potency.

Iskandar & Suardana (2017), Peranasari & Dhamandiaksa (2015), and Ramanuja & Mertha (2015) found that ROA positively influenced the earning management practice. The higher changes in ROA cause higher corporate earning fluctuation. Thus, the managers attempt to manage the earning so that the reported earnings will not fluctuate so that investors will believe. On the other hand, Irawan (2016) and Mahardini & Juwita (2018)

found that ROA did not influence the earning management practice. It means the higher ROA of a company does not stimulate the agent to commit to earning management. The research discrepancy that occurred specifically in Indonesia, made the researchers wanted to investigate the influence of ROA on the earning management practice by managers (agents).

One of the ways to detect the earning management is promoting the audit. Christiani & Nugrahanti (2014) argue that qualified auditors could detect the earning management of the clients. An audit service is a monitoring tool toward any conflict interest possibility between the principals or shareholders and the managers or among the shareholders with different ownerships. Some joint auditors in Public Accountant Office initiate this service. The audit quality could be measured with the measurement of the Public Accountant Office/KAP, the big-four and non-big-four PAC, and the specialists of office auditor.

In this research, the applied audit quality is the KAP auditor services, the big four because qualified auditors could find errors or bias in a financial report. These auditors will not accept any doubtful accounting practices (Bartov, Gul & Sui, 2000). The big four auditors are more

qualified than those non-big-four auditors (Caneghem, 2004). Rusmin (2010) explains that qualified audit negatively influences the earning management practice. It means the audited financial report by reputable auditors could provide valid information and be free from earning management practices. Khalil & Ozkan (2016) also argue that reputable auditors could detect the manipulated earning because they gamble on their names as reputable auditors. Alves (2013) and Lin, Ly & Yang (2006) found that the audit quality of the big four positively and significantly correlated with the earning management practices. However, Davidson, Goodwin, Steward & Kent (2005) found an insignificant correlation between audit quality and earnings management.

In Indonesia, the earning management issue becomes an interesting topic. The managers potentially commit the practice for their interests or attract investors especially from the large companies in the capital market. One of the preferred companies by investors is the listed company in LQ 45. It is because the performance is excellent and provides future benefits that are liquid. In 2016-2018, the corporate trading capitalization of LQ45 is still high. It shows the high interest of the investors toward the stocks of the companies. Therefore, the

researchers were interested to investigate how the earning management practices in the LQ45 indexed companies because the previous studies were not consistent.

The managers of LQ45 companies had the skill to manage the earning and to predict the profits and risks. A higher ROA value shows the management's capability to earn many profits thus investors will trust the companies. The LQ45 indexed companies have high capitalization in the exchange. Many investors think of the excellent financial or fundamental conditions, the stable tendency of corporate manipulation, and better prospects observed from the produced ROA. Thus, they prefer investing in these companies. ROA shows the managerial capability to earn profit by using the applied asset in the operation. This matter influences the investors to predict the profit and risk of the investment. Thus, it influences the investors' trust.

ROA influences the earning management practice. Higher ROA indicates the company's capability to earn higher profit with the current asset. Companies with highly increased earnings have the potentials to decrease the earning. Thus, their earnings seem stable. This action also has something to do with the tax paid by the companies. Managers must show excellent financial management to

avoid any failures seen by investors. This action benefits the managerial party. The management can save the position or the official rank in the companies. It is because the manager's performance is considered excellent by the shareholders. Investors will trust the increased earning level because the corporate earnings reflect how the company gives advantages to the investors. Peranasari & Dhamadiaksa (2014), Ramanuja & Mertha (2015), and Iskandar & Suardana (2016) found that ROA influenced earning management. From the explanation, the first hypothesis formulation is

**H<sub>1</sub>: ROA influences the earning management practice**

Investors can consider the information quality of financial performance from the audit quality. The audit quality is observable from the auditor quality because it influences the audit results. Auditors that work in the big four Public Accountant Office are seen as more qualified because they have some training, procedures, and accurate and effective audit programs than the non-big four PAO. Thus, the audit quality could minimize the earning management action. Most corporate financial reports of the LQ45 indexed companies are audited by

the big four PAOs. Thus, the LQ45 indexed companies are considered free from earning management practices. Christiani & Nugrahanti (2014) and Chen, Lin, & Zhou (2005) found the influence of audit quality on earnings management. Maijoor & Vanstraelen (2006) argue that the audited financial report by the big four is more qualified than those non-audited by the big four. It is because the information is free from discretionary accrual or earning management practice. From the explanations, the second hypothesis formulation is:

**H<sub>2</sub>: The audit quality influences the earning management**

## **METHOD**

This research is associative causal research, examining the influence of ROA and audit quality toward the corporate earning management practice of LQ45 indexed companies in Indonesia's capital market. The researchers took the samples with the purposive sampling technique. The criteria of the companies were companies indexed in LQ45 for three years. The results were 33 companies. The researchers researched in 2016-2018. The operational definitions are:

1. Earning management as the dependent variable (Y)

Earning management refers to the manipulations and decisions to reach certain demanded earning levels (Belkaoui, 2001). The earning management detection uses the Healy model, calculated with the following formula:

$$TAC = \frac{\text{Laba bersih setelah pajak}}{\text{Arus kas operasi}}$$

$$NDA = \frac{TAC}{TA}$$

NDA = Estimated *nondiscretionary accruals*

TAC = Total Accrual

TA = Total Asset

2. ROA as the independent variable (X<sub>1</sub>)

*Return on Assets* (ROA) indicates the corporate capability to produce net profit based on certain asset levels. The calculation of ROA is by dividing the net profit after the tax is divided by the total asset (Kasmier, 2015: 201).

$$\text{Return On Assets} = \frac{\text{Earning AfterTax}}{\text{Total Assets}}$$

*Return on Asset* = Corporate capability to earn profit

*Earning after Tax* = Earning or profit gained after being divided by tax

Total Asset = Current asset + fixed asset

3. The audit quality as the independent variable (X<sub>2</sub>)

An audit service can detect the conflict of interest possibilities among the owners, managers, and shareholders toward the different amount of holdings. The audit quality could be measured with the measurement of PAO/KAP (The big four PAO and the non-big four PAO), the specialists of industrial auditors, and the dummy variable - the audited companies by the big four PAO (scoring 1) and non-big four PAO (scoring 0).

The researchers tested the hypotheses by analyzing the significance or the regression (the beta coefficient) of the ROA and the audit quality on a certain significant level ( $\alpha = 5\%$ ). The applied regression model is:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + e$$

Remarks:

Y = Earning management

$\alpha$  = Constant value

$\beta_1$  = the regression coefficient of ROA

$\beta_2$  = the regression coefficient of audit quality

X<sub>1</sub> = the produced profitability on the ROA

X<sub>2</sub> = the audit quality

e = error

The next applied analysis is the determinant coefficient (R<sup>2</sup>) to measure the



capital model in explaining the independent model variations toward the dependent variables or as the influential proportion for all independent variables toward the dependent variable.

**FINDINGS AND DISCUSSIONS**

The researchers used multiple regression to examine the hypothesis. They had done this phase for all variables and found all variables had normal distributions and were free from autocorrelation. From the normality test, the *one-sample Kolmogorov-Smirnov* test showed the value of 0.050, with a significant level of 0.962. The significance,  $0.962 > 0.050$ , indicated the data had normal distributions. The autocorrelation test, with DW 1.459 between -2 and +2 or  $-2 < 1.459 < 2$ , indicated the variables were free from autocorrelation.

The descriptive statistics results of the variables are in Table 1. The table

shows the median of earning management is higher than the mean. It means the LQ45 indexed companies tended to commit less earning management. The same results go for both ROA and audit quality. It indicated an interesting phenomenon that even the initial assumption of the LQ45 indexed companies hired the qualified auditing service but the data show lesser qualified audits. The ROA also has a higher median than the mean. It indicates the LQ45 managers, as the respondents, committed less "engineering" of ROA data in the corporate financial reports.

This phenomenon was interesting especially if the focuses were on the earning management and audit quality data. The less "engineering" action of ROA seemed contradictory with the earning management based on the accrual, normal, and acceptable accounting standard and method (Dechow, Kothari, & Watts, 1998). This result confirmed the study of

**Table 1 The Descriptive Statistics Results**

	N	Minimum	Maximum	Mean	Median	Std. Deviation
ROA	99	-1.00	31.35	5.0831	6.2700	5.80548
AUDIT QUALITY	99	.00	1.00	.6970	1.0000	.46191
ENG MGT	99	-.17	.11	-.0171	-.0121	.05605
Valid N (listwise)	99					

Source: The processed data, 2020

Graham, Harvey, & Rajgopal, cited in Asim & Ismail (2019). They found that 80% of managers tended to participate in *real earning management*. They did it by manipulating the earning based on the real business asset (transaction). Therefore, the real earning management was difficult to detect because the manipulation existed within the real business transaction. Thus, the managers tend to use the earning management via the real business asset to cover their actions and evade the auditors or the policymakers (Roychowdhury, cited in Masri, 2018).

Then, the researchers analyzed the data multiple linear regression analysis to test the hypotheses. The output of the regression model analysis is in the presented equation (Table 2).

The Table 2 shows the regression analysis result. The variable coefficient substitutions will result in:

$$\text{Earning management} = -0.068643 + 0.003401_{ROA} + 0.021834_{\text{Audit quality}} + e$$

The constant value is -0.068643. It means the independent variables, *ROA*, and *audit quality* is constant. Thus, the earning management decreases. On the other hand, the regression coefficient of *ROA* is  $\beta_1 = 0.003401$ . It means the *ROA* increase could increase the earning management with the assumption of constant audit quality variable. The regression coefficient of audit quality is  $\beta_2 = 0.021834$ . It means the audit quality could increase the earning management with the assumption of a constant *ROA* variable.

The hypothesis test shows the significant influence of *ROA* toward the earning management practice with a significant level of 1%. Thus, the result accepts the first hypothesis,  $H_1$ . It means there is a potency of corporate managers to commit the earning management practice to modify the corporate performance and gain the shareholders' trust. Thus, the managers will obtain rewards or bonuses

**Table 2. The Multiple Linear Regression Analysis**

Model	Unstandardized Coefficients		Standardized Coefficients Beta	t	Sig.
	B	Std. Error			
(Constant)	-0.068643	0.008759		-7.837	.000
ROA	0.003401	0.000963	.352	3.532	.001
AUDIT QUALITY	0.021834	0.010260	.180	2.128	.036

Source: The processed data, 2020

due to the excellent corporate performance. This motif triggered the earning management potency by manipulating the financial performance via *return on assets* presented in the financial report. With stable return on an asset or the increased return on asset proportionally, it could give benefits for the investors. However, the managers had to think about the paid tax amount by the companies. This phenomenon made the earning management practice seemed under normal and tolerated levels by the accounting policy. This result was in line with the earning management practice theory. Some previous studies by Rifky (2017) and Iskandar & Suardana (2016) also found the influence of ROA on earning management.

This result also confirmed the studies of Asim & Ismail (2019) in Iran and Nawaiseh (2016) in Jordan. They found that ROA positively and significantly influenced earning management. Both researchers used ROA as the control variable to examine the influence of leverage and audit quality on earning management. It meant ROA caused the managers to commit to earning management. However, the applied data of earning management in their studies were different from this study. Asim & Ismail (2019) used the *discretionary accruals* instead

of the *non-discretionary accrual*, adopted from the modified Jones' model by Dechow, Sloan & Sweeney (1995). Nawaiseh (2016) used the *discretionary accruals* from 13 banking companies in Jordan listed in Amman Stock Exchange. Their reason to use the *discretionary accrual* was the large companies usually applied greater accruals so the corporate accrual values would be abnormal. Besides that, the authors also used panel data instead of the *time series* data. Thus, it was different from the current research. The time-series data had some weaknesses of data consistency. Therefore, it could be a consideration to improve future studies.

Then, on the t-statistic test result of the audit quality showed the significant influence of earning management practice. The audit quality of LQ45 indexed companies still had earning management practice potential with the *discretionary accrual* presented in the financial report. The earning management practice was still under the normal level of accounting policy and did not influence the corporate cash flow. This research result supported the study of Christiani & Nugrahanti (2014) and Nawaiseh (2016). They found that the corporate affiliation with the big four PAO significantly influenced the earning management committed by managers. Masri (2018) found that companies with

high audit quality could decrease the accounting managers' flexibility that would encourage them to commit *real earning management*.

This research result confirmed the descriptive data that the managers of LQ45 tended to commit less *accrual earning management*. This matter could cause the managers to use the big four PAO audit service to create accrual accounting parameters. Therefore, they tended to commit lesser *accrual earning management*.

This finding was more interesting than the influence of ROA on earning management. It showed that audit quality had a greater influence than ROA on earning management. It meant the trigger of earning management, found in this research, involved lesser *accrual earning management*. The cause seemed to be the audit quality. Thus, this research result confirmed Masri (2018). The author investigated 213 companies in Indonesia listed in IDX from 2010-2013. The companies in the research used substitution methods for their earning management, from the *accrual earning management* into *real earning management* triggered by the audit quality. The audit quality decreased the accounting managerial flexibility.

The next analysis was based on the observation of the reliability of the model

to explain the phenomena. It was by measuring the determinant coefficient with *Adjusted R Square*. The determinant coefficient value is in Table 3.

**Table 3. The Determinant Coefficient**

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.634 <sup>a</sup>	.402	.376	.04427

a. Predictors: (Constant), ROA, K.AUDIT

Source: The processed data, 2020

The table shows the determinant coefficient of the model (adjusted R<sup>2</sup>) is 0.376. It means the *return on asset* and audit quality influence the earning management with a percentage of 37.6%. The remaining percentage, 62.4%, was from the unobserved variables. It proved that ROA and audit quality could averagely explain the earning management committed by LQ45 managers. Although this matter was excluded from the research hypotheses the results showed ROA and audit quality were the important predictors of earning management (Nawaiseh, 2016; Asim & Ismail, 2019; Masri, 2018). Therefore, the next researchers should consider this variable as the control variable to conduct an investigation outside of ROA and audit quality.

## CONCLUSION AND LIMITATION

From the data analysis results, the hypothesis test, and the discussion about the LQ45 indexed companies listed in IDX from 2016-2018, ROA influenced the earning management. It was because of the managers' motivations to commit to earning management based on their intention to obtain maximum bonuses from their performance. On the other hand, the audit quality variable influenced the earning management although the managers did it by presenting the *discretionary accrual*. Thus, the management was still under normality and the corporate cash flow did not show any significant changes.

Companies must pay attention to the results about audit quality and so do shareholders. Higher audit quality decreases accounting flexibility so that managers tended to commit to real earning management. This result should be confirmed by future studies in a specific manner, by connecting the real earning management, the audit quality, and the accounting flexibility.

The limitations of this research were the applied variables to detect the earning management practice, only with ROA and audit quality. There were many variables to detect the earning

management, such as *net profit margin*, *Good Corporate Governance*, *debt to equity*, and other performance measurement variables. The researchers suggest the future researchers examine the other influential variables, outside of ROA and audit quality. Thus, these variables could be used as the control variables because of their excellent contributions toward earning management. Thus, future studies should explain clearly the other variable influences outside of ROA and audit quality toward the earning management.

Besides that, the applied data in this research were *time series* so they must be checked in terms of reliability with the panel data. Thus, the data analysis method should be adjusted to create perfect analysis in the future.

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