CURRENT ADVANCED RESEARCH ON SHARIA FINANCE AND ECONOMIC WORLDWIDE
(CASHFLOW)

FACTORS AFFECTING EARNING MANAGEMENT IN MANUFACTURING COMPANIES ON THE INDONESIAN STOCK EXCHANGE

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Abstract

The aim of this study is to gather empirical data on how factors like growth, company size, return on assets, debt ratio, size of audit firm, presence of an independent board of commissioners, and the size of the board of directors impact earnings management in the Indonesian stock market. The research focused on manufacturing companies listed on the Indonesia Stock Exchange between 2017 and 2019. By using a purposive sampling technique and identifying 73 qualifying companies, the study conducted data analysis through multiple regression. The findings indicate that return on assets plays a significant role in influencing earnings management. Conversely, factors such as company growth, size, debt ratio, audit firm size, presence of an independent board of commissioners, and board size do not have a discernible impact on earnings management practices within the companies.

Keywords: *Earnings Management, Discretionary Accruals, Leverage, Firm Size, Sales Growth*

1. INTRODUCTION

Financial reports are responsible for the final results of the accounting process to assess company management performance. One measure of company management performance is the analysis of profit information in financial reports. Therefore, Management's opportunistic actions frequently aim to maximize satisfaction by exploiting profit information, potentially harming external parties.

Opportunistic actions are often carried out by regulating company profits, namely by increasing or decreasing profits, and there are also differences in interests between management and external parties, which encourage company management to manipulate financial reports. Earnings management refers to the strategies implemented by executives to influence financial results (Roychowdhury, 2006). All parts of the financial report are essential in making decisions. However, users of financial reports often focus on the profit information contained in the comprehensive income statement without paying attention to the procedures used to produce the profit or loss. The comprehensive income statement contains valuable profit information for interested parties, such as internal and external parties (Karina & Sutandi, 2019). PT Kimia Farma Tbk is estimated to mark up net profit in 2001. Kimia Farma reports that they have succeeded and earned a profit of IDR 132 billion; in reality, it was different. This pharmaceutical company only made a profit of IDR 99 billion or lower than reported (Stephanus, 2018). Based on this case, the author was motivated to conduct further research titled "Factors that Influence Earnings Management in Manufacturing Companies on the Indonesian Stock Exchange." This research is a replication of research by Debnath (2017).

The objective of this study is to present factual data on how sales growth, company size, return on assets, leverage, audit committee size, independent board of commissioners, and board of directors impact earnings management. The intention is for this research to offer assistance to upcoming researchers, investors, and corporations, both directly and indirectly.

2. LITERATURE REVIEW

2.1. Agency theory

This theory assumes that each has its interests between the principal and management, so it can create a conflict of interest between the principal and management. Usually, conflicts in companies arise because there is excess cash flow, which causes differences in interests. After all, shareholders like investments with a high rate of return where the level of risk is also high, and conversely, agents want investments with a low level of risk, and the rate of return will also follow the risk (Chandra & Djahsan, 2018; Jensen & Meckling, 1976; Siahaan et al., 2023). Usually, agency problems do not arise in private companies because the company owner also serves as the company manager; there cannot be differences in interests between the owner and the manager. For private companies, there is usually a separation between the owner and the manager. Conflicts of interest are not limited to just owners and management, as they can also occur between majority shareholders and minority shareholders (Sudana, 2009).

2.2. Earnings management

Earnings management is a subject frequently debated and captivates the attention of many authors in the accounting field. Numerous research papers analyze how company traits influence the manipulation of earnings (Khanh & Thu, 2019). Profit information is often used as a basis for measuring the success or failure of a business in achieving operational goals. Management is motivated to alter earnings data in order to present financial statements in a positive light, a practice known as earnings management (Susanto et al., 2017).

2.3. Sales Growth and Earnings Management

The key measure of progress in this study is the increase in sales, as it can demonstrate the effectiveness of past investments and serve as a predictor for future sales growth and enhanced company revenue. Sales growth is evident in the fluctuations of sales figures from the previous year to the subsequent year; if the company experiences an increase in its operations, it experiences good growth (Karina & Sutandi, 2019).

Several indicators can measure a company's growth level, for example, growth in sales, assets, and share prices. If the indicators used produce high values, it can be concluded that the company is growing and will experience an increase in profits (Puspita & Febrianti, 2017).

Ha1: Sales growth influences earnings management

2.4. Company Size and Earnings Management

The size of a company is determined by evaluating its financial performance, which is reflected in the total assets listed on its financial statements. Company size can show the company's performance regarding its activities and operations (Dewi et al., 2017).

Company size is defined as an assessment of how large or small a company is. Company size is essential for investors and creditors because it relates to the risk of investing. Medium-sized and large corporations face increased pressure from stakeholders (Astari & Suryanawa, 2017).

Ha2: Company size influences earnings management.

2.5. Return on Assets and Earnings Management

Return on assets is a financial metric that evaluates the profitability of a company by comparing the profits generated with the assets it owns. A higher ROA value indicates superior performance and effectiveness in management (Karina & Sutandi, 2019). Yuliana and Trisnawati (2015) states that companies utilize return on assets as a metric to evaluate the effectiveness of management in generating profits as a whole. A higher return on assets indicates that the company is more adept at utilizing its assets efficiently to achieve substantial profits. However, excessively high returns may lead managers to manipulate earnings in order to attain larger profits.

Ha3: Return on assets influences earnings management.

2.6. Leverage and Earnings Management

The proportion of total liabilities to total assets is known as leverage. When the leverage ratio is higher, the company's debt value increases, leading to a tendency for the company to use earnings manipulation to prevent breaches of debt agreements (Astari & Suryanawa, 2017; Siahaan et al., 2023a, 2024). The concept of leverage involves assessing the proportion of a company's assets that are funded through borrowed money. This ratio shows the level of debt in relation to the total assets owned by the company (Karina & Sutandi, 2019). Companies use leverage to finance their assets and carry out their operational activities. A literature review on earnings management explains that leverage limits earnings management actions (Dewi & Wirawati, 2019).

Ha4: Leverage influences earnings management.

2.7. Audit Committee Size and Earnings Management

The audit committee serves as a link between external auditors and company management, therefore it is crucial for the audit committee to maintain independence while fulfilling its responsibilities (Lestari & Murtanto, 2017). The audit committee was created by the board of commissioners and directors to provide assistance and oversight in the creation of high-quality financial reports in compliance with relevant laws and regulations, ensuring accountability (Syahreza et al., 2016). The audit committee plays a role in ensuring the quality of the company's financial reporting because it is related to financial reports, so the information presented can be relied upon by interested parties in decision-making (Asitalia & Trisnawati, 2017).

Ha5: Audit committee size influences earnings management.

2.8. Independent Board of Commissioners and Earnings Management

The autonomous board of commissioners acts as an independent entity responsible for overseeing and offering advice and instructions to the leadership of the organization (Fahmie, 2018). An independent board of commissioners tends to influence earnings management because the composition of commissioners can provide practical contributions to the results of the financial report preparation process, which is likely to avoid fraud (Puspita & Febrianti, 2017). The Board of Independence is relied upon to avoid the possibility of information imbalances and deviant management actions. The independent commissioners' board is responsible for guaranteeing the company's business strategy is effective, adheres to the necessary laws and regulations, and correctly implements the principles and practices of good corporate governance (Arifin & Destriana, 2016).

Ha6: The independent board of commissioners influences earnings management.

2.9. Board of Directors Size and Earnings Management

The board of directors consists of individuals chosen by shareholders to advocate for the company's best interests. It has the ability to limit or stop managers from engaging in deceptive financial practices such as earnings management actions; the presence of parties involved in financial management will encourage management to provide actual company information. The more parties who manage a company, the smaller the company will practice earnings management (Taco & Ilat, 2016). The board of directors is not known in statutory regulations, but the term is known as directors. The responsibility of leading and managing the company to accomplish specific objectives lies with the board of directors (Chandra & Djahsan, 2018).

Ha7: The earnings management is affected by the size of the board of directors.

3. RESEARCH METHODS

Causality research is the type of research methodology that examines how independent variables interact with the dependent variable to establish a cause-and-effect relationship (Sekaran & Bougie, 2016). The objects used in this research are manufacturing companies listed on the IDX. The companies included in the study have been in operation for a period of three consecutive years, spanning from 2017 to 2019. The selection process employed in choosing these companies was purposive sampling. The table below is the procedure for selecting samples:

Table 1. Sample Selection Procedure

No.	Description	Amount of Data	
1	Manufacturing companies consistently listed on the Indonesia Stock Exchange (BEI) during 2016-2019.	145	435
2	Manufacturing companies that do not use Rupiah as currency in financial reports during the 2016-2019 period.	-34	-102
3	Manufacturing companies that do not present financial reports ending 31 December 2016-2019.	-37	-111
4	Manufacturing companies inconsistently obtained net profit after tax during 2016-2019.	1	3
	Total manufacturing companies used as research samples:	73	219

In this study, earnings management is used as the dependent variable. Altering financial statement information in order to mislead stakeholders about the company's performance and status is known as earnings management. This intervention is used as a basis for some parties to assess earnings management as fraud (Sulistyanto, 2008). In Debnath's (2017) research, earnings management is often evaluated using proxies such as discretionary accruals, which are calculated through the application of the cross-sectional modified Jones Model from 1995.

$$TAit / Ait{-}1 = \alpha 1\ (1/Ait{-}1) + \alpha 2\ (\Delta REVit - \Delta RECit)/Ait{-}1 + \alpha 3\ (PPEit\ /Ait{-}1) \ldots\ldots\ldots\ldots\ldots (i)$$

$$DAit\ /Ait{-}1 = TAit\ /Ait{-}1 - NDAit\ /Ait{-}1 \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (ii)$$

Information:

$\alpha 1$, $\alpha 2$, and $\alpha 3$ in the formula above are company-specific parameters.

TA_{it} =	total accruals of the company i in year t, estimated as the excess net profit of company I in year t (NIit) exceeds cash flow from operations in year t (CFOt)
A_{it-1} =	total assets of company i in year t-1
ΔREV_{it} =	change in company's income i from year t-1 to year t
ΔREC_{it} =	change in company's receivables i from year t-1 to year t
PPE_{it} =	property, plant, and equipment of company's i in year t, using gross value.
i and t =	company name and period

This research measures growth by looking at sales growth or sales growth. The growth of sales is determined by comparing the current year's sales volume to sales from the previous period. Businesses experiencing substantial sales growth are anticipated to have less incentive to participate in revenue management tactics (Abbadi *et al.*, 2016). In this research, Sales Growth uses a proxy from research Yunietha and Palupi (2017): $(Sales_{it} - Sales_{it-1})/Sales_{it-1}$. Assessing a company's financial performance can be determined by its size, as reflected in the assets reported in its financial statements. Company size can show the company's performance regarding its activities and operations (Dewi *et al.*, 2017). Debnath's (2017) measures Company Size with the current year's log value of total assets or *Size = Log (Total Assets)*.

Yuliana and Trisnawati (2015) explained that corporations utilize return on assets as a metric for assessing the effectiveness of management in generating profits. A higher return on assets indicates that the company is utilizing its assets efficiently, resulting in larger profits. The proxy used to measure Return on Assets is from research Firnanti *et al.* (2019): *Net Income After Tax/Total assets.* The relationship between total liabilities and total assets is known as leverage. A higher leverage ratio indicates a greater value of the company's debt. When a company has a high leverage ratio, the amount of debt surpasses the amount of assets. Additionally, companies may engage in earnings manipulation as a result (Astari & Suryanawa, 2017). In this research, the leverage variable uses measurements that refer to research Jatiningrum and Popoola (2016): *Total liabilities/Total Assets*.

The Audit Committee, established by the Board of Commissioners and Directors, provides support and oversight to the Board of Directors in creating accurate financial statements in compliance with laws and regulations, as well as ensuring accountability. (Syahreza *et al.*, 2016). The effectiveness of the audit committee is evaluated using a ratio scale that considers the number of members it comprises, who are stakeholders of the company: the measurement uses research Firnanti (2017): *Total audit committee in the company*. The Board of Independence is a minority interest representative relied upon to avoid the possibility of information imbalances and deviant management actions. The independent board of commissioners is responsible for overseeing the company's business strategy to ensure effectiveness, adherence to laws and regulations, and proper implementation of principles and practices of good corporate governance (Arifin & Destriana, 2016). The measurements used in the research Arifin and Destriana (2016) are: *The board of commissioners consists of both independent and total members.*.

The board of directors includes people chosen by shareholders to advocate for the best interests of the company, one of which is being able to reduce or prevent managers from carrying out earnings management actions. Having parties involved in financial management will encourage management to provide actual company information. The more parties who manage a company, the smaller the company will practice earnings management (Taco & Ilat, 2016). The measurement of the Board of Directors size variable uses a proxy in research Taco and Ilat (2016) as follows: *The total number of directors with board membership.*

4. RESULTS AND DISCUSSION

Descriptive statistics offer a summary or portrayal of data through metrics such as mean, variability, highest, and lowest values. Below are Tables 2 and 3 displaying the outcomes of descriptive statistical analyses as well as the findings of hypothesis testing:

Table 2. Descriptive statistics

Variabel	N	*Minimum*	*Maximum*	*Mean*	*Std. Deviation*
Earnings Management	219	-0,33371	1,18081	4,56E-08	0,107878
Sales Growth	219	-0,53135	0,858872	0,082451	0,16697
Company size	219	10,95098	14,54649	12,481408	0,671481
Return on assets	219	0,000281	0,920997	0,081107	0,09958
Leverage	219	0,083064	1,947496	0,411907	0,227545
Audit Committee	219	3	5	3,1	0,357
Board of Independence	219	0,2	0,8	0,419107	0,104723
Board of directors	219	2	14	5,32	2,287

Source: Data Processing Results

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Table 3. t-Test Results

Variabel	B	*Sig.*
(*Constant*)	0,172	0,266
Sales Growth	0,041	0,318
Company size	-0,02	0,128
Return on assets	0,503	0
Leverage	0,048	0,116
Audit Committee	0,014	0,469
Board of Independence	-0,054	0,436
Board of directors	-0,002	0,659

Source: Data Processing Results

According to the data in the table provided on the t-test outcomes, the research model's regression equation can be expressed in the following manner:

$$DA = 0.172 + 0.041\ GWT - 0.020\ SIZE + 0.503\ ROA + 0.048\ LEV + 0.014\ UKA - 0.054\ DKI - 0.002\ UD + \varepsilon$$

The sales growth variable has a significance value (sig). Amounting 0.318 is greater than the alpha value (0.05), which means Ha1 is not accepted, so sales growth does not affect earnings management. The findings suggest that whether a company has high or low sales growth does not impact management's decision to engage in earnings management tactics. The significance level of the company size variable is 0.128, with a Sig value above 0.05 indicating that company size does not affect earnings management. Therefore, Ha1 cannot be supported, revealing that company size is not an indicator of earnings management practices. Thus, both small and large companies have the chance to manipulate their earnings (Arifin & Destriana, 2016).

The return on assets variable has a significant level below 0.05, suggesting that profitability plays a crucial role in earnings management. This means that as profitability increases, so does earnings management. Profitability reflects the management's skill in generating profits from operational assets. The link to earnings management lies in profitability's ability to sway managers towards adjusting earnings. When a company's profitability is lacking, managers may resort to earnings management tactics to uphold the company's image in the eyes of its owners (Astari & Suryanawa, 2017). The importance of the leverage variable is measured at 0.116. If the significance value is above 0.05, it suggests that leverage has no impact on earnings management. This implies that having a high debt policy results in oversight from external creditors. When third parties closely monitor the company's actions, managers are compelled to prioritize the interests of both creditors and shareholders, thus diminishing the influence of leverage on earnings management (Annisa & Haspsoro, 2017).

The audit committee variable has a significance level of 0.469, indicating that it does not have a significant impact on earnings management. Therefore, the hypothesis Ha1 cannot be accepted. This suggests that the presence of the audit committee may not be as effective as expected. According to Regulation Kep. 29/PM/2004, the audit committee must have a minimum of three members, with one serving as an independent commissioner who also acts as the chairman of the committee. On average, the companies in this study have an audit committee composition of three people so that companies may use committees. Audits are only to fulfill the requirements proposed by the government (Dewi & Khoirudin, 2016). The creation of an audit committee to meet these standards or needs has resulted in ambiguity regarding the responsibilities and roles of each component, leading to reduced effectiveness of the audit committee in overseeing performance management and corporate governance aspects (Dewi & Khoirudin, 2016).

The significance level of the independent board of commissioners variable is 0.436, implying that this variable does not have a significant impact on earnings management as indicated by a value greater than 0.05. This means that Ha1, which suggests a relationship between the variable and earnings management, is not supported. The presence of an independent board of commissioners may actually enable company management to conduct earnings management practices. The significance level of the board size variable is 0.659, suggesting that this variable also does not have a significant influence on earnings management based on a value greater than 0.05. This indicates that the monitoring process of directors may not be as effective, resulting in no enhancement in the quality of financial reports, particularly those containing profit information (Setiawan & Siska, 2013).

5. CONCLUSION

After analyzing and discussing 73 companies between 2017 and 2019, the findings show that factors such as sales growth, company size, leverage, audit committee size, independence of board of commissioners, and board of directors have no impact on earnings management. However, earnings management is influenced by return on assets. This research has limitations, including: This research only uses seven independent variables, while other variables might influence the dependent variable of earnings management; The data remaining from this research does not follow a typical distribution; The variables return on assets, leverage, and independent board of commissioners have heteroscedasticity problems; The adjusted R^2 value is only 0.174. Based on the limitations that have been explained, suggestions for further research are as follows: Substitute or include different factors like institutional ownership, company age, and managerial ownership as independent variables that could potentially impact the dependent variable of earnings management. Expand the size of the dataset to address any skewed data that may exist. Transform the data in cases where there is heteroscedasticity present.

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