

# THE EFFECT OF COMPANY SIZE AND AUDITOR SWITCHING ON PROFIT MANAGEMENT IN THE MANUFACTURING SECTOR

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## Abstract

**Purpose:** This study aimed to elucidate the effect of firm size and auditor turnover on manufacturing earnings management.

**Research Methodology:** The data were analyzed using a multiple regression model. The sample was drawn using a purposive sampling technique from financial statements and independent auditor reports of manufacturing companies listed on the Indonesia Stock Exchange (IDX) between 2015 and 2019 and processed using the SPSS application.

**Results:** The test results indicate that while firm size has an effect on earnings management, auditor turnover has no effect.

**Limitations:** Due to the fact that the samples used in this study were drawn exclusively from annual reports of manufacturing companies, the research findings cannot be generalized to all industries. The study's short observation period is also a limitation; it is possible that different results would be displayed with a longer observation period.

**Results:** The findings of this study are expected to contribute to the development of accounting studies on earnings management practices and the factors affecting them.

**Keywords:** ukuran perusahaan , pergantian auditor, manajemen laba

## 1. Introduction

The disclosure of earnings management issues in publicly traded companies is of particular concern to regulators, the general public, and practitioners. The revelation of financial scandals involving Enron, Worldcom, Tyco, Xerox, and Global Crossing increased their concern (Healy & Wahlen, 1999). Different perspectives on the relationship between earnings management and firm size are elicited by conducting tests on previous researchers. Warfield et al. (1995) discovered that large companies' internal control systems are more effective than small businesses. Additionally, this study demonstrates that large companies employ a more qualified team of auditors. This relates to the financial statements that result. On

the other hand, contradictory findings indicate that large firms manage their earnings more effectively than small businesses (Barton & Simko, 2002). Gibbins (2002) argues that large companies employ more stringent accounting policies and own their current assets. This statement can be interpreted to mean that businesses operating in these conditions manage their income more effectively than small businesses. Large corporations manipulate their earnings in order to reduce their political costs. According to (Burgstahler & Dichev, 1997), earnings management practices are more prevalent in large and medium-sized businesses than in small businesses. (Kim et al., 2003; Moss & Stine, 1993; Paiva & Lourenço, 2013; Taco &

Ilat, 2016) all demonstrate that firm size has an effect on earnings management.

The requirement for reliable financial information justifies the conduct of independent audits by auditors subject to regulatory oversight. This is a critical audit mechanism (Kurklu & Turk, 2020). The Securities and Exchange Commission (SEC) requires public companies to disclose any change in their independent auditors, as well as whether the auditor was terminated or resigned. By and large, auditor resignation is regarded as a more negative signal than auditor dismissal (Lei et al., 2020; Miller & Tan, 2018). Due to the absence of a rule requiring disclosure of independent auditor turnover in Indonesia, it is impossible to determine whether the auditor turnover occurred as a result of the company firing or the auditor resigning from the client engagement. Resignation of an auditor may shift the company's earnings management behavior (Lei et al., 2012). Earnings management by businesses or managers is a central topic of accounting research, as it can breed investor and capital market distrust (Healy & Wahlen, 1999; Levitt, 1998). Companies are motivated to achieve profit targets, and they employ earnings management to accomplish this (Burgstahler & Dichev, 1997).

According to agency theory, earnings management can occur when the owner's (principal) and management's (agent) interests diverge, referred to as agency conflict. The disparity in the information received by the two parties, where the principal receives less information than the agent, is another source of conflict (Jensen & Meckling, 1976). Wei & Xing (2008) conducted research and discovered that the companies studied manipulated their earnings during auditor changes. As evidenced by the data presented, companies that reported earnings in the year of auditor turnover saw a significant increase in the value of discretionary accruals the following year. Meanwhile, companies that experience a loss in the auditor change will reduce their discretionary accruals in subsequent years. This result, however, contradicts the Tsipouridou & Spathis (2012) test, which indicates that no significant change in discretionary accruals occurs following the transition.

Earnings management activities such as engineering or presenting financial statements that do not accurately reflect the true value of the business can have a detrimental effect on the

business. This affects the company's deteriorating reputation, a decline in the trust of outsiders with interest, and potentially misleading decisions such as an investor's decision to invest in a business. This study aimed to identify and demonstrate the factors that can affect a company's earnings management.

## **2. Literature review and hypothesis development**

### **2.1 Agency Theory**

The accounting literature refers to the division of ownership and management as agency theory. This is one of the theories in accounting development research that entails altering the structure of a financial accounting model with a behavioral component. The agency theory of investment is predicated on the contractual relationship between investors (principals) and managers (agents). Additionally, the theory explains why establishing a relationship between the two parties is fundamentally difficult due to a conflict of interest (Scott & O'Brien, 2019).

The agency relationship theory serves as the foundation for comprehending earnings management issues. Agency theory elucidates the asymmetric relationship between owner and manager. To bring these parties' interests together, another independent party must act as an intermediary for the common good. The independent party's role is to make observations and determine whether management is carrying out the principal's expectations. The external auditor is the independent party in question. External auditors are considered independent due to their ability to evaluate management performance using audited financial statements. The auditor will express an opinion on the financial statements' reliability based on their contents (Healy & Wahlen, 1999)

In agency contracts, principals and agents perform some of the work on their behalf. The principal will delegate some decision-making authority to the agent (Jensen & Meckling, 1976). Conflicts of interest can result in unequal access to information. The information imbalance exists as a result of the information's unequal distribution. Outsiders' assessments are heavily reliant on accounting indicators, managers' actions prioritize personal interests, and a relatively high level of information

asymmetry all contribute to company managers manipulating accounting work for their own ends. Accounting can be used to manipulate management in order to further its own interests (Ghani et al., 2016).

Jensen & Meckling (1976) define the audit function as a process within a business that aligns managers' interests with those of shareholders. Additionally, this function aims to reduce information asymmetry and inter-party conflicts of interest (Arens, 2010). The decision by the company to replace the auditor may be motivated by principal-agent issues, specifically the separation of ownership and control of the business (Fama & Jensen, 2005).

## 2.2 Profit management

Earnings management is the process by which business executives intervene in financial statements by identifying accounting policies or actual actions that can affect the value of earnings (Scott & O'Brien, 2019). Scipper (1989) defines earnings management as a targeted intervention during the financial statement preparation process in order to obtain some personal motivation. Fischer (2009) defines earnings management activities as those performed by a manager that results in an increase (decrease) in the current period earnings of the business unit for which he is responsible but does not result in an increase (decrease) in the company's long-term economic profitability. Healy & Wahlen (1999) defined earnings management behaviour occurs when managers intervene in financial reporting and prepare transactions to alter financial statements by manipulating the number of earnings. The outcomes of these actions are communicated to external parties with interest in the company's performance to influence the outcome of contracts contingent on accounting presentation. Healy & Wahlen (1999) explain that earnings management encompasses a variety of facets. The existence of managerial intervention in financial reporting can be demonstrated through considerations such as those required in estimating a variety of economic events that will occur in the future and will be reported in the financial statements, such as estimates of the economic life and residual value of property, plant, and equipment, pension obligations, and deferred taxes. Additionally, managers have various accounting methods to choose from, such as the depreciation method or the cost

method. Additionally, earnings management can provide misleading information to stakeholders about the economic performance of the company. This situation may arise when management has access to information that is not accessible to the public.

Earnings management is motivated by a variety of factors. Positive accounting theory makes the following three hypotheses about earnings management motivation: (1) Hypothesis of a bonus plan, (2) Hypothesis of a debt covenant, and (3) Hypothesis of political cost (Watts & Zimmerman, 1983). The reason for concluding the contract between the manager and the firm's owner is based on a contract for the manager's remuneration and debt obligations. The higher a firm's debt ratio, which equates to a firmer (rigid) debt contract with contractual constraints, and the greater the probability of contract breach, the more likely managers will employ earnings-enhancing accounting techniques (Makhsun, Yuliansyah, Pahlevi, et al., 2018; Makhsun, Yuliansyah, Razimi, et al., 2018).

Bonus incentives incentivize company management to report profits earned in order to qualify for bonuses calculated on those profits. Managers of companies with bonus plans are more likely to use accounting techniques that increase current period reported earnings. This is because, if no adjustment is made for the selected method, this action may increase the percentage of the bonus amount (S. Jones & Belkaoui, 2009).

Political regulation motivation is a form of management motivation that stems from an anticipatory approach to various government regulations. Businesses can use earnings management to reduce profits in order to influence court decisions against companies that have suffered a loss of reputation (Magnan et al., 1999).

### 2.2.3 Earnings Management Measurement

Earnings management can take various forms, including the use of accruals, changes in accounting methods, and capital structure changes. Discretionary accruals are used to manage earnings (Jones, 1991). Several previous studies have also made use of discretionary accruals (DeAngelo, 1986; Healy, 1985; McNichols & Wilson, 1988). Models that attempt to quantify the normal and discretionary components of accrual values have become

research in the accounting and auditing fields. Despite the numerous criticisms leveled at the various models developed (Jackson, 2018). The discretionary accrual model has been extensively studied in the academic literature and is frequently used as a proxy for earnings management or earnings quality.

Dechow et al. (1995) conducted an empirical analysis using a modified version of the Jones model. This modification is intended to eliminate the possibility of error in the Jones model's measurement of discretionary accruals in misstatements with discretionary earnings. Non-discretionary costs are estimated over the event period in the modified model. Changes in income are adjusted for changes in receivables in the period in which they are incurred, a modification to the original Jones model. The Jones model implicitly assumes that income is not subject to discretion during either the measurement period or the event. The modified Jones model implicitly assumes that all changes in credit sales during the event are due to revenue management, as it is simpler to manage revenue through credit sales recognition than it is to manage revenue through discretionary revenue recognition derived from credit sales and cash sales (Dechow et al., 1995)

The advantage of this modified Jones model is that it separates total accruals into four distinct components: current discretionary accruals, non-discretionary current accruals, discretionary long term accruals, and non-discretionary long term accruals. Current accruals, both discretionary and non-discretionary, are accruals derived from current assets. Non-discretionary current accruals and non-discretionary long-term accruals, on the other hand, are accruals from fixed assets (Scott & O'Brien, 2019). The following are the steps for calculating earnings management using the Modified Jones Model (MJM):

#### 1. Step 1

Calculate the Total Accruals (TAC) value which is the difference between net income and operating cash flow of each company.

$$TAC_{it} = NI_{it} - CFO_{it}$$

Information :

TAC<sub>it</sub> = Total accruals of company i in period t

NI<sub>it</sub> = Net profit of company i in period t

CFO<sub>it</sub> = The operating cash flow of company i in period t

#### 2. Step 2

Calculate current accruals or period accruals which are the difference between changes in (B) current assets minus cash and changes in (D) current liabilities minus current maturity of long term debt

$$Current\ Accruals = B\ (current\ assets - cash) - D\ (current\ liabilities - current\ maturity\ of\ long)$$

#### 3. Step 3

Calculating Non-discretionary current accruals is the expected accruals using the modified Jones model. A company's expected current accruals in a given year are estimated using a cross-sectional ordinary least square (OLS) regression of current accruals (CurAcc) and changes in sales.

$$CurAcc / TA_{it-1} = \alpha_1 (1/TA_{it-1}) + \alpha_2 (\Delta Sales_{it} / TA_{it-1})$$

All values above were regressed using CurAcc/TA<sub>it-1</sub> as the dependent variable, while 1/TA<sub>it-1</sub> and  $\Delta Sales_{it}/TA_{it-1}$  as independent variables.

By regressing the three variables, the coefficients of the independent variables for  $\alpha_1$  and  $\alpha_2$  will be obtained, which are used to calculate the value of non-discretionary accruals using the formula below:

$$NDCA_{it} = \alpha_1 (1/TA_{it-1}) + \alpha_2 (\Delta Sales_{it} - \Delta TR_{it} / TA_{it-1})$$

Information :

NDCA<sub>it</sub> = Non-discretionary accruals of company i period t

$\alpha_1$  = Estimate intercept of company i period t

$\alpha_2$  = Slope for firm i period t

TA<sub>it-1</sub> = Total assets of company i in period t-1

$\Delta Sales_{it}$  = Change in net sales of company i period t

$\Delta TR_{it}$  = Change in receivables of company i period t

#### 4. Step 4

Calculate the value of discretionary current accruals, namely discretionary accruals that occur from the components of current assets owned by the company with the following formula:

$$DCA_{it} = (CurAcc_{it} / TA_{it-1}) - NDCA_{it}$$

Information:

$DCA_{it}$  = Discretionary current accruals company i period t

$CurAcc_{it}$  = Current accruals of company i period t

$TA_{it-1}$  = Total assets of company i in period t-1

$NDCA_{it}$  = Nondiscretionary current accruals company i period t

### 5. Step 5

To determine the discretionary and non-discretionary long term accruals, we must first determine the discretionary and non-discretionary total accruals. The total discretionary accruals are calculated by regressing total accruals as the dependent variable and gross property, plant, and equipment (PPE) as additional explanatory variables in a given year.

$$TAC_{it} / TA_{it-1} = \beta_0 (1/TA_{it-1}) + \beta_1 (\Delta Sales_{it} / TA_{it-1}) + \beta_2 (PPE_{it} / TA_{it-1})$$

Next, calculate the value of non-discretionary accruals according to the above formula by first performing a linear regression of  $TAC_{it}/TA_{it-1}$  as the dependent variable and  $1/TA_{it-1}$ ,  $Sales_{it}/TA_{it-1}$ , and  $PPE_{it}/TA_{it-1}$  as independent variables. By regressing the four variables, the coefficients that produce the values of  $\beta_0$ ,  $\beta_1$ , dan  $\beta_2$  are used to calculate the value of non-discretionary total accruals (NDTA) as follows:

$$NDTA_{it} = \beta_0 (1/TA_{it-1}) + \beta_1 (\Delta Sales_{it} - \Delta TR_{it} / TA_{it-1}) + \beta_2 (PPE_{it} / TA_{it-1})$$

Information :

$\beta_0$  = Estimated intercept of company i period t

$\beta_1, \beta_2$  = Slope for company i period t

$PPE_{it}$  = Gross property, plant, and equipment of company i period t

$NDTA_{it}$  = Non-discretionary total accruals company i period t

### 6. Step 6

Calculate the value of discretionary accruals, discretionary long term accruals, and non-discretionary long term accruals. Discretionary accruals (DTA) is the difference between total accruals (TAC) and non-discretionary accruals

(NDTA). Discretionary long term accruals (DLTA) is the difference between discretionary accruals (DTA) and discretionary current accruals (DCA), while non-discretionary long term accruals (NLDTA) is the difference between non-discretionary accruals (NDTA) and non-discretionary current accruals (NDCA).

## 2.3 Firm Size

Company size is a classification system for businesses based on a variety of parameters such as total assets, warehouse size, and market value of shares. Essentially, the business size is classified into three categories: large businesses, medium businesses, and small businesses (Taco & Ilat, 2016). The size of a business can be determined by adding up the company's wealth (assets). Due to the high value of the company's total assets, this can be simplified by converting to the natural logarithm, resulting in the following calculation of the company's size:

$$Size = \ln Total Assets$$

## 2.4 Auditor Switching

Auditor switchings outside the scope of the applicable rules can occur for two reasons: the client may dismiss the auditor, or the auditor may leave the client (Tanyi et al., 2010). Auditor switchings in businesses demonstrate miscommunication between auditors and management regarding accounting or auditing matters. When the auditor's relationship with his client deteriorates, the auditor may decide to leave the job or, conversely, the client may fire the auditor (Lindrianasari, 2013). Auditor turnover is quantified using a dichotomous metric, specifically:

1 = Auditor switching occurs.

0 = There is no auditor switching.

## 2.5 Hypothesis

### 2.5.1 Company Size and Earnings Management

Companies' earnings management actions, such as fabricating or presenting fictitious financial statements, can negatively affect the company. These earnings management actions can tarnish a company's image, erode the trust of external stakeholders, and result in deceptive decisions, such as investors' investment decisions (Barton & Simko, 2002). Nelson et al. (2002), large companies receive more favorable accounting

treatment for transactions and have a greater stock of current assets. This demonstrates that large companies are more capable of managing their income than small businesses. Large corporations manipulate their earnings in order to minimize political costs. According to Burgstahler & Dichev (1997), earnings management practices are more prevalent in large and medium-sized businesses than in small businesses. Kim et al. (2003); Moss & Stine (1993); Paiva & Lourenço (2013); Taco & Ilat (2016) all found that firm size has an effect on earnings management.

H1: The size of the business has an effect on its earnings management.

### 2.5.2 Auditor Switching and Earnings Management

Voluntary auditor switching is a process by which a business replaces its existing public accounting firm with a new public accounting firm that will audit the business (Erianyah dan Wahyu, 2016). According to the findings of Wei & Xing (2008), voluntary auditor turnover has an effect on the occurrence of earnings management practices, with the higher the level

of auditor turnover, the more earnings management practices occur.

H2: How a change in auditors affects earnings management

### 3. Population and Sample

The population for this study is manufacturing companies listed on the Indonesia Stock Exchange between 2015 and 2019. Purposive sampling was used to select the sample, yielding a total of 97 companies.

The sample selection criteria are as follows:

1. During the year of observation, manufacturing companies were listed on the Indonesian Stock Exchange.
2. There is no loss
3. Possess all necessary data

### 4. Results and Discussion

After performing the classical assumption tests for normality, multicollinearity, autocorrelation, and heteroscedasticity, a multiple linear regression analysis was conducted, the results of which are shown in the following table:

**Tabl 4.1**  
**Multiple Linear Regression Test Results**

Coefficients <sup>a</sup>						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-3397802,365	548041,246		-6,200	,000
	Size	125007,499	19350,526	,643	6,460	,000
	Change	20277,100	46072,160	,044	,440	,661

a. Dependent Variable: Profit management

Source: Processed secondary data, 2020

According to Table 4.1, the regression equation model developed from the multiple linear regression analysis results is as follows:

$$EM = \alpha + \beta_1 \text{Size} + \beta_2 \text{Change} + e$$

$$EM = -3397802,365 + 125007,499 \text{ Size} + 20277,100 \text{ Change} + e$$

#### 4.1 Hypothesis testing

A significance level of 0.05 (  $\alpha = 5\%$  ) or a confidence level of 0.95 was used to test this hypothesis. This study aimed to determine the effect of the independent variables Firm Size and Auditor Change on the dependent variable Earnings Management in manufacturing companies listed on the Indonesia Stock Exchange (IDX) from 2015 to 2019.

**Table 4.2**  
**T-Test Results (t-test)**

Coefficients <sup>a</sup>					
Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		

1	(Constant)	- 3397802,365	548041,246		-6,200	,000
	Size	125007,499	19350,526	,643	6,460	,000
	Change	20277,100	46072,160	,044	,440	,661
a. Dependent Variable: Profit management						

*Source: Processed secondary data, 2020*

According to table 4.2, the following are the results of this study's hypothesis testing:

1. The Effect of Firm Size on Earnings Management

According to table 4.2, the significance level for the Firm Size variable is  $0,000 < 0,05$ ,  $t_{count}$  is 6.460, and  $t_{table}$  is 1.670, indicating that  $t_{count} > t_{table}$  ( $6.460 > 1.670$ ), and thus H1 is accepted. This indicates that Company Size has a limited effect on Earnings Management.

2. The Effect of Auditor Changes on Earnings Management

According to Table 4.2, the significance level for the voluntary auditor turnover variable is

$0.661 > 0.05$ ; therefore,  $t_{count}$  is 0.440 and  $t_{table}$  is 1.670; therefore,  $t_{count} < t_{table}$  ( $0.440 < 1.670$ ) indicates that H2 is rejected. This means that auditor turnover has no effect on earnings management.

### 4.3 Coefficient of Determination Test ( $R^2$ )

The coefficient of determination ( $R^2$ ) calculated from the results of multiple regression indicates the extent to which the independent variables can explain the dependent variable. The closer the model is to 0, the less it can explain changes in the dependent variable's value. (Ghozali, 2018 : 101).

**Table 4.3**  
**Coefficient of Determination Test Results ( $R^2$ )**

Model Summary <sup>b</sup>				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	,646 <sup>a</sup>	,418	,398	169327,01139
a. Predictors: (Constant), Size, Change				
b. Dependent Variable: Manajemen Laba				

*Source: Processed secondary data, 2020*

The coefficient of determination (R Square) of 0.418 is shown in Table 4.3. This indicates that 41.8 percent of the variance in Earnings Management can be explained by the variance in the two independent variables, Company Size and Auditor Change, while factors outside the research model can explain the remaining 58.2 percent.

### 4.4 Discussion

The first hypothesis is supported by evidence that firm size has an effect on earnings management. It is believed that a company's size can affect the size of its earnings management. If earnings management is effective, the larger the company, the more effective the earnings management (Paiva & Lourenço, 2013; Taco & Ilat, 2016). The larger the company, the more information investors have at their disposal when making investment decisions. Kim et al. (2003) discovered that larger firms have greater incentives for liquid profits than smaller firms

because larger firms are examined. Another finding by Moss & Stine (1993) is that larger companies have the potential to smooth earnings more than small companies do, owing to the fact that larger companies are tested and viewed more critically by investors.

Auditor turnover has no effect on earnings management, as demonstrated by the second hypothesis. This finding contradicts Wei & Xing (2008) finding that auditor turnover has an effect on the occurrence of earnings management. Positively motivated businesses will hire auditors who are truly objective and independent in their audits in order to improve their future performance. Auditors are critical supervisors who possess a variety of qualifications for auditing a company's financial statements. The auditor has access to information about the company's earnings management.

## 5. Conclusion

The purpose of this study was to investigate the effect of firm size and auditor turnover on earnings management in manufacturing companies listed on the Indonesian Stock Exchange (IDX) between 2015 and 2019. The following conclusions can be drawn from the findings of the previous chapter's research:

The variable size of the business as measured by the natural log of total assets has an effect on the management of earnings. This means that the size of the company is believed to have an effect on the amount of earnings management performed by the company; if earnings management is efficient, the larger the company, the more earnings management or earnings management activities performed. Earnings management is unaffected by the auditor switching variable. This means that auditor switching has no effect on the possibility of engaging in earnings management practices. This occurs because management has grown accustomed to independent auditors who perform well, and regardless of whether the auditors change, they will continue to refrain from practicing profit administration.

### Limitations and further studies

This study has limitations, including the fact that it used a population and samples from manufacturing companies, which means that the findings cannot be generalized to all industries. When the observation period is extended beyond 2015-2019, the results may differ.

As hope for future research, additional variables affecting earnings management practices, such as audit committee variables, KAP size, audit quality, and corporate governance should be considered. Additionally, additional researchers are advised to use a larger sample size and a longer period of observation.

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