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Earnings Management and Auditor Switching

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Abstract:
Purpose- This study aims to discuss the effect of earnings management on auditors switching in various industrial sector companies listed on the Indonesia Stock Exchange (IDX) from 2010-2017.
Design/methodology/approach - Testing in this study uses a logistic regression analysis model.
Findings - The results of this study indicate that earnings management practices cannot be detected through auditor switching.
Research Limitation/implication - The limitation in this study is the lack of sample size, so the results of the study may not be able to generally describe the phenomena that occur.
Keywords: *Auditor switching, earnings management, discretionary accrual*

INTRODUCTION

The case of auditor turnover before its time has been a heated discussion among practitioners, the government and academics. As the two of examples are the cases of auditor turnover at finance company in PT. Sunprima Nusantara Financing and PT. Garuda Indonesia. In PT. Sunprima Nusantara Financing (SNP Finance) case, PT. Bank Mandiri Tbk is suing a public accounting firm that audits the company's financial statements, one of them is Deloitte Indonesia, because it is considered that the KAP does not actually audit SNP Finance's financial statements (source: https://www.cnnindonesia.com). The same thing happened to PT. Garuda Indonesia which a financial statement scandal that occurred in 2018 was found. The financial performance report of PT. Garuda Indonesia for the fiscal year 2018 showed a net profit of US$ 809.000 . This value was inversely proportional to the condition of 2017 which lost US$ 216.58 million. The Financial Services Authority (OJK) provides a one-year freezing sanction to Kasner Sirumapea, Partners at KAP Tanubrata, Sutanto, Fahmi, Bambang & Partners (Member of BDO International Limited) to auditors who conduct audits of PT. Garuda Indonesia (source: https://www.cnnindonesia.com). Both of these cases show that management can manipulate financial statements and the role of independent auditors is very influential in evaluating the reasonableness of the company's financial statements. The manipulations of earnings management, in both cases above, result in the change of auditors before its time. The decision to change auditors made by a company can be caused by several reasons, because of regulations that require changes of auditors (mandatory) or for other reasons outside the regulation (voluntary). Company with high discretionary accrual values can be indicated if it implements earnings management, this can also be one of the factors to do auditor changing outside the existing regulations. Earnings management is an action that may potentially be done by accrual management to make a profit. The efforts of the company or certain parties to manipulate information, and even take earnings management actions that can cause financial statements to no longer reflect their fundamental value, because financial statements should function

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as a medium of management communication with external parties or between the company and stakeholders (Subhan, 2008). The greater the accrual value indicates a strategy to increase profits, conversely, the lower the accrual value can indicate that the company is trying to do a strategy to reduce earnings (Sulistiawan: 10, 2011). The accrual basis for preparing financial statements was chosen because it provides a better indication of the company's economic performance than the information generated from the latest aspects of cash receipts and disbursements. Accrual accounting provides management flexibility in choosing accounting methods as long as it does not deviate from the applicable Financial Accounting Standards, so that they can provide opportunities for management to manage earnings (Setiawan, 2009).

To ensure the reasonableness of the information from the financial statements, it is necessary to conduct an examination by an independent auditor. To produce better audit quality and maintain auditor independence, companies are required to rotate auditors in accordance with applicable regulations. Due to the existence of auditor rotation obligation, the company will conduct auditor switching (Soraya and Haidhi, 2017). Auditor switching conducted outside the rules can cause suspicion for the users of financial statements and external parties. Research conducted by Wei & Xing (2008) with a sample of companies listed on the China stock exchange (China A-share) shows that the listed companies manipulate their income through auditor switching. Companies reporting earnings in the year of auditor switching, which the discretionary accruals was previously negativel tend to increase.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Information Asymmetry Theory

Information asymmetry is a condition in which there is an imbalance in the acquisition of information between management as a provider of information with stakeholders and stakeholders in general as users of information. A manager as the manager of the company knows more about internal information and prospects of the company in the future than the owner (shareholder). Therefore as a manager, the manager is obliged to give a signal regarding the condition of the company to the owner. The signal given can be done through the disclosure of accounting information such as financial statements.

The financial statements are intended for use by various parties, including the management of the company itself. The parties most interested in financial statements are actually external users (outside management). This situation will trigger the emergence of a condition called information asymmetry (information asymmetry). a condition in which there is an imbalance in the acquisition of information between management as a provider of information (prepaper) with the shareholders and stakeholders in general as users of information (users). According to Scott, there are two kinds of information asymmetry, namely:

1. Adverse selection, that managers and other insiders usually know more about the circumstances and prospects of the company than outside investors. And the facts that may influence the decisions to be taken by the shareholders are not conveyed to the shareholders.
2. Moral hazard, that the activities carried out by a manager are not entirely known by shareholders or lenders. So that managers can take action outside the knowledge of shareholders who violate contracts and actually may not be appropriate ethically or in norms. (Scott, 2015)

Agency Theory

The separation of owner and management in the accounting literature is called Agency Theory (agency theory). This is one of the theories in the accounting development research which is a modification from the development of financial accounting model by adding aspects of human behavior in the economic model. Agency theory bases the contractual relationship between shareholders (principal) and managers (agents). According to this theory, the relationship between owners and managers is essentially difficult to create due to Conflict of Interest (Scott, 2015). A conflict of interest is caused by the possibility that the agent does not always act in accordance with the principal's interests. To overcome this, an independent party is needed, in this case an independent auditor who acts as an intermediary for both parties (principal and agent),

Define the agency relationship as a contract under which one party (the principal) engages another party (the agent) to perform some service on their

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behalf. As part of this, the principal will delegate some decision-making authority to the agent (Jensen & Meckling, 1976). Conflicts and conflicting interests between principals and agents can cause problems which in Agency Theory known as Asymmetric Information (AI), which is unbalanced information caused by the unequal distribution of information between principals and agents. The dependence of external parties on accounting numbers, the tendency of managers to find their own benefits and a high level of AI, cause a great desire for managers to manipulate reported work for their own benefit. To achieve its own interests, management can act using accounting as a tool for manipulating (Ghani, Tarmezi, Said, & Yuliansyah, 2016). The agency theory perspective is the basis for understanding earnings management issues. Agency theory explains the existence of an asymmetrical relationship between owners and managers. To bridge the interests of principals and agents, an independent party who can be a mediator or intermediary for the common interest is needed. This independent party can make observations and assessments regarding whether the agent's performance has worked well as expected by the principal or not. One that can become an independent party is an independent auditor. The auditor is considered an independent party because the auditor can assess the performance of the agent based on the audited financial statements. From the financial statements, the auditor will give his/ her opinion on the reasonableness of the financial statements.

Earnings Management

Earnings management is action taken by manager in sorting the accounting policies, or concrete actions that can affect earnings (Scott, 2015). Schipper (1989) defines earnings management as an intervention with a particular purpose to the process of deliberate external financial reporting to obtain some personal benefits. Fischer and Rosenzweig (1995) define earnings management as the actions of a manager by presenting a report that raises (decreases) the current period earnings of the business unit for which they are responsible, without causing an increase (decrease) in the economic profitability of the unit in the long run. Healy and Wahlen (1999) explain that earnings management occurs when managers use judgment in financial reporting and transaction preparation to change financial statements, with the aim of manipulating the magnitude of earnings to some stakeholders related to company's economic performance or to influence the outcome of the agreement (contract) that depends on the accounting numbers reported.

According to Healy and Wahlen (1999), the definition of earnings management includes several aspects. First, earnings management interventions on financial reporting can be done with the use of judgments, for example the judgment needed in estimating a number of future economic events to be shown in financial statements, such as the estimated economic age and residual value of fixed assets, liability for pensions, deferred taxes, losses receivables and impairment of assets. Besides, managers have choices for accounting methods, such as depreciation methods and cost methods. Second, the purpose of earnings management is to mislead stakeholders regarding the company's economic performance. This occurs when management has access to information that is not accessible to outsiders. There are various motivations that encourage earnings management. Positive accounting theory proposes three earnings management motivational hypotheses as follows: (1) the bonus plan hypothesis, (2) the debt covenant hypothesis, and (3) the political cost hypothesis (Watts and Zimmerman, 1986). The motivation for the contract arises because the agreement between the manager and the owner of the company is based on managerial compensation and debt covenant. The higher the debt / equity ratio of a company, which is equivalent to more closely (becoming tighter) the company with the constraints in debt agreements and the greater the probability of breach of agreement, the more likely managers use accounting methods that increase income (Belkaoui, 2000, Makhsun, Yuliansyah, Pahlevi, Razimi, & Muhammad, 2018, Makhsun, Yuliansyah, Razimi, & Muhammad, 2018). Bonus motivation is the encouragement of company managers in reporting the obtained profits to get a bonus which is calculated on the basis of these profits. Company managers with bonus plans more likely use accounting methods that increase income reported in the current period. The reason is that such an action might increase the percentage of bonus value if there is no adjustment for the chosen method (Belkaoui, 2000). Healy's research (1985) uses a management bonus program approach, that

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managers will get a positive bonus when profits are between the lower limit (bogey) and the upper limit (cap). When the profit is below the bogey, the manager does not get a bonus, and when the profit is above the stamp the manager only gets a fixed bonus. The motivation of political regulation is the motivation of management in anticipating various government regulations. Companies that are proven violating anti-trust and antitrust regulations, their managers manipulate earnings by reducing the reported earnings (Cahan, 1992; Jogiyanto and Ainun, 1998). The companies also conduct earnings management to reduce profits with the aim of influencing court decisions against companies that experience damage awards (Hall and Stammerjohan, 1997). Besides, income taxation is also a motivation in earnings management (Lilis, 2001). The selection of accounting methods in reporting earnings will give different results to the spent profits as the basis for calculating taxes.

Auditor Switching

Auditor switching is a change of KAP and auditor conducted by the company. Auditor switching can be mandatory or voluntary. Mandatory auditor switching occurs because it carries out obligations from the applicable regulatory provisions. While voluntary auditor switching occurs due to a reason or there are certain factors on the part of the client company or the relevant KAP outside the applicable regulatory provisions. The change of auditor aims to maintain the independence of the auditor so that they remain objective in carrying out their duties as an auditor (Pawitri and Ketut Yadnyana, 2015)

Regulation of the Minister of Finance No 17 / PMK.01 / 2008 concerning "public accountant services" states that the provision of general audit services on financial statements of an entity is carried out by the KAP for a maximum of 6 (six) consecutive financial years and by a Public Accountant at most long for 3 (three) consecutive book years. Public Accountants can accept general audit assignments for clients after 1 (one) financial year does not provide general audit services on the client's financial statements.

The Effect of Earnings Management on Switching Auditors

Wei & Xing (2008) revealed that for companies reporting earnings in the year of auditor change, DA values that were previously negative tended to increase. This is in line with research conducted by Reed et al. (2007) with a sample of companies for Laventhol and Horwarth clients which shows companies that switch to using big 6 auditors relatively have higher DA values. However, this is contrary to Carver et al (2011) who concluded that companies that move to smaller auditors report a significant increase in DA. Research conducted by Wang and Xing (2011) states cross-list companies in China audited by big 4 auditors reporting DA values that tend to be lower. In Indonesia, since the end of 2002, there are regulations that require auditor rotation every 3 years and KAP rotation every 5 years. Research conducted by Siregar et al (2012) shows that the average DA value is low after the auditor change regulation compared to the previous period.

Hypothesis Development

Referring to research conducted by Wei & Xing (2008), Reed et all (2007), Carver et all (2011), Wang & Xing (2011), and Siregar et all (2012), the hypothesis proposed in this study is Earnings management influences auditor switching.

Sample

Based on data obtained through www.idx.co.id, there were 31 manufacturing companies in various industry sectors listed on the IDX during the period 2010-2017. The sample selection was done by purposive sampling method, and the data obtained were 11 companies.
The sample selection criteria were as follows:

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1. Various industrial sector companies listed on the Indonesia Stock Exchange during the period 2010 - 2017.
2. Having all necessary data

3. OPERATIONAL VARIABLE

Earnings Management

The earnings management detection model used in this study was the Modified Jones Model developed by Dechow et al. (1995). This model appears to address weaknesses in the Jones Model (1991), that in this Jones model it can be implicitly assumed that management discretion is not carried out on income. If management manipulates through income, this Jones model will be biased. Determination of the value of discretionary accruals as an indicator of earnings management is explained as follows:

Determine the total value of accruals

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

Determine the parameter values α_1, α_2, α_3

$$TA_{it} = \alpha_1 + \alpha_2 \Delta R_{evit} + \alpha_3 \; PPE_{it} + \varepsilon_{it}$$

Then, to scale the data, all of these variables are divided by the assets of the previous year (A_{it-1})

$$TA_{it}/ A_{it-1} = \alpha_1 (1/A_{it-1}) + \alpha_2 (\Delta R_{evit} /A_{it-1}) + \alpha_3 \; (PPE_{it} / A_{it-1}) + \varepsilon_{it}$$

Calculate the NDA value

$$NDA_{it} = \alpha_1 (1/A_{it-1}) + \alpha_2 (\Delta R_{evit} /A_{it-1} - \Delta R_{ecit} /A_{it-1}) + \alpha_3 \; (PPE_{it} / A_{it-1}) + \varepsilon_i$$

Determine the value of discretionary accruals which are indicators of earnings management

$$DA_{it} = TA_{it} - NDA_{it}$$

Information :

TA_{it} = Total company accrual i in period t
NI_{it} = Net profit of company i in period t
CFO_{it} = Company operating cash flow i in period t
NDA_{it} = Non-discretionary accrual of company i in period t
DA_{it} = Company discretionary accrual i in period t
A_{it-1} = Total assets of company i in period t-1
ΔR_{evit} = Change in net sales of company i in period t
ΔR_{ecit} = Change in company receivables i in period t
PPE_{it} = Property, plant, and equipment of company i in period t
α_1, α_2, α_3 = Parameters obtained from the regression equation
ε_{it} = company term error i in period t

Auditor Switching

The auditor switching was measured using the numbers 0 and 1 (dummy), the company which did not replace the KAP was given a number of 0 and the company which changed the KAP was given a number of 1.

4. Results and Discussion

Case Processing Summary

Unweighted Cases[a]		N	Perc nt
Selected Cases	Included in Analysis	77	100,
	Missing Case	0	,0
	Total	77	100,
Unselected Cases		0	,0
Total		77	100,

a. If weight is in effect, see classification table for the total number of cases.

Dependent Variable Encoding

Original Value	Internal Value
,00	0
1,00	1

Classification Table[a,b]

	Observed		Predicted		
			Y		Percentage Correct
			,00	1,00	
Step 0	Y	,00	66	0	100,0
		1,00	11	0	,0
	Overall Percentage				85,7

a. Constant is included in the model.
b. The cut value is ,500

Variables in the Equation

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 0	Constant	-1,792	,326	30,20	1	,000	,167

Variables not in the Equation

			Score	df	Sig.
Step 0	Variables	x1	,521	1	,471
	Overall Statistics		,521	1	,471

Omnibus Tests of Model Coefficients

		Chi-square	df	Sig.
Step 1	Step	,756	1	,385
	Block	,756	1	,385
	Model	,756	1	,385

Model Summary

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square

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1	62,402[a]	,010	,017

a. Estimation terminated at iteration number 6 because parameter estimates changed by less than ,001.

Hosmer and Lemeshow Test

Step	Chi-square	df	Sig.
1	11,415	8	,179

Contingency Table for Hosmer and Lemeshow Test

		Y = ,00		Y = 1,00		Tota
		Observed	Expected	Observed	Expected	
St p 1	1	8	7,39	0	,606	8
	2	7	7,06	1	,934	8
	3	6	6,95	2	1,05	8
	4	7	6,88	1	1,11	8
	5	7	6,82	1	1,17	8
	6	7	6,79	1	1,20	8
	7	7	6,75	1	1,24	8
	8	4	6,70	4	1,29	8
	9	8	6,63	0	1,36	8
	1	5	3,98	0	1,01	5

Classification Table[a]

	Observed		Predicted		
			Y		Percentage Correct
			,00	1,00	
St p 1	Y	,00	66	0	100,0
		1,0	11	0	,0
	Overall Percentage				85,7

a. The cut value is ,500

Variables in the Equation

		B	S.E.	Wal	df	Sig.	Exp B)
Ste 1[a]	x1	2,27	3,05	,552	1	,458	9,68
	Constant	-1,859	,353	27,71	1	,000	,156

a. Variable(s) entered on step 1: x1.

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Auditor switching probability value of 0.458 is greater than the significance value (0.458> 0.005) means that the hypothesis is rejected, that earnings management has no effect on auditor switching. This might have happened because the data produced showed that not many manufacturing companies in various industry sectors implement auditor switching, so if the company implements earnings management, it will be difficult to be detected through auditor switching.

Conclusion and Suggestion

In this study, we examine the effect of earnings management on auditor switching with research objects of various industrial companies listed on the Indonesian Stock Exchange with the 2010-2017 observation year. The results of the study indicate that earnings management has no effect on auditor switching, which means that the hypothesis cannot be accepted. The limitation in this study is the lack of sample size, so the results of the study may not be able to describe the phenomena that occur in general. Further researchers are advised to increase the number of study samples.

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